THIRD IN SERIES ON THE EXTRATERRITORIAL INCOME REGIME

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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CONTENTS

THIRD IN SERIES ON THE EXTRATERRITORIAL INCOME REGIME

THURSDAY, JUNE 13, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:05 a.m., in room 1100 Longworth House Office Building, Hon. Jim McCrery, (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE CONTACT: (202) 226–5911
June 6, 2002
No. SRM–7

McCrery Announces Third in a Series of Hearings on the Extraterritorial Income Regime

Congressman Jim McCrery (R–LA), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will hold its third hearing on the extraterritorial income (ETI) regime. **The hearing will take place on Thursday, June 13, 2002, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

On January 14, 2002, the World Trade Organization (WTO) Appellate Panel issued its report finding the United States' ETI rules to be a prohibited export subsidy. This marks the fourth time in the past two and one-half years that the United States has lost this issue, twice in the Foreign Sales Corporation case and now twice in the ETI case. There is no opportunity for the United States to appeal this latest determination.

On January 29, 2002, a WTO Arbitration Panel began proceedings to determine the amount of retaliatory trade sanctions that the European Union (EU) can impose against U.S. exports to the EU. The EU has requested $4.043 billion in sanctions. The United States has asserted that the proper measure of sanctions is no more than $1.1 billion. Originally expected on April 29, 2002, a decision by the panel is now expected by June 17, 2002.

The Subcommittee held its first two hearings on the issue on April 10 and May 9 of this year. The full Committee held a hearing on February 27, 2002.

In announcing the hearing, Chairman McCrery stated: "It was clear from our first hearing that we cannot replicate the benefits of FSC/ETI. Our second hearing examined whether this dispute presents an opportunity to fundamentally reform the Tax Code. This hearing will explore a third possible response to the WTO's ruling, namely making changes to the Tax Code to promote the international competitiveness of U.S. companies."

FOCUS OF THE HEARING:

The focus of the hearing will be to consider proposals to modify the Tax Code in ways which promote the competitiveness of U.S. companies while respecting our international obligations under the WTO.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225–2610, by the close of business, Thursday, June 27, 2002. Those filing written statements that wish to have their statements distributed to the press and interested public at the hearing should deliver their 200 copies to the Subcommittee on Select Revenue Measures in room 1135 Longworth House Office

Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225–2610, in Word Perfect or MS Word format and MUST NOT exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Any statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at http://waysandmeans.house.gov.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman MCCRERY. The hearing will come to order.

Today's hearing continues the work of this Subcommittee to examine possible responses to the World Trade Organization (WTO) finding that the Extraterritorial Income (ETI) regime is an export subsidy in violation of our international trade obligations.

Four days from today, an arbitration panel of the WTO will issue its decision on the level of remedies which the European Union (EU) may impose on products exported from the United States. While there is no requirement that the EU impose these sanctions, the decision of the arbitration panel will give them a fairly heavy club, and cast a shadow over American exports and the high paying jobs they support.

Given this situation, it is clear to me and others that it would be unacceptable for the Congress to do nothing and just hope the Europeans decide against the use of authorized sanctions. We must show the world that our commitment to meeting our obligations under the WTO is not just lip service.

These hearings are exploring possible solutions. I hope they will help the Committee as it contemplates possible responses to the WTO's decisions. Our first hearing held in April examined whether the ETI regime could be fixed so as to provide the same benefits to the same companies while responding to the objections of our trading partners. The unanimous conclusion of the witnesses was that the WTO decision in the ETI case makes it clear any modification which constitutes a mere repackaging of the existing benefits will not survive the inevitable challenge.

Our second hearing held a month later reviewed proposals which would fundamentally reform the Tax Code. Witnesses advocated a number of alternatives, including variations of a national sales tax or a value-added tax (VAT). The hearings showed the potential benefits of such wholesale reform as well as the difficult transition issues which any rewrite of the Tax Code would present.

Today's hearing explores another possible response to the WTO decision. Instead of either tinkering with ETI or fundamentally reforming the Tax Code, a third option would be to repeal the ETI regime and use the revenue raised to address some of the shortcomings of our international tax rules, which hinder the competitiveness of U.S. companies.

The worldwide tax system employed by the United States and the resulting international tax rules are complex and often place U.S. business at a competitive disadvantage relative to their foreign counterparts. Moreover, in some instances the system actually encourages American companies to invest abroad, rather than here in the United States.

Instead of investing profits in the United States to generate more economic growth and more jobs, our Tax Code actually encourages American companies with overseas operations to keep those funds abroad. The international Tax Code's complexities and shortcomings have hindered the competitiveness of American companies, and has therefore made them excellent takeover targets by their international competitors.

In the sixties, the United States served as the world's dominant market. As we enter the new millennium, there is a real danger that U.S. businesses will be less competitive in the global marketplace. We cannot afford to sit idly by while economic growth and high paying jobs are forced overseas by a Tax Code cobbled together largely when America was the unchallenged economic leader of the world.

Today's hearings will provide the Committee with a wealth of ideas for possible reforms of the international Tax Code. In particular, Glenn Hubbard and Barbara Angus will give us insights into the thoughts of the Administration on this issue.

Our second panel will provide us with input from several industry sectors, including large exporters, small manufacturers, large retailers, shippers, software manufacturers, and the electronics industry. Their suggestions on ways to make American companies more competitive will be helpful to us in determining whether changes to the Tax Code should accompany repeal of the ETI regime.

[The opening statement of Chairman McCrery follows:]

Opening Statement of the Hon. Jim McCrery, a Representative in Congress from the State of Louisiana, and Chairman, Subcommittee on Select Revenue Measures

Today's hearing continues the work of this Subcommittee to examine possible responses to the WTO's finding that the ETI regime is an export subsidy in violation of our international trade obligations.

Four days from today, an Arbitration Panel of the WTO will issue its decision on the level of remedies which the European Union may impose on products exported from the United States.

While there is no requirement that the EU impose those sanctions, the decision of the Arbitration Panel will give them a fairly heavy club and casts a shadow over American exports and the high-paying jobs they support.

Given the situation, it is clear to me and others that it would be unacceptable for the Congress to do nothing and hope the Europeans decide against the use of authorized sanctions.

We must show the world that our commitment to meeting our obligations under the WTO is not just lip service. These hearings are exploring possible solutions; I hope they will help the Committee as it contemplates possible responses to the WTO's decisions.

Our first hearing, held in early April, examined whether the ETI regime could be "fixed" so as to provide the same benefits to the same companies while responding to the objections of our trading partners. The unanimous conclusion of the witnesses was that the WTO decision in the ETI case makes it clear any modification which constitutes a mere repackaging of the existing benefits will not survive the inevitable challenge.

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The worldwide tax system employed by the United States and the resulting international tax rules are complex and often place U.S. businesses at a competitive disadvantage relative to their foreign counterparts. Moreover, in some instances, the system actually encourages American companies to invest abroad, rather than here in the U.S. Instead of investing profits in the U.S. to generate more economic growth and more jobs, our Tax Code actually encourages American companies with overseas operations to keep those funds abroad.

The international Tax Code's complexities and shortcomings have hindered the competitiveness of American companies and has therefore made them excellent takeover targets by their international competitors. In the 1960's, the U.S. served as the world's dominant market, but as we enter the next millennium, there is a real danger that U.S. businesses will be less competitive in the global marketplace. We cannot afford to sit idly by while economic growth and high-paying jobs are forced overseas by a Tax Code cobbled together largely when America was the unchallenged economic leader of the world.

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I yield to my friend from New York, Mr. McNulty, for any opening statement he might wish to make. . . .

Chairman MCCRERY. Now I would like to yield to my friend and Ranking Member of the Subcommittee, Mr. McNulty.

Mr. MCNULTY. Thank you, Mr. Chairman. I welcome our guests today. I am pleased to join with the Select Revenue Measures Subcommittee in its third hearing on the replacement of the ETI regime, which the World Trade Organization ruled to be prohibited export subsidy.

Our hearing today will focus on the three issues raised during our earlier Subcommittee hearings: Number one, how the United States should respond to the WTO ruling on the ETI; number two, whether fundamental corporate tax reform is a viable option for replacing the ETI; and number three, why there are concerns about the international competitiveness of U.S. companies.

The Administration's response to the WTO ruling must be done in a way that does not harm the overall competitiveness of American businesses in the global marketplace. There must be a bipartisan approach for handling the ETI, and our actions must be taken in a timely manner. Earlier testimony confirmed that overhaul of our current system of international taxation would be a major undertaking and something that must not be done in haste.

The competitiveness of our multi-national companies is at stake and the issues merit full analysis and discussion. Finally, it is important that this Subcommittee continue its review of international tax issues and move the discussion from theoretical approaches to realistic alternatives.

As always, the devil is in the details. Until specifics of a proposal are put on the table, it is unclear how the Committee should proceed, and who the winners and losers will be. Today's testimony from experts in the area of international taxation and multinational corporate associations will be of assistance to us in each of these areas.

I thank Chairman McCrery for scheduling this important hearing. Again, I thank our guests for taking the time to come before us and to share their expertise.

[The opening statement of Mr. McNulty follows:]

Opening Statement of the Hon. Michael R. McNulty, a Representative of Congress from the State of New York

I am pleased to join the Select Revenue Measures Subcommittee in its third hearing on replacement of the "Extraterritorial Income" (ETI) regime which the World Trade Organization (WTO) ruled to be a prohibited export subsidy.

Our hearing focus today will focus on the three issues raised during our earlier Subcommittee hearings:

- how the U.S. should respond to the WTO ruling on the ETI;
- whether "fundamental corporate tax reform" is a viable option for replacing the ETI; and,
- why there are concerns about the international competitiveness of U.S. companies.

The Administration's response to the WTO ruling must be done in a way that does not harm the overall competitiveness of American businesses in the global marketplace. There must be a bipartisan approach for handling the ETI and our action must be taken in a timely manner.

Earlier testimony confirmed that overhaul of our current system of international taxation would be a major undertaking and something that must not be done "in haste." The competitiveness of our multinational companies is at stake, and the issues merit full analysis and discussion.

Finally, it is important that this Subcommittee continue its review of international tax issues and move the discussion from theoretical approaches to realistic alternatives. As always, the "devil is in the details." Until the specifics of a proposal are put on the table, it is unclear how the Committee should proceed and who the "winners and losers" will be.

Today's testimony—from experts in the area of international taxation and multinational corporate associations—will be of assistance to us in each of these areas. I thank Chairman McCrery for scheduling this important hearing and I thank our guests for coming before us to testify.

Chairman MCCRERY. Thank you, Mr. McNulty. Our first panel today is from the Administration. We have the Honorable Glenn Hubbard, Chairman of the Council of Economic Advisers, and Ms. Barbara Angus, International Tax Counsel with the U.S. Department of the Treasury.

Mr. Hubbard, we welcome your testimony. Your written testimony will be in the record in full. We would like for you to try to summarize that within about 5 minutes. Thank you.

STATEMENT OF THE HON. R. GLENN HUBBARD, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. HUBBARD. Okay. Thank you very much. Mr. Chairman, I will be brief. I think your own introduction covered a great many of the important issues. What I really wanted to do was three things: One, give you a sense of the charge from the President to his staff and to the Treasury Department about principles to use; second, to describe briefly the importance of the issue, that is, the important role multinationals play in our economy; and third, to tee up, as you did, Mr. Chairman, the idea that tax reform in this area is very, very important.

The proximate reason that you called the hearing has to do with the Foreign Sales Corporation (FSC) ETI dispute. In light of the WTO finding, the President gave us two principles, one that he wanted the United States to honor quite explicitly its international commitments, and to be candid, not walk close to the line, that is, to have a genuine response to the finding.

Second, to work with you in the Congress to come up with a policy instead which could, if possible, enhance, and certainly not diminish, the competitiveness of U.S. firms.

To go to the issue of why this is so important for the economy, just put a fact out that you, of course, are familiar with on the Subcommittee, that multinationals account for quite a large chunk of American economic activity. About a quarter of our Nation's gross national product is produced by nonfinancial multinationals.

An economist would note that the primary motivation for being a multinational is to compete more effectively in foreign markets, not domestic markets. This is sometimes portrayed as an issue of domestic versus foreign in jobs. That is simply not the case.

Multinationals' activities generate substantial additional jobs at home, and more to the point, the kind of jobs that we all want, high-wage technical jobs in the United States.

On the issue of tax policy in international competitiveness, I think it is quite clear that globalization has taken place faster than we have been able to reform our Tax Code. An example of this is the sharp decline over the past 40 years in American companies' shares in the world's largest multinationals.

Tax policy matters a lot, and U.S. policy differs from that of our major trading partners in at least four important ways.

First, about half of the Organization of Economic Cooperation and Development (OECD), about half of the industrial countries have territorial tax systems, so that a U.S. firm in such a case wouldn't be subject to tax on active income earned abroad under such a system.

Second, even among the countries that do tax worldwide income on a worldwide basis, as do we in the United States, active business income is generally not taxed until it is remitted to a parent. In some circumstances, for example, income that would arise from base companies' sales or service, that is, business income that would be earned abroad, one foreign-controlled corporation to another, would not be deemed to be repatriated in alternative systems.

Third, the United States tends to place greater restrictions on the use of foreign tax credits which, of course, were intended to avoid double taxation. This is beyond the issue you are very familiar with on multiple baskets, but allocation rules for interest and other expenses sometimes will preclude full offset. This is double taxation; it is not good tax policy.

Fourth, the United States is one of only a handful of countries that fails to provide some integration of the corporate and individual tax systems, that is, again, double taxation of equity income. This absence of integration is a general problem; it extends far beyond international tax, but I would urge you to think of it in your discussion. Economists have been less helpful than we might in this debate over the years. You know, there are principles for neutrality that have been suggested: Both capital export neutrality which would say that an investor should face the same tax irrespective of where it places the investment, and capital import neutrality, which is focused more on competitiveness, that is equal taxation in the host country.

Despite 40 years of debate, (and I promise you, I won't go through the entrails of that debate) to cut to the chase, these notions have proven not to be terribly useful in practice. In part, that is because the debate among economists has been a bit simplistic. That is, we all know, of course, that capital can flow through multinationals making allocations; it can also flow through portfolio investors. Many ideas justifying capital export neutrality are based on a world that simply doesn't exist.

A perhaps larger weakness with traditional notions of capital export neutrality it is designed under the benchmark of perfect competition. Now, perfect competition is an exciting concept, and it is most exciting in economic textbooks. It, however, does not describe the world in which multinationals work. Indeed, it would be very hard to imagine why you would want to be a multinational if you were in a world of perfect competition. To cut to the chase, there is abundant work that suggests among economists that the theories of why a multinational exists point very strongly in the direction of something closer to capital import neutrality.

Now, what does all of this have to do with implications for multinationals and what you are doing? It is very important for the Nation, from an economic perspective to maintain the viability of U.S. multinationals and the headquartering of U.S. multinationals in the United States.

Tax policy matters for this, and frankly has played a role in the relocation for headquarters purposes of some multinationals.

To conclude, Mr. Chairman, I agree with you in your introduction. This is a very important topic. I think the clear guidance from the President is that this topic be taken to try to improve the competitiveness of U.S. firms. There is quite specific guidance there in the sense of trying to avoid double taxation, and trying to promote competitiveness that translates into many of the proposals that you have been actively looking at on the Committee. I salute you for doing so. Thank you very much, sir.

[The prepared statement of Mr. Hubbard follows:]

Statement of the Hon. R. Glenn Hubbard, Chairman, Council of Economic Advisers

Chairman McCrery, Mr. McNulty, and Members of the Subcommittee, thank you for the opportunity to testify today on the effect of U.S. tax rules on the international competitiveness of U.S. companies. Increasingly, the markets for U.S. companies have become global, and foreign-based competitor companies operate under tax rules that are often more favorable than our own. The existing U.S. tax law governing the activities of multinational companies has been developed in a patchwork fashion, with the result that current law can result in circumstances that harm the competitiveness of U.S. companies. In addition to their economic implications, the international tax rules are among the most complex in the Code, with the result that they are both costly and difficult for companies to comply with and challenging for the Internal Revenue Service to administer. That is why I salute your interest, Mr. Chairman, in reviewing the current U.S. international tax rules with a view to reducing complexity and removing impediments to U.S. international competitiveness.

The proximate cause of this hearing is the finding by the Appellate Panel of the World Trade Organization (WTO) that the United States' Foreign Sales Corporation/Extraterritorial Income (FSC/ETI) regime does not comply with our international agreements. In light of this finding, the President has emphasized that two principles will guide our response. First, the United States will honor its international commitments and come into compliance by modifying it tax laws. Second, in doing so, we should work with Congress to enhance if possible, but certainly not diminish, the competitiveness of our tax rules. This guidance raises the larger question of tax policy and international competitiveness, to which I will now turn.

Multinational Corporations and the United States Economy

Multinational corporations are an important part of the United States economy. Approximately one quarter of the 1999 U.S. Gross National Product of $9.3 trillion was produced by U.S. non-bank multinationals. These corporations had a gross product of $2.4 trillion.[1] In the manufacturing sector, the contribution is even higher, with U.S. parent firms producing 54 percent of all U.S. gross manufactured product. In the conduct of these operations, U.S. multinational firms provide a large number of jobs to American workers. In 1998, parent firms employed over 21 million people in the United States, compared to a national workforce of 130 million.[2]

The primary motivation for U.S. multinationals to operate abroad is to compete more effectively in foreign, not domestic, markets. Thus their overseas investment activities are largely aimed at providing services that cannot be exported, obtaining access to natural resources abroad, and to selling goods that are costly to export due to transportation costs, tariffs, and local content requirements. As one piece of evidence in this regard, the Department of Commerce notes that two-thirds of sales from U.S.-owned foreign affiliates were local (i.e., to their host country). Only 11 percent of sales from these firms were made back to the United States, and less than 10 percent of U.S. plants abroad exported goods back to the U.S. market.[3] Thus the primary market for foreign operations of U.S. companies is the host country, followed by other foreign countries. Indeed, more than one-half of all foreign affiliates of U.S. multinationals are in the service sector, including distribution, marketing, and servicing U.S. exports.

Sales. By definition, multinationals operate and sell their products in more than one country. However, research indicates that U.S. operations abroad do not serve to displace exports. Indeed, in part because foreign affiliates of U.S. companies rely heavily on exports from the United States, the activities of multinationals generate a net trade surplus. A recent study by the Organization for Economic Cooperation and Development (OECD) complements other academic research in finding that each dollar of outward foreign direct investment is associated with $2.00 of additional exports and an increase in the bilateral trade surplus of $1.70.[4]

How important are multinationals in international transactions? In 1999 (the most recent year for which data are available), foreign affiliates of U.S. companies purchased $203 billion of goods from U.S. sources. At the same time, domestic operations of U.S. multinationals exported $267 billion to other foreign customers. Drawing these together, U.S. multinationals contributed roughly $440 billion of merchandise exports in 1999, or about two-thirds of overall U.S. merchandise exports.[5]

U.S. multinationals are also an important part of import behavior. Many are familiar with the notion that imported goods give domestic businesses and consumers access to a wider variety of goods at lower prices and competition that forces domes-

[1] Department of Commerce, *Survey of Current Business*, March 2002.
[2] Department of Commerce, *Survey of Current Business*, March 2002.
[3] National Foreign Trade Council, *International Tax Policy for the 21st Century*, 2001.
[4] Organization for Economic Cooperation and Development, *Open Markets Matter: The Benefits of Trade and Investment Liberalization*, 1998.
[5] Department of Commerce, *Survey of Current Business*, March 2002.

tic firms to operate more efficiently. However, imports also provide specialized equipment that helps American businesses to compete and improve their productivity. The United States imported $377.1 billion of goods that involved multinationals, 37 percent of the share of U.S. total imports (down from 42 percent in 1989). In total, U.S.-owned multinationals exported $64 more than they imported.[6]

Intangible Capital Assets. Physical capital assets often dominate the discussion of multinational investment decisions. However, among the assets of U.S. companies is their scientific expertise. Foreign physical capital investments are one avenue to increase their use of this expertise, thereby raising the rate of return on firm-specific assets such as patents, skills, and technologies. Not surprisingly, raising the rate of return provides enhanced incentives for investment in research and development. In 1999, non-financial U.S. multinationals performed $142 billion of research and development. Such research and development allows the United States to maintain its competitive advantage in business and be unrivaled as the world leader in scientific and technological know-how. In addition, this activity tends to be located in the United States—$123.5 billion, or nearly 90 percent, was done in a domestic operation. Thus, in this area as well, the foreign and domestic operations of multinationals tend to be complements, and not substitutes, for one another.

Employment. A common concern is that the overseas activities of U.S. multinationals come at the expense of domestic employment. There are reasons, however, for the opposite to be true. The need for labor by any firm is related to its overall success. In the case of multinational corporations, this is no different. Foreign investments can lead to more domestic employment because the need for employees by a multinational is linked to its entire international, firm-level success at trade in intermediate and final goods.[7] This link generates a complementary, as opposed to competitive, relationship between employment in industrialized and developing countries.

Put differently, international investment by U.S. multinationals generates sales in foreign markets that could not be achieved by producing goods entirely at home and exporting them. U.S. multinationals use foreign affiliates in coordination with domestic operations to produce goods that allows them to compete effectively around the world, generating overall success evidenced by employment in the United States and significant exports. As evidence of their success, employment in these export-related activities yields higher-than-average wage rates.

Put differently, suppose that a U.S. multinational chose to forego opening a foreign affiliate and relied exclusively on exports from domestic production. Without the benefit of local marketing and distribution support, it might be less successful in its sales. Or the sheer cost of transport may make it non-competitive. In either event, it would lose out to competitors that either pursued a presence in the country or had lower transportation costs. The end result may be a company with lower profits, slower growth, and fewer employment opportunities.[8]

For these reasons, it is unlikely that U.S. direct investment abroad displaces U.S. jobs or reduces U.S. exports on a net or overall basis.

Summary. U.S. multinationals provide significant contributions to the U.S. economy through a strong reliance on U.S.-provided goods in both domestic and foreign operations. These activities generate additional domestic jobs at above average wages and domestic investments in equipment, technology, and research and development. As a result, the United States has a significant interest in insuring that its tax rules do not bias against the competitiveness of U.S. multinationals.

TAX POLICY AND U.S. INTERNATIONAL COMPETITIVENESS

The increasing globalization of economic competition has centered attention on the impact of U.S. tax rules. Foreign markets represent an increasing fraction of the growth opportunities for U.S. businesses. At the same time, competition from multinationals headquartered outside of the United States is becoming greater. An example of this phenomenon is the sharp decline over the past 40 years in the United States share of the world's largest multinational corporations.

Why Tax Policy Matters. If U.S. businesses are to succeed in the global economy, the U.S. tax system must not generate a bias against their ability to compete effectively against foreign-based companies—especially in foreign markets. Viewed from the narrow perspective of income taxation, however, there is concern that the United States has become a less attractive location for the headquarters of a multi-

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[6] Department of Commerce, *Survey of Current Business*, March 2002.

[7] David Riker and Lael Brainard, "U.S. Multinationals and Competition from Low Wage Countries," National Bureau of Economic Research Working Paper No. 5959, 1997.

[8] See the Council of Economic Advisers, *Economic Report of the President 1991*, p. 259.

national corporation. This concern arises from several major respects in which U.S. tax law differs from that of most of our trading partners.

First, about half of the OECD countries have a territorial tax system (either by statute or treaty), under which a parent company is not subject to tax on the active income earned by a foreign subsidiary. By contrast, the United States taxes income earned through a foreign corporation, either when the income is repatriated or deemed to be repatriated under the rules of the Tax Code.

Second, even among countries that tax income on a worldwide basis, the active business income of a foreign subsidiary is generally not subject to tax before it is remitted to the parent. In some circumstances, for example income arising from "base country sales or service" sources, the active business income is deemed to be repatriated and taxed immediately. Indeed, one reading of tax history is that the FSC regime originally developed at least in part in response to the pressures generated by the absence of deferral on these income sources. I will defer the details of the mechanics of these tax rules, and any potential routes to modification, to the testimony of my colleague Treasury International Tax Counsel Barbara Angus.

Third, the United States places greater restrictions on the use of foreign tax credits than do other countries with worldwide tax systems. For example, there are multiple "baskets" of tax credits which serve to limit the flexibility of firms in obtaining credits against foreign taxes paid. In some circumstances, allocation rules for interest and other expenses also preclude full offset of foreign tax payments, raising the chances of double-taxation of international income. Again, I will leave the details for further discussion by my colleague.

Fourth, the United States (along with Switzerland and the Netherlands) is one of only a handful of industrialized countries to fail to provide some form of integration of the corporate and individual income tax systems. The absence of integration results in double taxation of corporate income, making it more difficult for U.S. companies to compete against foreign imports at home, or in foreign markets through exports from the United States, or through foreign direct investment.

Principles of Neutrality. A strict concern for the competitiveness of a U.S. multinational operating in a foreign country would dictate an approach to taxation that results in the same tax as a foreign-based multinational operating in that country. This competitiveness principle is also known as Capital Import Neutrality (CIN), as it results in the same rate of return for all capital flowing into a country. An alternative notion of efficiency is that a U.S. investor should be taxed equally whether the investment is made at home or abroad. This latter notion is referred to as Capital Export Neutrality (CEN).

The debate regarding the principles of competitiveness and capital export neutrality dates back at least to the early 1960s and the proposal of the Kennedy Administration to tax immediately all foreign source income earned by subsidiaries of U.S. companies (except in developing countries). Despite 40 years of debate, however, CEN and CIN have not proven to be very useful principles in practice. The theories supporting the principles have been overly simplified and have not advanced much in the intervening time. In many instances, analysis fails to account for the existence of a corporate tax, the ability of portfolio investors to buy foreign corporate shares, and the utter complexity with which actual tax systems involve mixtures of residence-based and source-based taxation.

The conventional economic analysis supporting CEN assumes that all foreign investment is in the form of direct equity and that there are no international flows of portfolio equity or debt investments. Under these assumptions, any decrease in foreign investment by U.S. companies would result in increased corporate investment in the United States. However, capital can flow out of the United States because portfolio investors can reinvest their shareholdings, selling U.S. in favor of foreign companies. Such investment can also flow into the U.S. non-corporate sector. Currently, portfolio investment accounts for about two-thirds of U.S. investments abroad and about two-thirds of foreign investment in the United States, casting doubt on any heavy reliance on a theory that excludes portfolio investment.

A second weakness of the typical economic analysis underpinning CEN is the presumption of "perfect" competition. Perfect competition is a useful analytic benchmark for economists. However, strictly interpreted, it requires that firms produce the same products, cannot take advantage of scale economies, and do not ever earn above-market profits. In practice, multinationals produce differentiated products, and compete in industries where there are some economies of scale—which is one explanation why foreign plants are affiliated with a parent firm at all. A reevaluation of tax principles in a more realistic setting casts doubt on the traditional analysis, including my own research with Michael Devereux. We reexamined the theory of international tax policy, noting that foreign investment is different from portfolio investment. In particular, foreign investment offers the possibility of exploiting intangible factors such as brands or patents and company-specific cost advantages. This research calls into question the basic findings that support CEN. Interestingly, in this setting it is often the case that average tax rates—not just marginal tax rates—have a large influence on investment decisions.

One implication of the accumulation of research is that there is no simple general abstract principle that applies to all international tax policy issues. The best policy in each case depends on the facts of the matter and how the tax system really works. A U.S.-controlled operation abroad must compete in several ways for capital and customers. They might have to compete with foreign based companies for a foreign market. They might have to compete with U.S. exporters or domestic import-competing companies. Each of these competing businesses can be controlled either by U.S.-based or foreign-based parents. It is a challenge for policy to determine the best path to a competitive tax system.

A direct application of the simple CEN notion can actually make efficiency worse, even from the perspective of its objectives. A well-known economic theorem shows that when there is more than one departure from economic efficiency, correcting only one of them may not be an improvement. Unilateral imposition of capital export neutrality by the United States may fail to advance either worldwide efficiency or U.S. national well-being.

A direct application of the alternative notion of neutrality, CIN can be equivalent to a territorial tax system. As noted above, it is unlikely that any single, pure theory of international tax rules will provide direct and universal policy guidance. Nevertheless, concerns have been raised over the possibility that using CIN to guide tax policy will result in a narrower tax base and a shift in the structure of production for multinational firms. In this light, it is interesting to note that recent analyses of territorial tax systems by Harry Grubert and Rosanne Altshuler depart from traditional conceptions of the implications of a territorial tax system, arguing that revenue may rise when moving to a territorial system and there may be little impact on plant location decisions by multinationals.[9]

Implications for U.S. Multinationals. As noted earlier, from a tax perspective the United States is now less favorably viewed as an industrial country in which a multinational corporation should locate. Over time, any such bias from U.S. tax rules could lead to a reduction in the share of multinational income earned by companies headquartered in the United States. Incentives supporting a decline in the importance of U.S. multinationals should be a concern, not out of any narrow concern over particular companies, but because of the potential loss in economic opportunities such a decline would bring about for American workers and their families. Professor Laura Tyson, one of my predecessors as Chair of the Council of Economic Advisers, points out a number of political, strategic, and economic reasons why maintaining a high share of U.S. control over global assets remains in the national interest.[10] These include the fact that U.S. multinationals locate over 70 percent of their employment and capital assets in the United States. Also, they have higher pay and investment per employee in the United States than in either developed or developing countries. Finally, as noted earlier, U.S. multinationals conduct a very large percentage of their research and development domestically.

The Department of Commerce data support the view that the vast majority of the revenue, investment and employment of U.S-based multinationals is located in the United States. This has not changed over time. In 1999, U.S. parents accounted for about three-fourths of the multinationals' sales, capital expenditures and employment. These shares have been relatively stable for the last decade.[11] Therefore where a firm chooses to place its headquarters will have a large influence on how much that country benefits from its domestic and international operations.

The decline in the market share of multinationals headquartered in the United States has important implications for the well-being of the U.S. economy. To the extent that tax rules are the source of this shift, higher-paying manufacturing jobs and management functions may move along with these headquarters. Research and development may be shifted abroad, in addition to jobs in high-paying service industries, such as finance, associated with headquarters' activities. Future investments made by these companies outside of the United States are unlikely to be made through the U.S. subsidiary since tax on these operations can be permanently re-

[9] See Harry Grubert, "Dividend Exemption and Tax Revenue," and Rosanne Altshuler, and Harry Grubert, "Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations," papers presented at the Conference on Territorial Income Taxation, The Brookings Institution, April 30, 2001.

[10] Laura D'Andrea Tyson, "They Are Not Us: Why American Ownership Still Matters," *American Prospect*, Winter 1991.

[11] Department of Commerce, *Survey of Current Business*, March 2002.

moved from the U.S. corporate income tax system by instead making them through the foreign parent. As I pointed out earlier, portfolio investment offers still another, perhaps less visible, route by which foreign-owned multinationals can expand at the expense of U.S. multinationals. If U.S. multinationals cannot profitably expand abroad due to unfavorable U.S. tax rules, foreign-owned multinationals will attract the investment dollars of U.S. investors. Individuals purchasing shares of foreign companies—either through mutual funds or directly through shares listed on U.S. and foreign exchanges—can generally ensure that their investments escape the U.S. corporate income tax on foreign subsidiary earnings.

Conclusions

Multinational corporations are an integral part of the U.S. economy, and their foreign activities are part of their domestic success. Accordingly, we must ensure that U.S. tax rules do not impact the ability of U.S. multinationals to compete successfully around the world. I urge that this Committee continue to review carefully the U.S. international tax system with a view to removing biases against the ability of U.S. multinationals to compete globally. Such reforms would enhance the well-being of American families and allow the United States to retain its world economic leadership.

Chairman MCCRERY. Thank you, Mr. Hubbard. Ms. Angus.

STATEMENT OF BARBARA ANGUS, INTERNATIONAL TAX COUNSEL, U.S. DEPARTMENT OF THE TREASURY

Ms. ANGUS. Mr. Chairman, Congressman McNulty, and distinguished Members of the Subcommittee. I appreciate the opportunity to appear today at this hearing focusing on international tax policy and competitiveness issues. The issues that the Subcommittee has explored in this series of hearings on the recent WTO decision are critically important as we work toward meaningful changes in our tax rules that will protect the competitive position of American businesses and workers and honor our WTO obligations.

The concern facing the Subcommittee today is that our Tax Code has not kept pace with the changes in our real economy. International tax policy remains rooted in tax principles developed in the fifties and sixties. That was a time when America's foreign direct investment was preeminent abroad and competition from imports to the United States was insignificant.

Today we have a truly global economy in terms of both trade and investment. The principles that guided tax policy adequately in the past must be reconsidered in today's highly competitive knowledge-driven economy. It is significant that the U.S. tax system differs in fundamental ways from those of our major trading partners. In considering these competitiveness issues, it is important to understand the major features of the U.S. tax system and to how they differ from those of our major trading partners.

First, the United States has a worldwide tax system, while many of our trading partners do not tax on the basis of worldwide income. U.S. citizens and residents and corporations are taxed on all of their income regardless of where it is earned. Income earned from foreign sources is subject to tax both by the country where the income is earned and by the United States.

To provide relief from this potential double taxation, the United States allows taxpayers a foreign tax credit. However, detailed rules apply to limit the foreign tax credit. A U.S. corporation generally is subject to U.S. tax on the active earnings of a foreign subsidiary once such income is repatriated as a dividend. However, the

U.S. parent is subject to current U.S. tax on certain income earned by a foreign subsidiary without regard to whether the income is distributed.

The U.S. worldwide system of taxation is in contrast to the territorial systems operated by half of the OECD countries. Under these systems, domestic residents and corporations generally are subject to tax only on their incomes from domestic sources. A domestic business is not subject to domestic tax on the active income earned abroad by a foreign branch or on dividends paid from active income earned by a foreign subsidiary.

Differences between a worldwide tax systems and a territorial system can affect the ability of U.S.-based multinationals to compete for sales in foreign markets against foreign based multinationals. Under a worldwide tax system, repatriated income is taxed at the higher of the source country rate or the resident's country rate. In contrast, foreign income under a territorial system is subject to tax at the source country rate. The use by the United States of a worldwide tax system may disadvantage the competitiveness of U.S. foreign direct investment in countries with effective corporate tax rates below those of the United States. The use of a worldwide tax system does not disadvantage in countries with effective corporate rates above those of the United States. In instances where the taxpayer has lower-taxed foreign income, that may actually result in favorable treatment for incremental U.S. investment relative to investment from companies established in territorial countries.

Second, the U.S. worldwide tax system differs in significant ways from the worldwide systems of our major trading partners. About half of the OECD countries employ worldwide systems. Looking at competition among multinationals established in these countries, U.S. multinationals still may be disadvantaged when competing abroad. This is because the United States employs a worldwide system that, unlike other systems, may tax active forms of business income earned abroad before it has been repatriated and may more strictly limit the use of foreign tax credits to prevent double taxation.

Income earned abroad by a foreign subsidiary generally is subject to U.S. tax at the U.S. parent 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, under which a U.S. parent is subject to current U.S. tax on certain income of its foreign subsidiaries. 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 forms of income from active foreign business operations. No other country has rules for the immediate taxation of foreign income that are comparable to the U.S. rules in terms of breadth and complexity.

Under the worldwide system of taxation, U.S. 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 foreign tax credit. The United States allows U.S. taxpayers a foreign tax credit for taxes paid on income earned outside of the United States. However, complex rules apply to limit the availability of the foreign tax credits by requiring the categorization of income into multiple baskets to which the foreign tax credit rules are applied separately. Detailed rules also require the reduction of income for which foreign tax credits may be claimed to reflect a broad allocation of U.S.-incurred expenses without regard to locally incurred expenses. These rules can have the effect of denying U.S.-based companies the full ability to credit foreign taxes paid on incomes 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.

Finally, the U.S. domestic tax rules also differ significantly from those of our major trading partners. While concern about the effects of the U.S. tax system on international competitiveness may focus on the treatment of foreign 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.

One aspect of the U.S. system is that income from an equity-financed investment in the corporate sector is taxed twice: First, 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, most other OECD countries offer some form of integration under which corporate tax payments are either partially or fully taken into consideration when assessing shareholder taxes. Whether competing at home or abroad, the U.S. double tax makes it harder for the U.S. company to compete successfully against a foreign competitor.

Both the increase in foreign acquisitions of U.S. multinationals and the recent corporate inversion activity are evidence that the potential competitive disadvantages created by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy. The urgency of this issue is further heightened by the recent WTO decision against our ETI provisions and the need to respond promptly to that decision to come into compliance with the WTO rules. We must undertake a reexamination of the U.S. international tax rules and the fundamental assumptions underlying them. Given the global economy in which we live, that reexamination must consider the experiences and choices of our major trading partners in designing their international tax systems. These competitiveness issues should form the basis for the beginning of that reexamination.

I would be happy to answer any questions. Thank you.

[The prepared statement of Ms. Angus follows:]

Statement of Barbara Angus, International Tax Counsel, U.S. Department of the Treasury

Mr. Chairman, Congressman McNulty, and distinguished Members of the Subcommittee, I appreciate the opportunity to appear today at this hearing focusing on international tax policy and competitiveness issues. The issues that the Subcommittee has explored in this series of hearings on the recent WTO decision regarding the U.S. extraterritorial income exclusion provisions are critically important as we work toward meaningful changes in our tax rules that will protect the competitive position of American businesses and workers and honor our WTO obligations.

Introduction

The pace of technological advancement around the world is awe inspiring. Computer processing abilities are expanding at exponential rates, roughly doubling every year or two. Innovations in pharmaceuticals and biotechnology are providing breakthroughs in treating disease, permitting dramatic improvements in the quality of life. Today, the keys to production in even basic commodity industries like oil, paper, and steel are found in better knowledge and innovation: the ability to produce more with less waste.

The concern facing this Subcommittee today is that our Tax Code has not kept pace with the changes in our real economy. International tax policy remains rooted in tax principles developed in the 1950s and 1960s. That was a time when America's foreign direct investment was preeminent abroad and competition from imports to the United States was scant. Today, we have a truly global economy, in terms of both trade and investment. The value of goods traded to and from the United States increased more than three times faster than GDP between 1960 and 2000, rising to more than 20 percent of GDP. The flow of cross-border investment, both inflows and outflows, rose from a scant 1.1 percent of GDP in 1960 to 15.9 percent of GDP in 2000.

The globalization of the world economy has provided tremendous benefits to consumers and workers. Those who can build a better mousetrap now can sell it to the world. The potential for a world market encourages companies to invest in research that leads to continuous innovation. At one time, the strength of America's economy was thought to be tied to its abundant natural resources. Today, America's strength is its ability to innovate: to create new technologies and to react faster and smarter to the commercialization of these technologies. America's preeminent resource today is its knowledge base.

A feature of a knowledge-driven economy is that unlike physical capital, technological know-how can be applied across the world without reducing the productive capacity of the United States. For example, computer software designed to enhance the efficiency of a manufacturing process may require substantial investment, but once developed it can be employed around the world without diminishing the benefits of the know-how within the United States. Foreign direct investment by companies in a knowledge-driven economy provides opportunities to export this know-how at low cost and incentives to undertake greater domestic investment in developing these sources of competitive advantage.

There are many reasons to believe that the principles that guided tax policy adequately in the past should be reconsidered in today's highly competitive, knowledge-driven economy. In this regard, it is significant that the U.S. tax system differs in fundamental ways from those of our major trading partners. In order to ensure the ability of U.S. workers to achieve higher living standards, we must ensure that the U.S. tax law does not operate to hinder the ability of the U.S. businesses that employ those workers to compete on a global scale.

Competitiveness and U.S. Tax Policy

There are several different ways in which tax policy can affect the ability of firms to compete. It may be helpful to consider the ways in which commercial operations based in different countries compete in the global marketplace.

Competition may be among:

- U.S.-managed firms that produce within the United States;
- U.S.-managed firms that produce abroad;
- Foreign-managed firms that produce within the United States;
- Foreign-managed firms that produce abroad within the foreign country in which they are headquartered; and
- Foreign-managed firms that produce abroad within a foreign country different from the one in which they are headquartered.

These entities may be simultaneously competing for sales within the United States, within a foreign country against local foreign production (either U.S., local, or other foreign managed), or within a foreign country against non-local production. Globalization requires that U.S. companies be competitive both in foreign markets and at home.

Other elements of competition among firms exist at the investor level: 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 United States. Firms compete in global capital markets as well as global consumer markets.

In a world without taxes, competition among these different firms and different markets would be determined by production costs. In a world with taxes, however, where countries make different determinations with respect to tax rates and tax bases, these competitive decisions inevitably are affected by taxes. Assuming other countries make sovereign decisions on how to establish their own tax systems and tax rates, it simply is not possible for the United States to establish a tax system that restores the same competitive decisions that would have existed in a world without taxes.

The United States can, for example, attempt to equalize the taxation of income earned by U.S. companies from their U.S. exports to that of U.S. companies producing abroad for the same foreign market. However, in equalizing this tax burden, it may be the case that the U.S. tax imposed results in neither type of U.S. company being competitive against a foreign-based multinational producing for sale in this foreign market.

The manner in which balance is achieved among these competitive concerns changes over time as circumstances change. For example, as foreign multinationals have increased in their worldwide position, the likelihood of a U.S. multinational company competing against a foreign multinational in a foreign market has increased relative to the likelihood of U.S. export sales competing against sales from a U.S. multinational producing abroad. The desire to restore competitive decisions to those that would occur in the absence of taxation therefore may place greater weight today on U.S. taxes not impeding the competitive position of U.S. multinationals vis-á-vis foreign multinationals in the global marketplace. Similarly, while at one time U.S. foreign production may have been thought to be largely substitutable with U.S. domestic production for export, today it is understood that foreign production may provide the opportunity for the export of firm-specific know-how and domestic exports may be enhanced by the establishment of foreign production facilities through supply linkages and service arrangements.

Given the significance today of competitiveness concerns, it is important to understand the major features of the U.S. tax system and how they differ from those of our major trading partners. The primary features of the U.S. tax system considered here are: (i) the taxation of worldwide income; (ii) the current taxation of certain types of active foreign-source income; (iii) the limitations placed on the use of foreign tax credits; and (iv) the unintegrated taxation of corporate income at both the entity level and the individual level.

Taxation of Worldwide Income

The United States, like about half of the OECD countries, including the United Kingdom and Japan, operates a worldwide system of income taxation. Under this worldwide approach, U.S. citizens and residents, including U.S. corporations, are taxed on all their income, regardless of where it is earned. Income earned from foreign sources potentially is subject to taxation both by the country where the income is earned, the country of source, and by the United States, the country of residence. To provide relief from this potential double taxation, the United States allows taxpayers a foreign tax credit that reduces the U.S. tax on foreign-source income by the amount of foreign income and withholding taxes paid on such income. As discussed below, detailed rules apply to limit the foreign tax credit. A U.S. corporation generally is subject to U.S. tax on the active earnings of a foreign subsidiary if and when such income is repatriated as a dividend. However, the U.S. parent is subject to current U.S. tax on certain income earned by a foreign subsidiary, without regard to whether that income is distributed to the U.S. parent. As discussed further below, while these current taxation rules are focused on passive, investment-type income earned by a foreign subsidiary, their reach extends to active business income in certain cases.

The U.S. worldwide system of taxation is in contrast to the territorial tax systems operated by the other half of the OECD countries, including Canada, Germany, France, and the Netherlands. Under these territorial tax systems, domestic residents and corporations generally are subject to tax only on their income from domestic sources. A domestic business is not subject to domestic taxation on the active income earned abroad by a foreign branch or on dividends paid from active income earned by a foreign subsidiary. A domestic corporation generally is subject to tax on other investment-type income, such as royalties, rent, interest, and portfolio dividends, without regard to where such income is earned; because this passive income is taxed on a worldwide basis, relief from double taxation generally is provided through either a foreign tax credit or a deduction allowed for foreign taxes imposed on such income. This type of territorial tax system sometimes is referred to as a "dividend exemption" system because active foreign business income repatriated in the form of a dividend is exempt from taxation. By contrast, a pure territorial system would provide an exemption for all income received from foreign sources, including passive income such as royalties, rent, interest, and portfolio dividends. Such pure territorial systems have existed only in a few developing countries.

Differences between a worldwide tax system and a territorial system can affect the ability of U.S.-based multinationals to compete for sales in foreign markets against foreign-based multinationals. Under a worldwide tax system, repatriated foreign income is taxed at the higher of the source country rate or the residence country rate. In contrast, foreign income under a territorial tax system is subject to tax at the source country rate.

Consider a U.S.-based company and a foreign-based company established in a country with a territorial tax system. Each company is considering investment in a new foreign subsidiary to establish a manufacturing operation for the local foreign market. The effect of the worldwide system on this form of competition depends on the relationship of the foreign rate of tax on corporate income to that of the United States.

Let us first assume that the effective tax rate on corporate income of this foreign country is *lower* than the effective U.S.-tax rate on corporate income (because the foreign country has a lower statutory rate on corporate income or because it has investment incentives such as accelerated depreciation). If the foreign subsidiary of the U.S.-based company repatriates on a current basis its economic profits to its U.S. parent, it will effectively be subject to the higher U.S. tax rate on its income. The foreign subsidiary of the company established in the territorial country, however, will be subject to the lower foreign rate of tax. If the U.S. company cannot garner sufficient efficiency advantages relative to its foreign competitor, it will be unable to compete since it must sell its product in this market at prices competitive with that of its foreign competition.

An alternative outcome results if the foreign country in which the foreign investment is being considered has a *higher* effective corporate tax rate than the United States. In this case, the U.S. parent is not disadvantaged relative to the company established in a country with a territorial tax system. Income earned by the U.S.-owned foreign subsidiary will be subject to tax at only the source country tax rate, the same result as under a territorial system.

The foregoing examples assumed that the U.S. parent company had no other foreign-source income. The presence of other foreign-source income can affect the rate of tax paid on additional foreign-source income under U.S. tax rules because credits for taxes paid to one foreign country can effectively be pooled with credits for taxes paid to another foreign country.

Consider for example the case of a U.S. parent that has other foreign-source income that is taxed at foreign rates *higher* than the U.S. tax rate. In this case, the U.S. parent will have excess foreign tax credits before considering its decision to invest in a new foreign subsidiary. If the U.S. parent is considering establishing its new foreign subsidiary in a country with a tax rate *lower* than the U.S. rate, these excess credits generally may be used to offset the additional U.S. tax that would be levied on the income of this new investment. The presence of excess foreign tax credits thus reduces the tax burden imposed by the United States on income from the new lower-taxed foreign location. As a result, a U.S. parent in this position will be relatively less disadvantaged by the U.S. tax system. If it has sufficient excess foreign tax credits, the U.S. parent can offset all of its U.S. corporate tax on the income from the new investment and its tax burden will be just the taxes paid in the foreign country—the same result as under a territorial system.

A different competitive result occurs when the U.S. parent has other foreign-source income that is taxed at foreign rates *lower* than the U.S. tax rate. In such a case the U.S. tax rate is the effective tax rate on such foreign income. If the U.S. parent is now considering establishing its new foreign subsidiary in a country with a tax rate *higher* than the U.S. rate, the income earned from this new investment will generate excess foreign tax credits that can offset the additional U.S. tax paid on its preexisting foreign-source income. As a result, in this case the U.S. parent receives a tax advantage from making the new investment in the high-tax country relative to the treatment of such investment under a territorial system.

These examples illustrate that the use by the United States of a worldwide tax system may disadvantage the competitiveness of U.S. foreign direct investment in countries with effective corporate tax rates below those of the United States. The use of a worldwide tax system does not disadvantage investment in countries with effective corporate tax rates above those of the United States, and in some instances may actually result in more favorable treatment for incremental U.S. investment relative to investment from companies headquartered in territorial countries. Of course, these results are based just on the distinction between a territorial and worldwide tax system, and ignore other key features of the U.S. tax system.

The complexities present in taxing income generally are heightened in determining the taxation of income from multinational activities, where in addition to measuring the income one must determine its source (foreign or domestic). This complexity affects both tax administrators and taxpayers. Indeed, the U.S. international tax rules have been identified as one of the largest sources of complexity facing U.S. corporate taxpayers.

The distinction in the treatment under a territorial tax system of foreign-source income relative to domestic-source income puts particular pressure on the determination of the source of items of income and expense. While classification of income as foreign source is important under a worldwide tax system because it determines availability of foreign tax credits, in a territorial system classification as foreign-source income gives rise to an exemption from tax. Similarly, under a territorial tax system, expenses allocable to foreign-source income would not be deductible for tax purposes while expenses so allocated in a worldwide tax system would reduce the availability of foreign tax credits.

Under most territorial systems, certain investment-type income is subject to tax without regard to where that income is earned. This raises the further issue of classification of income as subject to tax under this exception from the generally applicable territorial principles. Moreover, to the extent that this income is eligible for a foreign tax credit, the computational steps that are required to determine the amount of foreign-source income for purposes of applying foreign tax credit rules in a worldwide tax system would be built into the territorial system as well.

Given the complexity of the task of taxing multinational income under a worldwide or territorial system on top of the general complexity of the income tax system, some consideration might be given to alternative tax bases other than income. Other OECD countries typically rely on taxes on goods and services, such as under a value added tax, for a substantial share of tax revenues. In the European OECD countries, for example, these taxes raise nearly five times the amount of revenue as does the U.S. corporate income tax as a share of GDP.

Differences in Worldwide Tax Systems

As described above, about half of the OECD countries employ a worldwide tax system as does the United States. However, even limiting comparison of competition among multinational companies established in countries using a worldwide tax system, U.S. multinationals may be disadvantaged when competing abroad. This is because the United States employs a worldwide tax system that, unlike other worldwide systems, may tax active forms of business income earned abroad before it has been repatriated and may more strictly limit the use of the 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 making 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 to make 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 intercompany 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.

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 only to offset U.S. tax on foreign-source income and not to offset U.S. tax on U.S.-source income. The rules for determining and applying this limitation are detailed and 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 that are 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 recharacterize 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 recharacterization 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.

U.S. Corporate Taxation

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.

One aspect of the U.S. tax system is that the income from an equity-financed investment in the corporate sector is taxed twice. Equity income, or profit, is taxed first under the corporate income tax. Profit is taxed 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, most other 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 non-integration of corporate and individual tax payments on corporate income applies equally to domestically earned income or foreign-source income of a U.S. company. This double tax increases the "hurdle" rate, or the minimum rate of return required on a prospective investment. In order 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 makes it less likely that the U.S. company can compete successfully against a foreign competitor.

An example may help to clarify matters. Suppose that a corporation earns $100 of pre-tax profit. Consider the tax burden imposed by the present U.S. tax system. On its $100 profit, the corporation must pay corporate income tax of $35 assuming a 35 percent corporate tax rate, leaving $65 to be distributed to shareholders or reinvested in the firm. If the money is distributed as a dividend, shareholders also must pay tax under the individual income tax. If shareholders are subject to an average tax rate of 20 percent, they pay tax of $13, leaving them $52 of after-tax income. In this example, the $100 profit is taxed twice—$35 in tax payments are collected under the corporate income tax and an additional $13 are collected under the individual income tax. In total, the tax system collects $48 in tax and so imposes a 48 percent "effective" tax rate on corporate profits distributed as dividends.

Now consider how integration reduces the tax burden on income from corporate equity. Full integration of the partnership type eliminates the corporate income tax and imputes the $100 of pre-tax profit directly to the shareholders, where it is taxed at the shareholders' 20 percent tax rate under the individual income tax. Full integration reduces the total tax on $100 in profits from $48 under present law to $20. A simple form of partial integration is a dividend exclusion, which exempts dividends from the shareholders' taxable income. A dividend exclusion reduces the total tax burden to $35, entirely paid under the corporation income tax.

Because the unintegrated tax system results in a higher effective tax rate on income earned in the corporate sector, it is more difficult for a given investment to achieve a desired after-tax return (after both corporate and individual taxes are paid) than in an integrated tax system. As a result, projects that could attract equity capital in an integrated tax system may not be sufficiently profitable to attract equity capital in the present unintegrated 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.

As noted above, most OECD countries offer some form of tax relief for corporate profits. This integration typically is provided by reducing personal income tax payments on corporate distributions rather than by reducing corporate level tax payments. International comparisons of corporate tax burdens, however, sometimes fail to account for differences in integration across countries and consider only corporate level tax payments. To be meaningful, comparisons between the total tax burden faced on corporate investments by U.S. companies and those of foreign multinational companies must take into account the total tax burden on corporate profits at both the corporate and individual levels.

Both the increase in foreign acquisitions of U.S. multinationals and the recent corporate inversion activity are evidence that the potential competitive disadvantage created by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy. The urgency of this issue is further heightened by the recent WTO decision against our extraterritorial income exclusion provisions and the need to respond promptly to that decision to come into compliance with the WTO rules.

A reexamination of the U.S. international tax rules is needed. It is appropriate to question the fundamental assumptions underlying the current system. We should look to the experiences of other countries and the choices that they have been made in designing their international tax systems. Consideration should be given to fundamental reform of the U.S. international tax rules. Consideration also should be given 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 also must work to simplify our international tax rules.

Chairman MCCRERY. Thank you, Ms. Angus.

Well, if the opening testimony in today's hearing has done nothing else, it has made all of us want to be tax lawyers. It is pretty exciting stuff.

I am a lawyer, but I didn't get into international tax issues back in Leesville, Louisiana, or even Shreveport. I have had to delve into them at length as our Subcommittee has studied this problem of the ETI regime, and before that, FSC, and before that Domestic International Sales Corporation (DISC). So, we all on this Subcommittee have had to become somewhat familiar with international tax rules and the complexity of international tax provisions in our Tax Code. I think it is safe to say that the DSC and FSC and ETI came about because of the complexities and the disadvantages that are apparent when one looks at treatment of foreign income by U.S. companies.

So that is why we are here.

First of all, I have three questions by Mr. Crane, who is not a Member of the Subcommittee, but a Member of the full Committee, and wanted me to ask. If it is okay with the witnesses from the Administration, I will submit these in writing and would ask that you return a response to Mr. Crane's questions. They are regarding the 30 percent withholding tax on incomes from U.S. mutual funds.

[The questions submitted from Mr. Crane to Ms. Angus, and her responses follow:]

U.S. Department of the Treasury
Washington, DC 20220

Questions:

1. Would you agree that the current 30% withholding tax on the "dividend income" received by offshore investors in U.S. mutual funds acts as a punitive export tax? Does this force U.S. mutual funds to set up offshore "mirror" funds in order to be competitive with foreign investment funds?
2. I understand that the investment management industry pays some of the highest average wages in the U.S. Should we be concerned that American mutual fund companies are forced to send these jobs overseas to respond to the investment needs of non-citizens?
3. In light of the economic devastation from 9/11 that hit the financial services industry particularly hard, would correcting U.S. tax policy to remove the 30% withholding of dividend income earned by foreign investors help restore this industry and the jobs they support?

Response:

Distributions to shareholders from a U.S. regulated investment company, or mutual fund, are characterized as dividends. Under current law, such dividend distributions from a U.S. mutual fund to a foreign investor generally are subject to the U.S. 30-percent withholding tax. The U.S. withholding tax applies without regard to the character of the underlying earnings of the U.S. mutual fund out of which the distributions are made. Therefore, distributions from a U.S. mutual fund made out of earnings that are interest income or short-term capital gains are subject to the U.S. withholding tax, even though interest income and short-term capital gains generally would not be subject to the withholding tax if paid directly to a foreign investor.

Characterization of all distributions from U.S. mutual funds as dividends which are subject to the U.S. withholding tax does not reflect the economic character of the underlying investment income. In addition, the imposition of the U.S. withholding tax in the case of investments made through a U.S. mutual fund, when none is imposed on comparable investments through a foreign mutual fund, inhibits the ability of U.S. mutual funds to attract foreign investors. Current law thus encourages the establishment of "mirror" funds outside the United States for foreign investors that wish to invest in U.S. securities.

These economic distortions could be addressed by modifying the current-law rules so that the application of the U.S. withholding tax to distributions from a U.S. mutual fund to its foreign investors depended upon the character of the underlying earnings out of which the distribution was made. Under this approach, distributions to a foreign investor of interest income earned by a mutual fund would not be subject to the U.S. withholding tax, just as the interest income would not be subject to the U.S. withholding tax if paid directly to the foreign investor. Under this approach, foreign investors would not be subject to U.S. withholding tax on distributions of investment income from a U.S. mutual fund in situations where such investors would not be subject to withholding tax on such investment income if it were earned directly or if it were earned through a foreign mutual fund.

Obviously, we wanted to overcome some of the problems that the witnesses described by giving some special tax advantages to exporters, to companies in this country who wanted to sell their products overseas.

The WTO has ruled that the method we chose was contrary to the rules of the WTO. I think we have decided that we can't fight that any longer, and we must do something different to try to overcome these problems in our Tax Code.

Those companies who are advantaged by ETI and who now face repeal of that and replacement with some other tax provisions tell me, and I am sure others on this Subcommittee that if we do that, it will cost jobs in their companies, in their industries that are directly benefited by the ETI, but will only perhaps be generally benefited, and not as much, by changes to the Tax Code, some of which we have talked about.

So, Mr. Hubbard, I would like to ask you your opinion as to the impact on jobs generally in the country if we repeal ETI, but use the revenue raised from that repeal to give other tax breaks generally to the business community along the lines that—some of the lines that the Treasury Department has suggested.

Mr. HUBBARD. Well, certainly. Mr. Chairman, I think it largely depends on what you decide to do. When you think about business tax reform, you could think generally about tax policy generally for corporations or you could think in the international area. Even in the international area, moving to better tax policy is likely for the economy as a whole to generate more jobs and income than was possible under the FSC ETI regime. There will be winners and losers. As you know, whenever you change tax policy, that is so. We can't wish that away.

For the economy as a whole, I think there are many options you could take which would make us generally better off.

Chairman MCCRERY. You are saying that if we use that revenue to provide tax changes to industry and maybe particularly to industries that compete in the global marketplace, that it could result in more jobs, not just keep us even, but you think it could result in more economic activity here and more jobs here?

Mr. HUBBARD. I think that is possible, Mr. Chairman. It depends on what you do. There are some very good tax policy options that are just good tax policy in the international area that you might wish to consider and no doubt are considering. So, I think that is possible, yes.

Chairman MCCRERY. Now, let's talk about the quality of those jobs. We are told over and over that jobs that are tied to exports are generally higher paying jobs. Some say 10 to 15 percent more, that those jobs pay 10 to 15 percent more than the average U.S. job. If all of that is true, and we think it is, then are we risking those higher paying jobs by changing, by doing away with ETI and not directing those revenues at the targets of the ETI?

Mr. HUBBARD. Well, again, going back to the President's principles, it is likely not possible for you to make whole the exact distribution. If it were, we wouldn't be in this box. I think that there are also very high paying jobs associated with headquarters of multinationals, and there are tax policy changes that can be taken to make it attractive for multinationals to be in the United States.

So, I think that those are also high paying jobs. So, on average, I think that there are things you can do that are very positive for the economy. No matter what you do, you are likely to create winners and losers.

Chairman MCCRERY. Should we look, as much as possible, at directing this revenue to companies that export?

Mr. HUBBARD. Well, I would urge you to look as much as possible for the best possible tax policy, because that is what is going to generate the highest gains for the economy as a whole. You identify, I think very aptly and more succinctly than Barbara and I did, the complex problems in the international area. This is an area that is really ripe for reform. I think there are some great things that you can do there that would be very positive for the economy.

Chairman MCCRERY. So bottom line, you are confident that we can make this transition from ETI to maybe a simpler international Tax Code without doing damage, and in fact, we might even improve the Nation's economy?

Mr. HUBBARD. Well, I guess, first, I would suggest humbly to you that we must make the transition. It would be my judgment as an economist that you could find a package of policies that would make the economy as a whole as well off or better off.

Chairman MCCRERY. Thank you. Ms. Angus, Mr. Newlon, who will testify later, states in his testimony that competitiveness is a particular concern for financial services income because integration of the international financial markets leads to direct competition among foreign financial institutions.

While that is certainly true, is that the only arena where there is integration of world markets?

Ms. ANGUS. No. It is certainly clear that there is integration of world markets in all industries. The globalization that is facing the financial services industry may be somewhat more recent than the globalization that has faced and is facing other industries equally.

Chairman MCCRERY. In fact, we have pretty healthy integration in manufacturing, software, and other services as well as financial services, don't we?

Ms. ANGUS. Yes. Yes. The integration of markets is happening both with respect to goods and products and also increasingly in the service sectors of our economy.

Chairman MCCRERY. So, competitiveness is an issue pretty much across the board with respect to our domestic corporations and multinationals residing here?

Ms. ANGUS. Yes, it is.

Chairman MCCRERY. Thank you. I would say to the Members of the Subcommittee we have a 15-minute vote followed by one 5-minute vote. So, we will recess at this time and go vote. Please, as soon as possible, return to the hearing room and we will resume the hearing. The Subcommittee is in recess.

[Recess.]

Chairman MCCRERY. The Subcommittee will come to order. I appreciate the witnesses understanding of our need to go vote occasionally. I am told that we won't have another vote for a couple of hours. So, maybe we can get the rest of the hearing in before we are interrupted again.

I would like to now recognize my colleague, Mr. McNulty, for any questions that he may have of the panel.

Mr. MCNULTY. Thank you, Mr. Chairman. Again, I thank both of our witnesses for testifying. Ms. Angus, does the Administration believe it will take major or minor changes to fix the ETI regime?

Ms. ANGUS. Yes. In looking at the WTO opinion, we don't believe that it is possible to tinker with the current provisions or make minor fixes. We will need to make more meaningful changes to our tax law. It won't be possible simply to tweak around the edges and replicate the benefits. This is an exercise that will require that we look more fundamentally at our tax law and make more meaningful changes.

Mr. MCNULTY. What are we looking at? What is on the table?

Ms. ANGUS. Well, as Mr. Hubbard indicated, we think it is a priority that whatever we do must honor our WTO obligations and be compatible with the WTO rules.

Mr. MCNULTY. What specifically do you think we would propose? What would the outline be of a solution, in the opinion of the Administration?

Ms. ANGUS. I don't——

Mr. HUBBARD. If I might, Mr. McNulty. You wanted to think of international tax reform. There are a whole variety of issues that the Subcommittee and the Committee has looked at in the past. I referred to two in my testimony that related to the President's principles trying to emphasize competitiveness by looking at base company rules, avoiding double taxation in the interest allocation. There are many, many areas as the Chairman said in his remarks. This is both mindlessly inefficient and mindlessly complex, but there are many such policies that you could put together.

Mr. MCNULTY. Can you give me some examples? Could you be any more specific than that?

Mr. HUBBARD. Well, I just gave two that are probably on an economist's list as among the areas needing greatest reform, if that were your objective.

Mr. MCNULTY. Do you think those would do it?

Mr. HUBBARD. It depends upon what you mean by “do it,” sir. Terms of improving tax policy in the international area——

Mr. MCNULTY. Fix it so we would be in compliance.

Mr. HUBBARD. It would certainly be WTO compliant. The other part of the President’s charge had to do with improving competitiveness. It would accomplish that as well, but there are also other policies that would do the same thing. We would certainly look forward to working with you on that.

Mr. MCNULTY. Would either of you have an idea of what a timeframe would be for getting an administrative proposal, a legislative proposal to us?

Mr. HUBBARD. I think that from the President’s charge, we look forward to working with Congress. The President had asked us to work first with the Committee on Ways and Means. We have been doing so and continue to be at your service.

Mr. MCNULTY. What do you think the timetable would be in order to avoid the imposition of penalties by the WTO?

Ms. ANGUS. I think that that is certainly a difficult question. We believe that it is critically important that we address these issues promptly, that it is essential that we start making real progress toward a solution. Certainly the issues that are facing us, all of us, are complicated ones.

It is important, particularly with the WTO arbitration decision expected very shortly, that we begin to show real progress. Obviously that has begun with the work of this Subcommittee, the three hearings in this Subcommittee as well as the full Committee hearing earlier this year.

Mr. MCNULTY. I thank both of the witnesses. Thank you, Mr. Chairman.

Chairman MCCRERY. Thank you, Mr. McNulty. Mr. Ryan.

Mr. RYAN. Thank you, Mr. Chairman. Well, Mr. Hubbard, you were saying in your testimony that putting to the categories of different tax reform proposals into the capital import neutral system and the capital export neutral system is not really a good way to measure those things.

Then, I think you went on in your testimony to talk about how capital import neutrality is basically a territorial system. What are your thoughts on a territorial system? What do you think are the benefits and the pros and the cons of a territorial system?

Mr. HUBBARD. Well, of course, a territorial system is one example of a capital import neutral system. There might be others. I think a territorial system properly designed is consistent with a number of fundamental tax reform objectives. Remember, fundamental tax reform would not have you tax income multiple times. Since we are talking about dividends from foreign subsidiaries back to the parents, that is the same issue.

So arguably, a territorial tax system could be consistent with both fundamental income tax reform or fundamental consumption tax reform, but here the devil really lies in the details. When people say territorial, they can mean very many different things. I think that a territorial tax discussion would be part of any fundamental tax reform discussion that you might decide to have.

Mr. RYAN. Well, the third hearing that we are having here today is talking about sort of a rifle shot fix to ETI, FSC. Ultimately do you believe that even if we do a narrow fix to FSC or ETI that that will have to be changed later in place of ultimate tax reform? Do you believe that the incompatibility of the U.S. business tax regime internationally with respect to our competitors is ultimately going to have to force the hand of our country to fundamentally reform our tax system? If that is the case, where do you think we should head? Which direction should we go?

Mr. HUBBARD. To the first part of your question, I would hope that what you would do would buildupon, in other words, have fundamental tax reform be a logical follow on. There are many steps you could take that would be consistent, ultimately, with tax reform. I share your belief that ultimately we have to discuss fundamental tax reform in the United States. The Treasury Department, of course, is engaged in such an exercise.

Mr. RYAN. Do you think that what we do right now to respond to FSC is going to set up the direction of tax reform with respect to whether we go territorial or whether we go to something like a subtraction method VAT or something like that? Do you think that it matters with respect to where we want to go on tax reform at the end of the day, based upon what we are going to do to respond this year, if we do this year, to this current problem?

Mr. HUBBARD. Well, what I would say is, do you want to take an answer on the FSC ETI that doesn't diminish the chance of fundamental tax reform? There are many things you could do as a replacement for FSC ETI that would be on the path toward tax reform.

I am not sure that you could roll in a fundamental tax reform discussion into this and accomplish it in a short period of time. I think you do want to be consistent.

Mr. RYAN. Ms. Angus, I know the Administration hasn't come up with a specific proposal. I am not going to press you for one right now. We are trying to learn more about this ourselves to come up with a suitable response to the WTO problems we have, along the lines that the President mentioned, make sure that we don't do harm to the economy, to jobs, and make sure that we improve our competitiveness, but time is ticking. We will have to put a response out there fairly soon. We at least have to show progress.

When do you expect to bring a proposal to the Committee? Are you going to wait for the Committee to come up with something that you will then respond to, or are you actually planning on bringing a proposal to us this year?

Mr. HUBBARD. Our current plan, Mr. Ryan, is to work with the Committee, and this work has already been going on at the technical level. We also, of course, in the Administration, plan to raise the issue of direct versus indirect taxes general in the WTO round. We will be doing that independent of the work of the work here, but we do look forward to working with the Committee. That work is already going on.

Mr. RYAN. You don't agree with their definition of direct taxes, correct?

Mr. HUBBARD. I do not. I think that we will be working within the next round on that.

Mr. RYAN. Okay. Thanks.

Chairman MCCRERY. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. Mr. Hubbard, regarding the corporate inversion problem, some have suggested that we move forward with a temporary fix. While reading both of your testimonies, I don't see a consensus conclusion about what we should do. In fact, I don't even see agreement on whether we should do fundamental reform within our system or fundamental reform within a whole new system of taxation.

With no clear recommendation from the Administration, do you think Congress can overhaul our corporate tax system within the next 3 months? How about with an election coming up? Do you think this is doable within a year?

Mr. HUBBARD. Sure. Why not? No. Going to your question in two parts. On corporate inversions. Inversions, of course, are an important question, slightly different question than was the subject of the hearing today. Inversions raise the important topic that the Tax Code itself has sufficient problems that lead to tax strategies that we would all wish were not there. I think solution there is to fix the Tax Code. The Treasury Department has made a very concrete suggestion there.

As to the issue of overhauling the Tax Code within the next 3 months, as I was suggesting to Mr. Ryan earlier, I think that having a very short-term discussion on fundamental tax reform is not likely to produce a quick answer for you on FSC ETI. What you might want to do is consider reforms that are consistent with a variety of fundamental tax reforms, but also help in the FSC ETI. There are several roads you could take; I know that the Committee is exploring.

Mr. NEAL. In your previous presentation, you used the term "best tax policy," and you spoke about winners and losers. Would you agree that those who are currently winning think that is the current system is the best tax policy?

Mr. HUBBARD. Well, I was speaking from the point of view of the national interests. In other words, if one's objective in tax policy were to have the most efficient tax system so our economy as a whole is doing the best, that is what, from an economic perspective, would be the best tax policy? There are any of a number of winners in any particular tax policy, but overall for the country, what is best is what is in the national interest.

Mr. NEAL. You think that is going to happen?

Mr. HUBBARD. Well, of course, what we would look for is the best possible tax policy, as I am sure you would on the Committee.

Mr. NEAL. Let me just refresh your memory, if I can, for a second here. The Majority Leader, upon taking office in 1994 said that we were going to change the tax system, fundamentally. The former Chairman of our Committee here, a good friend of mine, and if I can just give you the rhetoric of the time, because we listen to it here patiently, said, "We were going to pull the Tax Code up by its roots, we were going to drive a stake into the heart of the tax system."

He said we were all going to a long funeral procession for the tax system. Now, I ask you, Mr. Hubbard, what evidence do you have during the last 8 years that supports the suggestion today that we are about to radically reform the tax system at the same time allowing an opportunity for these companies to continue to move to

Bermuda? While we have this academic discussion, here they are sneaking out of town in the dark of night?

Does the Administration support these companies moving to Bermuda?

Mr. HUBBARD. Well, first again, let me cut to the premise of your question. We have suggested a very concrete way to go at that. It does not require fundamental tax reform. It exposes the need for fundamental tax reform. There are certainly ways to deal with corporate inversions. I just remind you of the issue of tax reform generally; 1986, which was a landmark tax reform, was many, many years in the making. There was part of my earlier answer to you. Tax reform doesn't happen overnight, you are quite right.

There is much that we can do, both for inversions and in FSC ETI area that is consistent with tax reform and doable by you very quickly.

Mr. NEAL. With the exception of what Mr. McCrery has done here to help us out in this discussion, I don't recall the Committee having done a heck of a lot over the last 6 years about structural tax questions.

Let me just ask. Does the Administration support those companies, agree with these companies sneaking out of town in the dark of night and moving to Bermuda?

Mr. HUBBARD. The question from the perspective of the Administration and what the Treasury Department has helpfully suggested, is that we want to make sure that we fix the problems in the Internal Revenue Code that lead to this kind of behavior.

We do believe that headquartering in the United States is a plus for the economy, and we want to make sure that we don't have a Tax Code that is biasing companies from wanting to do business in the United States.

Mr. NEAL. Mr. Hubbard, let me give you a third opportunity. Does the Administration support these companies moving to Bermuda—and I will use my previous suggestion—in the dark of night?

Mr. HUBBARD. Rather than wishing the problem away, Congressman, what the Administration wants to do is to suggest a concrete proposal, and did, to remove the economic incentive for such transactions.

Mr. NEAL. Mr. Hubbard, I understand the talk of economists, vague as it can be. Yes or no?

Mr. HUBBARD. The Administration supports the fixes in the Internal Revenue Code that would not provide the incentive for the behavior you want. You simply can't wish away activities.

Mr. NEAL. I guess, then, in terms of economic nomenclature, yes and no don't exist. Thank you, Mr. Chairman.

Chairman MCCRERY. You are welcome. I will say to my good friend from Massachusetts that I don't think we should condone that.

Mr. NEAL. Mr. Chairman, I know you don't.

Chairman MCCRERY. I don't think the Administration does.

Mr. NEAL. Well, they could have said that.

Chairman MCCRERY. They have.

Mr. NEAL. Mr. Hubbard, do you want to say that?

Chairman MCCRERY. They have said that.

Mr. HUBBARD. I believe we actually put out a specific and concrete proposal.

Mr. NEAL. Do you want to say no, Mr. Hubbard?

Mr. HUBBARD. We put out a specific——

Mr. NEAL. You don't agree with this. Do you want to say that?

Chairman MCCRERY. Mr. Neal, I am reclaiming my time.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman MCCRERY. The Administration has been very helpful, the Treasury Department has been very helpful in coming up with a very specific list of suggestions which would not prevent but certainly discourage companies from doing that. I think it is very constructive, and I think we will find, you and I and others, when we get further along into this that we might be able to put together a nice little package on inversions and on ETI that would make a lot of sense in terms of restructuring our international tax provisions, It would solve the problem that you are concerned about, that I am concerned about and would, I think, not make everybody happy that is getting ETI now, but get us a long way down the road to having a system that makes a lot more sense for our multinational companies.

Mr. NEAL. Mr. Chairman, would you yield for a brief question?

Chairman MCCRERY. Sure.

Mr. NEAL. Would it be possible for you to ask Mr. Hubbard if the answer is yes or no to the question I raised?

Chairman MCCRERY. Well, I will say that in my discussions with the Administration and based on their cooperation and suggestions through the Treasury Department, it is clear to me that the Administration thinks that the practice of companies moving offshore to reduce their tax burden is not a desirable outcome for the U.S. economy. They are trying very hard to work with us to restructure our tax provisions so that those things don't happen. That is the best answer you are likely to get out of them.

Mr. NEAL. Mr. Chairman, would you yield for one quick comment? Now, I understand why the framers of our Constitution decided to separate the executive branch from the legislative branch. You have really cleared that up. Thank you.

Chairman MCCRERY. Let me say for the record, I do appreciate the cooperation we are getting from the Treasury Department and the expertise we are getting from the Treasury Department on the question of inversions and on this very complex question of the ETI and approaches to solving that.

Now I would like to turn to Mr. Lewis.

Mr. LEWIS. Thank you, Mr. Chairman. Ms. Angus, has the Treasury Department studied the effects of the Tax Code on the international shipping industry?

Ms. ANGUS. We have not studied, those effects, although certainly I think that is something that we ought to be looking at as we talk about some of the aspects of our subpart F rules and the ways that the U.S. subpart F rules operate to impose current taxation on active business income earned abroad when the aim of the provisions is at passive income. That is something that is a real concern, and one of those areas is the treatment of shipping.

We have talked a little bit about the need to look to the tax approaches of our major trading partners. When we look to other countries, none of our major trading partners treat shipping income in the same way that the U.S. tax rules treat shipping income. Certainly the evidence that has been presented about the changes in the U.S. shipping industry recently are dramatic and that is something that we ought to look at very carefully.

Mr. LEWIS. What has actually happened to the U.S. controlled shipping interests?

Ms. ANGUS. Well, I am not an expert on the shipping industry. I believe you actually have a witness that will be talking about that. Certainly from reading that testimony in preparation for this hearing, there has been a significant change in the shipping industry over the last decade or so, and that is something that we ought to look at very carefully.

Mr. LEWIS. Well, it is evident it has had a very devastating effect to the shipping industry. So, I hope that will be something that you will look at. Thank you.

Chairman MCCRERY. Thank you, Mr. Lewis. Mr. Foley.

Mr. FOLEY. Thank you very much, Mr. Chairman. I feel somewhat compelled to at least respond to the gentleman from Massachusetts relative to this Committee's endeavor on tax relief. There is no question since I have been in Congress in 1994 and joined this Committee in 1998, we have endeavored to try and straighten out the complexities of the Tax Code. We have tried to eliminate estate taxes, we have reduced capital gains taxes. We are on the Floor debating marriage penalty elimination.

Almost every one of these measures has been universally met with opposition from the minority. Virtually every trade agreement we try to enunciate with world partners is met with a stunning rejection of the minority party. So when there are companies leaving, which I do not agree or support, they may be leaving because this Committee and the minority have obstructed the ability to give clear signals to the business community that we are, in fact, serious about trying to retain the best and brightest corporations in this country. The Senate rejected yesterday the ability to provide estate tax relief.

Now, I know the Administration does not support the exodus of corporations offshore. I can answer that question for the Treasury Department, and I will for the President.

Mr. NEAL. Gentleman yield?

Mr. FOLEY. Absolutely.

Mr. NEAL. If you can answer it for them, why can't they answer it for them?

Mr. FOLEY. They may not be here to answer that specific question. But let me speak——

Mr. NEAL. That was clearly——

Mr. FOLEY. I reclaim my time. The Treasury Department—many times when we were sitting here listening to Mr. Rubin they wouldn't answer direct questions posed by this Committee either. Mr. Rubin is probably one of the most talented men I have met in my time in this process, but we were met with stone-faced silence when we asked him about capital gains. In fact, he said to this Committee they not only didn't support it, didn't think it was appropriate, were going to cause deficits to soar and, to the contrary, we saw economic stimulus. So, even when they did answer on occasion their answers proved to be false.

I think what we need to do is look at the problems we place before domestic companies, and I think this is systemic of the problems and the complexities of the Tax Code. I would work tirelessly with the Democratic leadership if they choose in fact to show a welcome attitude toward our domestic corporate partners on some of these global issues that we face because we are in a global world.

There is an issue, Ms. Angus, I would like to inquire about relative to software. Their rents and royalties from software transactions should be considered active income and exempt from subpart F. Do you share that thought?

Ms. ANGUS. I think it is fair to say that the treatment of software under our subpart F rules in particular raises a number of difficult issues, and some of them arise from the fact that our subpart F rules do date back to the sixties. So, we have got rules that are now covering transactions and a technology that wasn't contemplated at the time that they were written.

Over recent years Congress has been grappling with the application of the subpart F rules to the financial services industry and making some changes to modernize those rules as the financial services industry became more global, and I think those same issues need to be addressed in this industry as well. It is an industry that is obviously new relative to when the rules were written and also an industry that has become increasingly global. So we do need to take a hard look at our rules, subpart F in particular, but also other aspects of international rules to make sure that they are properly characterizing these transactions.

Some of these transactions in the software area are fairly complex and there may be several different forms in which a transaction can be done and the subpart F may give a different answer depending on which form is done. That doesn't make sense when the transactions are all economically equivalent. So, it is an area that needs a careful look.

Mr. FOLEY. It seems though we are very late in coming to the table on some of these more complex issues. The dynamics of those business models seem to be thriving and yet we are slow to catch up with their technology.

Ms. ANGUS. I would agree that it is fair to say that the U.S. tax rules and the international rules in particular have not kept up with the changes in our economy, and that is why we do need to take a careful relook at these rules so that they aren't out of step with the way that business is done in today's global economy.

Mr. FOLEY. Thank you very much. I yield back.

Chairman MCCRERY. Thank you, Mr. Foley. Mr. Doggett is not a Member of the Subcommittee, but he is a Member of the full Committee, and he is with us this morning.

Mr. DOGGETT. Thank you very much.

Chairman MCCRERY. If you would like to inquire of the witnesses, please proceed.

Mr. DOGGETT. Appreciate it, Mr. Chairman. Ms. Angus, I know that in the Treasury Department report there was a recommendation to take a look at section 163(j) of the Tax Code. Is it your belief that section 163(j) should be amended?

Ms. ANGUS. Yes, and in fact at the hearing last week we proposed some very specific amendments to revise those rules in order to address concerns about the ability for foreign based companies to use debt as a form of shifting income out of the United States and reducing their tax on income that would otherwise be subject to U.S. taxes.

Mr. DOGGETT. So whatever else, this Committee does on a short-term or a long-term basis, one thing it most certainly should do is to amend section 163(j), and do it now.

Ms. ANGUS. We certainly do believe that it is important to address the section 163(j) issue immediately.

Mr. DOGGETT. Isn't it true that section 163(j) would only capture interest payments and not royalty fees?

Ms. ANGUS. Section 163(j) is focused on interest payments. In the proposals that we made last week and in the issues that were discussed in our study from last month, we also talked about the need to take a careful look at our transfer pricing rules and in particular——

Mr. DOGGETT. I hope we have time to get into that because I am very interested in that issue also. Closing the—you don't really close it, but changing section 163(j) will get to interest payments. It does not get to royalty payments, correct?

Ms. ANGUS. No. We need to look at the transfer pricing rules to address the royalty payments. There are very difficult issues that arise there and something that——

Mr. DOGGETT. Section 163(j) won't address transfer pricing or royalty payments, correct?

Ms. ANGUS. Right, which is why we have——

Mr. DOGGETT. Have your other recommendations——

Ms. ANGUS. Need to work in that area.

Mr. DOGGETT. Your recommendation on those matters relates more to study than changing a statute now?

Ms. ANGUS. No, I wouldn't describe it that way because we indicated that we were going to work immediately to look at our transfer pricing rules. The transfer pricing rules are based on an arm's-length standard. We do believe that that is the standard that is an appropriate economic standard. There are very difficult issues that arise in applying that, particularly in the case of transfer of intangibles. So, we need to take an immediate look at our rules and to work with the Internal Revenue Service (IRS) on enforcement practices to make sure that those rules are operating correctly.

Mr. DOGGETT. I believe the other area that Ms. Olson actually mentioned in her testimony before the full Committee are our tax treaties because there has been exploitation of our tax treaties, has there not, in this area?

Ms. ANGUS. There have been some issues that have arisen under some of our tax treaties and, as Ms. Olson indicated in her testimony last week, we intend to take a comprehensive look at our tax treaties. The purpose of our network of tax treaties is to eliminate double taxation. We need to make sure that that is what our treaties do and that they don't serve to eliminate all taxation together. If there are instances where they operate that way, we need to address that.

Mr. DOGGETT. That would be a—when you say address it, it would be through renegotiation, which could take several years with the dozens of tax treaties that we have.

Ms. ANGUS. Well, I think we need to identify the treaties where there are particular problem areas and address those immediately and obviously focusing on the places where these issues arise.

Mr. DOGGETT. There is no doubt, as indicated in the prospectus for Stanley Works and the claims of reduced tax savings, that it was concerned not only about reducing any double taxation that may occur on its international operations but to reduce taxes on its American-based operations also. Isn't that correct?

Ms. ANGUS. That is exactly the issue that we think needs to be addressed through changes to section 163(j). The transactions that you can do through creation of debt that allow you to reduce the U.S. tax on income earned in the United States that would otherwise be subject to U.S. tax is something that we need to deal with.

Mr. DOGGETT. Let me just ask then in closing, so it will be in the record, that I want to renew my request from February 27, when you testified, and asked you for the names of the members of the 877 Coalition and the Coalition of Corporate Taxpayers which you represented to preserve tax shelters. I would renew that request. I know it is pending in the—before you and the Treasury Department, but would ask you to supply that information.

I thank you for your testimony.

Chairman MCCRERY. Thank you, Mr. Doggett. That was very nice. Excellent questions, and I want to thank all the Members of the Subcommittee for your excellent questions. I do think we share a common goal here to get something done in the international field, and again I appreciate the cooperation of the Administration and thank you for your excellent testimony and responses to questions. We will welcome you back, I am sure, at a later date. Thank you.

Now I would call up our final panel, the Honorable William A. Reinsch, the President of National Foreign Trade Council; Dan Kostenbauder, General Tax Counsel for Hewlett-Packard, Palo Alto, California, on behalf of AeA; Gary McLaughlin, Senior Director, International Tax, Wal-Mart Stores, Inc., Bentonville, Arkansas, on behalf of the International Mass Retail Association; Gary D. Sprague, Partner, Baker & McKenzie, from Palo Alto, California, on behalf of the Software Industry Coalition for Subpart F Equality; Robert Cowen, Senior Vice President and Chief Operating Officer for Overseas Shipholding Group, New York; Doug Parsons, President, Excel Foundry and Machine, Inc., Pekin, Illinois, on behalf of the National Association of Manufacturers; and Scott Newlon, Managing Director of Horst Frisch.

I am sorry if I mangled any of those names. I hope I got close. Welcome, everybody. Thank you for coming today to try to help us sort through this quagmire of international tax complexity.

Mr. Reinsch. Is that how you pronounce your name?

Mr. REINSCH. Yes, it is. Well done, Mr. Chairman.

Chairman MCCRERY. Thank you. We will begin with you. Your full written testimony will be entered into the record, but we would ask you to summarize that if you could in about 5 minutes. You may begin.

STATEMENT OF THE HON. WILLIAM A. REINSCH, PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL, AND FORMER UNDERSECRETARY FOR EXPORT ADMINISTRATION, U.S. DEPARTMENT OF COMMERCE; ACCOMPANIED BY LABRENDA GARRETT-NELSON, PARTNER, WASHINGTON COUNCIL ERNST & YOUNG

Mr. REINSCH. Thank you, Mr. Chairman. This is the first time I have been able to testify before this Subcommittee, and it is an honor to be with you. I am Bill Reinsch. I am President of the National Foreign Trade Council (NFTC), founded in 1914. The NFTC is an association of businesses with some 400 members. It is the oldest and largest U.S. association of businesses in support of open rules based trade.

The NFTC FSC/ETI Coalition, which is composed of many of the companies currently using FSC/ETI, has developed a conceptual draft of a proposal of modifications to the Tax Code that combined with the repeal of the ETI regime we believe will bring the United States into compliance with its international trade obligation as well as ensuring that U.S. exporters are not disproportionately disadvantaged. I would like to describe those concepts underlying the proposal briefly, and I would ask, Mr. Chairman, that a copy of the Coalition's entire draft proposal be inserted into the record.

Chairman MCCRERY. Without objection.

Mr. REINSCH. Thank you very much. The Coalition does not believe that an appropriate response to the WTO decision would be to simply repeal ETI, which we believe would have an adverse impact on the international competitiveness of domestic exporters and threaten thousands of American jobs.

Our proposal is a conceptual draft. It is not a finished legislative document. We have already begun to meet with Members of the Committee, and we are ready to work with all of you on further improvements in it. We have worked very hard on it, and we believe that it comes close to ensuring that as many companies as possible approach the level of their current ETI tax benefits. No company, however, would obtain a greater benefit than under current law because our proposal includes an overall cap.

We also believe that our proposal meets the stringent test of WTO compliance, although we expect that whatever resolution Congress comes to will ultimately be subject to discussions or negotiations with the European Commission. We believe our proposal would be a good basis for those discussions.

Our proposal has four parts. First, it would permit taxpayers to exclude from U.S. tax foreign source income earned by U.S. taxpayers in export transactions. We believe that this concept complies with the appellate body rulings in the FSC/ETI case that the fifth sentence of Footnote 59 of the Agreement on Subsidies and Countervailing Measures permits a WTO member state to adopt the measure taken to avoid the double taxation of foreign source income. The exclusion would apply to foreign source income from property sold, leased, or licensed for direct use outside the United States and income from services as a commissioned agent in connection with the sale, lease, or license of property for export. The proposal would have—the property would have to be manufactured or produced in the States for final disposition outside the United States.

The second part of our proposal would restrict the scope of subpart F in a manner that would partially conform to the less stringent anti-deferral rules adopted by the countries, including member states of the Commission, which countries generally apply anti-deferral regimes only to passive investment income earned by foreign subsidiaries. This proposal would eliminate the provisions that define subpart F income to include foreign based company sales income.

The proposal also would exempt a portion of the Foreign Base Company Source Income from U.S. tax as permitted by Footnote 59 and permit the tax free transfer of a limited category of associated marketing intangibles to control foreign corporations under section 367(d). No foreign tax credits would be allowed for taxes associated with income exempted under this proposal.

The third part of our proposal, Mr. Chairman, retains ETI-like benefits for a limited category of qualifying international transportation property such as aircraft, rolling railroad stock, vessels, motor vehicles, containers, orbiting satellites, and other property used for international transportation purposes. Although these transactions qualified for ETI treatment under the predominant use test of existing law, they are not considered exports under trade law and therefore should not be considered, in our judgment, to be contingent on export performance within the meaning of the agreement on subsidies.

Finally, in our proposal, in order to provide some level of tax benefits for direct exporters, we have developed a wage tax credit for manufacturers of qualifying property based on the wages paid to employees producing the qualifying property. The credit would be 1 percent of qualifying wages.

In closing, Mr. Chairman, I would like to reiterate that our proposal is conceptual and not a finished legislative package. We continue to review it and work on it, and we welcome the opportunity to work with you and the other Members of the Committee as you decide how you want to proceed. Thank you.

[The prepared statement of Mr. Reinsch follows:]

Statement of the Hon. William A. Reinsch, President, National Foreign Trade Council, and former Undersecretary for Export Administration, U.S. Department of Commerce

Chairman McCrery, Ranking Member McNulty and distinguished Members of the Subcommittee.

My name is Bill Reinsch and I am the President of the National Foreign Trade Council (NFTC). The NFTC, founded in 1914, is an association of businesses with some 400 members. It is the oldest and largest U.S. association of businesses devoted to international trade matters. Its membership consists primarily of U.S. firms engaged in all aspects of international business, trade, and investment. Most of the largest U.S. manufacturing companies are NFTC members. The NFTC's emphasis is to encourage policies that will expand open trade and U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities and anomalies.

Thank you for holding this important hearing on the WTO Appellate Body (AB) ruling, *United States—Tax Treatment for "Foreign Sales Corporations"—Recourse to Article 21.5 of the DSU by the European Communities*. According to the Hearing Advisory, the focus of the Subcommittee hearing is to "consider proposals to modify the

Tax Code in ways which promote the competitiveness of U.S. companies while respecting our intentional obligations under the WTO." [1]

The NFTC FSC/ETI Coalition [2] (the Coalition) has developed a conceptual draft of a unitary proposal of modifications to the Tax Code that, combined with a repeal of the ETI regime, we believe will bring the United States into compliance with its international trade obligations as well as ensuring that U.S. exporters are not disproportionately disadvantaged. I would like to focus my testimony on describing the concepts underlying the proposal and the need to take a holistic approach to any legislative changes to promote the competitiveness of U.S. exporters, as illustrated by the NFTC's unitary proposal. With your permission, I would ask that a copy of the Coalition's conceptual draft of a unitary proposal be inserted into the record.

Introduction

I. Historical Background

The Tax Code has provided explicit tax incentives for U.S. exporters since 1971 with the enactment of the Domestic International Sales Corporation (DISC) regime. The DISC provisions were designed to restore the competitiveness of U.S. exporters hampered by the 1962 enactment of the Subpart F rules. The DISC was successfully challenged by the Europeans at the General Agreement on Tariffs and Trade (GATT), the predecessor organization of the WTO. Relying on a 1981 "Understanding" reached in the DISC case, the United States enacted the Foreign Sales Corporation (FSC) tax provisions in 1984. After a string of WTO losses, the European Commission ("Commission") filed a WTO challenge against the FSC in 1997; both the WTO Panel and Appellate Body ruled that the FSC was a prohibited export subsidy.

Accordingly, the United States enacted the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (P.L. 106–519) (the "ETI" regime). The ETI regime, while enacting a new general rule that excluded extraterritorial income, closely tracked the tax benefits available to American exporters through the FSC. The Commission immediately brought a WTO challenge against ETI. In August of last year, a WTO Panel upheld the Commission's claim and, after the United States appealed this decision, the WTO Appellate Body affirmed the panel decision (while substantially refining the legal reasoning underlying the ruling). In essence, the case turned on the fact that WTO rules prohibit the rebate of direct taxes on export transactions, although rebates of indirect taxes on exports are permitted.

The United States and the Commission are currently awaiting an arbitration panel's decision regarding the appropriate level of sanctions the Commission will be authorized to charge U.S. exports, with the Commission having argued for a $4.043 billion figure and the United States maintaining that the appropriate amount is in the neighborhood of $1.1 billion. The WTO arbitration panel's ruling giving the Commission the legal authority to impose sanctions on U.S. exports is expected on June 17.

II. The NFTC Conceptual Unitary Proposal

Having briefly considered the historical background and policy underpinnings of the FSC/ETI issue, it is clear that this Committee has long been cognizant of the need to ensure that our tax system does not unfairly penalize U.S. businesses, especially vis-á-vis our foreign competitors. The Coalition does not believe that an appropriate response to the WTO ETI decision would be to simply repeal ETI—in effect, a tax increase on American exporters. Such a result would have an adverse impact on the international competitiveness of domestic exporters, threatening thousands of American jobs.

The Coalition supports compliance with America's international trade obligations. We stand ready to work with the Administration and the Congress, on a bipartisan basis, to find a solution that brings the United States into compliance with the WTO ruling. The unitary proposal I will describe, supported by a broad array of America's leading exporters, provides a set of legislative recommendations that would preserve U.S. jobs, promote the international competitiveness of U.S. corporations, and enable the United States to fulfill its WTO obligations.

As indicated previously, the Coalition's proposal is a conceptual draft—we do not view our package as a finished legislative document. We stand ready to work with

[1] Ways and Means Committee Advisory Number SRM–7.

[2] The NFTC FSC/ETI Coalition is a broad-based group of companies with varying business models representative of typical FSC/ETI users. Companies in the Coalition employ thousands of Americans in high-paying export related jobs.

the Members of this Committee to improve the ideas contained in our document and assist in the development of legislation.

I also would like to stress that the Coalition views this package as a unitary proposal. Since our coalition runs the gamut from pure exporters to broad-based multinational corporations, not all of the provisions benefit every company. In fact, some companies may only benefit from one of the provisions. We have worked very hard on the proposal and believe that it comes very close to ensuring that as many companies as possible get close to their ETI tax benefits. No company, however, would obtain a greater benefit under our proposal than under current law because our proposal contemplates the adoption of an overall cap on the tax benefits provided by any combination of the proposals.

The Coalition developed these provisions with a careful eye on the WTO case law and with the understanding that any legislative package must be WTO-compliant. We believe that the unitary proposal meets that stringent test. As Ways and Means Committee Members, you have had this issue you before you several times and, understandably, will want assurances that the legislative package you adopt will put this matter to rest, once and for all. This level of confidence in the WTO-legality of a replacement package can be achieved through discussions or negotiations with the Commission. The Coalition believes that our unitary proposal would serve as a good basis for these discussions with the Commission.

Discussion

Recognizing the diverse nature of American exporters, the NFTC's conceptual draft of a unitary proposal takes a four-pronged approach: (1) implement the exception to the prohibition on export subsidies for measures to avoid double taxation, in the case of income derived from certain sales, leases, and licenses of property; (2) repeal certain exceptions to the general rule of deferral for active business income derived by U.S.-controlled foreign corporations ("CFCs") from foreign sources; (3) enact an exemption for a limited category of transactions that are WTO-permissible; and (4) provide a new wage-based tax credit of general application.

I. A Measure to Avoid Double Taxation

Conceptually, a legislative response could target exports in the context of a measure to avoid double taxation of foreign-source income.

This proposal would permit taxpayers to exclude from U.S. tax (up to prescribed limits) all foreign-source income earned by U.S. taxpayers in export transactions. We believe that this concept complies with WTO rules, as interpreted by the January 14, 2002 Appellate Body ruling in the FSC–ETI case. The Appellate Body ruled that the fifth sentence of Footnote 59 of the Agreement on Subsidies and Countervailing Measures (the "SCM Agreement") permits a WTO member state to adopt a measure taken to avoid the double taxation of foreign-source income (the "Footnote 59 exception").[3]

The exclusion would apply to foreign-source income from property sold, leased, or licensed for direct use outside the United States, and income from services as a commission agent in connection with the sale, lease or license of property for export. The property would be required to be manufactured or produced in the United States for final disposition outside the United States.

The foreign-source income eligible for exclusion would be calculated using arm's length pricing methods (ensuring that only was foreign-source—and no U.S.-sourced—income is excluded). In addition, the provision would require that the definition of foreign-source income qualify under widely recognized international norms of taxation, as prescribed by the WTO Appellate Body.

Finally, the proposal would allow taxpayers to treat excluded foreign-source income as previously taxed income ("PTI") when received from a controlled foreign corporation (CFC).

II. Subpart F Modifications

Conceptually, the United States remains free to amend any of its general rules for the taxation of income earned abroad; the applicable WTO agreements would not prevent the United States from amending rules of general application in a manner that could benefit exporters, among other taxpayers.

[3] *United States—Tax Treatment for "Foreign Sales Corporations"—Recourse to Article 21.5 of the DSU by the European Communities*, at ¶ 132.

The general rule under U.S. tax law provides for unlimited deferral of U.S. tax on business profits earned abroad through CFCs. Such income is subject to tax when it is distributed to the U.S. in the form of dividends or other transactions. The "subpart F" anti-deferral regime is an exception to the general rule of deferral and results in the imposition of a current U.S. tax. The proposal would restrict the scope of subpart F in a manner that would partially conform to the less stringent anti-deferral rules adopted by other countries (including member states of the Commission), which countries generally apply anti-deferral regimes only to passive investment income earned by foreign subsidiaries.[4]

The Congress defined subpart F income to include "foreign base company sales income" and "foreign base company services income" (collectively, "FBCSI"), in part to stop domestic corporations from shifting income to foreign subsidiaries through "artificial arrangements between parent and subsidiary regarding intercompany pricing."[5] The precursor of ETI, the DISC, was designed to restore the competitiveness of U.S. exporters hampered by the enactment of the FBCSI rules. The current state of U.S. transfer-pricing law and administration (including the globalization of transfer pricing enforcement) calls into question the continued need for subpart F to serve as a backstop to the transfer-pricing rules.[6]

This proposal would eliminate the provisions that define subpart F income to include FBCSI. Very generally, FBCSI refers to related-party transactions in which income is earned by a CFC outside of its country of incorporation. Unlike most other definitions of Subpart F, FBCSI constitutes active business income (not passive income).

The proposal also would exempt a portion of income that would be defined as FBCSI from U.S. tax (as permitted by Footnote 59), and permit the tax-free transfer of a limited category of associated marketing intangibles to CFCs under Section 367(d). No foreign tax credits would be allowed for taxes associated with income exempted under this proposal. In conforming amendments, the proposal would clarify the extent to which royalty and rental income qualifies for the "active rents and royalties exception" to subpart F.

III. International Transportation Property

Conceptually, property that qualifies for ETI tax treatment under the "predominant use" test of current, but that is not a Trade-Law Export, should not be considered to be contingent on export performance within the meaning of the applicable WTO agreements.

This proposal envisions retaining ETI-like benefits for a limited category of qualifying "international transportation property." Sales and leases of qualifying property to U.S. companies for predominant use outside the United States are not considered exports under international trade law norms. International transportation property includes aircraft, railroad rolling stock, vessels, motor vehicles, containers, orbiting satellites and other property used for international transportation purposes (including engines, components and spare parts).

Although these transactions qualify for ETI tax treatment under the "predominant use" test of existing law, they are not considered exports under trade law and, therefore, should not be considered to be contingent on export performance within the meaning of the Agreement on Subsidies.

IV. Wage Tax Credit

Conceptually, consideration could be given to the development of legislation that might benefit broad classes of taxpayers of a type that currently utilize the ETI regime (e.g., small exporters) without requiring exportation.

As indicated previously, the Coalition is comprised of a broad cross-section of U.S. companies, including "direct exporters," U.S. taxpayers that sell to unrelated foreign businesses but whose activities are (for the most part) located in the United States. Similarly, many farmers receive ETI benefits for the agricultural products they export overseas. They currently qualify for ETI benefits but would not obtain any tax benefits from modifications to U.S. international tax rules if they have no overseas operations.

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[4] *See* National Foreign Trade Council, Inc., International Tax Policy for the 21st Century, Part One: A Reconsideration of Subpart F (December 15, 2001), for a discussion of the subpart F rules and a summary of several other CFC-like regimes.

[5] *See* S. Rep. No. 1881, 87th Cong., 2d Sess. 78 (1962) (quoting a message from the President).

[6] *See* the discussion of this issue beginning on page 65 of the NFTC Foreign Income Project: International Tax Policy for the 21st Century, Conclusions and Recommendations (December 15, 2001).

In order to provide some level of tax benefits for direct exporters, the Coalition has developed the concept of a wage tax credit. The proposal envisions the creation of a tax credit for manufacturers of qualifying property based on the wages paid to employees producing the qualifying property. The credit would be 1% of qualifying wages. As mentioned previously, the credit proposal (as well as all of the other provisions of the unitary proposal) would be subject to an overall combined cap on benefits to ensure that a taxpayer did not receive greater benefits under the wage credit than under current ETI benefits.

Conclusion

In closing, I would like to again thank the Subcommittee for the opportunity to testify on behalf of the NFTC FSC/ETI Coalition and explain the concepts underlying our unitary proposal. As I indicated earlier, our proposal is a conceptual paper and should not be considered a finished legislative package. Crafting legislation that replaces the ETI regime and complies with our WTO obligations while ensuring the competitiveness of American exporters is a very challenging task. The Coalition would like to assist you in that endeavor and believes that our conceptual draft of a unitary proposal could serve as a useful starting point as the Committee begins this legislative process. I would be happy to answer any questions you may have.

APPENDIX
April 30, 2002

NFTC FSC–ETI COALITION

DRAFTING SPECIFICATIONS FOR UNITARY PROPOSAL

EXECUTIVE SUMMARY

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

- It will take a considerable amount of time to develop and implement an appropriate response to the WTO decision in the FSC–ETI case, one that is likely to require some combination of negotiations with the European Commission and legislation.
- Accordingly, the NFTC FSC–ETI Coalition has developed preliminary drafting concepts, to facilitate the discussion of legislative options for addressing the resolution of the FSC–ETI dispute in a manner that brings the United States into compliance with its international trade obligations while maintaining the international competitiveness of U.S. exporters and workers.
- *Drafting Parameters*. The WTO decision AB Report precludes a legislative response that merely "tinkers" with the ETI regime, and thus, it will not be possible to replicate present law.
    - There is, however, a limited category of transactions for which ETI-like treatment should be maintained.
    - Also, and significantly, the WTO decision confirms the availability of an exception for legislation that targets exports in the context of a measure to avoid double taxation of foreign-source income.
    - Moreover, nothing in the WTO decision would prevent the United States from amending rules of general application in a manner that could benefit exporters, among other taxpayers.
- *Summary of Unitary Proposal*. The unitary proposal is premised on the repeal of the ETI provisions, and includes all of the following elements:
    - *Footnote 59 Exception*.—Implementing the recognized exception to the prohibition on export subsidies for measures to avoid double taxation, by excluding from U.S. tax (up to prescribed limits) foreign-source income earned by U.S. taxpayers in export transactions. The exclusion would apply to income from property manufactured within the United States and sold, leased, or licensed for direct use, consumption or disposition outside the United States, and income from services as a commission agent in connec-

tion with a sale or license of property for export or otherwise related and subsidiary to a sale, lease, or license of property for export.

- *Subpart F Modification*.—Repealing certain exceptions to the general rule of deferral for active business income derived by U.S.-controlled foreign corporations ("CFC(s)") from foreign-sources sales and services in a manner that would partially conform to the less stringent anti-deferral rules adopted by other countries (including EC member states). The general rule under U.S. tax law provides unlimited deferral of U.S. income tax on business profits earned abroad through CFCs. Deferral results from a basic structural feature of the U.S. system, namely, the treatment of a corporation and its shareholders as separate taxpayers. The anti-deferral regime of "Subpart F" is an exception to the general rule of deferral. The proposal would restrict the scope of Subpart F by repealing the provisions that define subpart F income to include "foreign base company sales income" and "foreign base company services income." The proposal would also exempt a portion of such foreign-source earnings from U.S. tax (as permitted by the recognized exception for foreign-source income).
- *WTO-permissible Transactions*.—Enacting an exemption for a limited category of transactions that are WTO-permissible because they are not exports under international norms.
- *Wage-based Tax Credit*.—Providing a new wage-based tax credit of general application, for taxpayers engaged in businesses in specified North American Industrial Classification System (NAICS) industry codes.

- To constrain the revenue effect to the current law cost of ETI, the unitary proposal contemplates that an overall cap would be imposed on the benefits that could be obtained by use of any combination of the individual proposals.

Chairman MCCRERY. Thank you, Mr. Reinsch. Mr. Kostenbauder, is that close?

Mr. KOSTENBAUDER. Yes, very good.

Chairman MCCRERY. Very good. Thank you. I think your microphone needs to be turned on.

Mr. KOSTENBAUDER. There we go. Thank you.

Chairman MCCRERY. Thank you.

STATEMENT OF DANIEL KOSTENBAUDER, GENERAL TAX COUNSEL, HEWLETT-PACKARD COMPANY, PALO ALTO, CALIFORNIA, ON BEHALF OF AeA

Mr. KOSTENBAUDER. Thank you, Mr. Chairman. I appreciate the opportunity to be here today on behalf of Hewlett-Packard (HP) Company. HP is based in Palo Alto, California. We have over half of our revenue from outside of the United States, so that means that we are both an exporter, and we care greatly about the treatment of U.S. companies by the international provisions of the Tax Code. I am also appearing on behalf of AeA, formerly the American Electronics Association, which has about 3,500 members, and a great number of these companies have global markets for their high tech electronics products. So again, they are both exporters and care deeply about the treatment of U.S. companies with respect to their international activities.

We appreciate very much your having these hearings, looking at both the big picture of international reform and possible approaches to improving the U.S. tax system as well as more specific, focused possibilities, and we have some thoughts today on those. We think that the provisions and the legislation you are about to work on should help exporters and should also help the competitiveness of U.S. companies in international markets.

The AeA has four specific proposals that we would recommend to your attention. One is to repeal the foreign base company services income and foreign base company sales income provisions. Another would be to remove active software rents and royalties from the subpart F provisions. In the foreign tax credit area, we recommend extending the foreign tax credit carryforward period from 5 to 10 years, and eliminating the restriction on using foreign tax credits to offset the alternative minimum tax (AMT). Today they are limited to offsetting only 90 percent of the AMT, and we would propose that in pursuit of the principle of avoiding double taxation, that corporations should be permitted to offset 100 percent of the AMT with foreign tax credits.

Let me make just a very quick review of the international tax system for the United States. We, as you all know, tax on a worldwide basis. The tax on active income earned by controlled foreign corporation (CFC) subsidiaries of U.S. companies is generally deferred until there is a distribution of those earnings. Subpart F, a very complex provision, provides exceptions to that deferral, which means immediate U.S. taxation of some aspect of international activity. Certainly the passive income rules are well accepted and very standard in most countries' international tax systems. The United States, however, has a far more robust subpart F, and that is one of the reasons we are suggesting the repeal of these base company rules.

Let me briefly describe what these base company rules are. Foreign base company income generally includes sales income that is earned by a controlled foreign corporation in a country that neither manufactures or sells property and which it purchases from or sells to a related party. The service company rules are similar. When I think of these base company rules, and nobody in the world uses the word "base company" except in the context of subpart F, I think of the words "trading company." The key things you look for are a transaction with a related party and a transaction outside the country of its incorporation. If you have both of those, generally that is what we are talking about. Is this a tax dodge or does this make sense? Let me give you an example.

If you had a company with 10 factories and 10 sales companies all outside the United States and if all the factories were going to sell to all the sales companies, you have right there a hundred different sets of transactions, a hundred value-added tax registrations to comply with, lots of data processing systems, and lots of logistical challenges. The way companies short circuit all that extra work is to put a trading company, or a "base company," in the middle. Then all of the factories sell to one company and one company sells to all of the sales companies. Voila, you have 20 transactions, you have a lot better management, and that is what base companies are all about, whether it is sale of goods or sale of services. Notice, this is all related to normal active business.

One of the concerns and one of the reasons these base company rules have been in the subpart F for the last 40 years has been the concern about transfer pricing. Since 1962, the transfer pricing rules and their enforcement have been dramatically improved both in the United States and elsewhere. Also, repealing these base company rules would encourage exports to the extent that the United States is the factory that is manufacturing and selling to one of these trading companies that would have some subpart F imposed. Quite clearly, those transactions have an extra U.S. tax that would not otherwise exist with the repeal of the base company rules. So, there is a very direct relief from their repeal and then more broadly, to the extent that U.S. companies can organize themselves to compete better internationally, they will be more competitive. It is important to note that most exports of U.S. companies are actually to their foreign subsidiaries and probably to foreign trading companies that then distribute into foreign markets.

I will make one final comment, which is that removing those rules will greatly simplify the Tax Code and the operation of the Tax Code for taxpayers. So, the repeal of the base company rules will have that additional benefit.

Thank you.

[The prepared statement of Mr. Kostenbauder follows:]

Statement of Daniel Kostenbauder, General Tax Counsel, Hewlett-Packard Company, Palo Alto, California, on behalf of AeA

My name is Dan Kostenbauder, General Tax Counsel at Hewlett-Packard Company in Palo Alto, California. HP was founded in 1939. With our recent merger with Compaq Computer Corporation, the new HP is a leading technology solutions provider for consumers and businesses with market leadership in fault-tolerant servers, UNIX® servers, Linux servers, Windows® servers, storage solutions, management software, imaging and printing and PCs. Furthermore, 65,000 professionals worldwide lead our IT services team. Our $4 billion annual R&D 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.

I am appearing today on behalf of the AeA, formerly the American Electronics Association. Advancing the business of technology, AeA is the nation's largest high-tech trade association. AeA represents more than 3,500 member companies that span the high-technology spectrum, from software, semiconductors and computers to Internet technology, advanced electronics and telecommunications systems and services. With 18 regional U.S. councils and offices in Brussels and Beijing, AeA offers a unique global policy grassroots capability and a wide portfolio of valuable business services and products for the high-tech industry. AeA has been the accepted voice of the U.S. technology community since 1943.

Summary of Testimony

Repeal of the Extraterritorial Income Exclusion regime ("ETI") is a possible response to the World Trade Organization ("WTO") Appellate Body decision that ETI is a prohibited export incentive. If the ETI is repealed, then it should be replaced with tax legislation that clearly will comply with WTO rules. Such legislation should be designed to help those sectors of the U.S. economy that currently benefit from the ETI and to improve the competitiveness of U.S. based companies. If the timeframe for such legislation probably is too short to permit a complete review and reform of the international provisions of the U.S. tax system, AeA believes that a number of improvements can be made to today's rules that will be consistent with future efforts toward more comprehensive reform. AeA believes that reforms in the Subpart F and foreign tax credit areas would be good tax policy and very straightforward to adopt.

In particular, the AeA suggests that the following provisions should be among those that should be adopted upon repeal of the ETI:

1. Repeal the foreign base company sales income and the foreign base company services income rules under Subpart F,
2. Remove active rents and royalties from the passive income rules under Subpart F,
3. Increase the foreign tax credit carryforward period to 10 years, and
4. Repeal the limitation on use of foreign tax credits to offset the corporate alternative minimum tax.

Benefits of Current ETI Regime Should Be Preserved to the Extent Possible

The WTO decision that the ETI regime enacted by Congress in 2000 is a prohibited export subsidy violating U.S. international treaty obligations could lead to significant sanctions against the United States. There are other sources of trade friction between the United States and many of our trading partners that should be resolved in a manner that enhances international trade. The "compliance work plan" announced by Ambassador Zoellick and EU Commissioner Lamy, under which the Administration and Congress will together to develop a proposal that will allow the U.S. to comply with the Appellate Panel ruling, is a good step forward.

AeA is pleased to contribute its ideas at this hearing, which is an important step in the process of developing an alternative to the ETI. We hope the process is both credible and rapid enough to forestall retaliation by the EU, or at least to minimize the possibility of sanctions and the attendant trade friction that would result.

As part of this process, AeA believes that the ETI regime should be replaced with legislation that helps those sectors of the economy that currently benefit from the ETI and that helps to improve the international competitiveness of U.S. based companies.

Since it would be imprudent to enact provisions that once again test the limits of what constitutes an export subsidy, Congress should exercise its judgment to support sectors of the economy enjoying benefits of ETI in a way that does not have a direct reliance upon exports.

The AeA recommends that the foreign base company sales income and foreign base company services income rules of Subpart F be repealed in their entirety.

In general, U.S. tax is imposed under Subpart F not only on a foreign subsidiary's passive income (interest, dividends, etc.) but also on income earned from certain active business transactions with related persons. For example, U.S. tax is imposed on the income of a foreign subsidiary from purchasing goods from legal entities within the multinational group and reselling them outside its country of incorporation. By imposing U.S. tax on intercompany payments between foreign subsidiaries, Subpart F of the Internal Revenue Code puts U.S. multinationals at a competitive disadvantage in the global marketplace by imposing current U.S. tax on ordinary foreign business transactions that otherwise would not be subject to current U.S. taxation.

The Subpart F base company rules have been justified as measures that counteract efforts by U.S. multinationals to shift foreign profits to tax havens, in part by making payments to related companies located in tax havens.

The 1962 legislative history to Subpart F reveals that the related person provisions were targeted at transfer pricing abuses. Since 1962, however, the ability of the IRS and foreign tax authorities to combat transfer-pricing abuses has improved dramatically. The IRS has issued increasingly detailed transfer pricing regulations to provide guidance, and Congress has enacted stern penalties for non-compliance. As a result, the profits of the various members of a U.S.-based multinational group are much more likely today to be properly allocated based on real economic factors (such as the functions performed, investments made, and risks borne).

Subpart F generally does not apply to transactions within a single "country" under the rationale that, in such cases, artificial profit shifting between tax jurisdictions does not occur. For example, the provisions applicable to intercompany payments (the "foreign personal holding company income" rules) exclude dividends and interest received by a controlled foreign corporation ("CFC") from a related person that is (1) a corporation organized under the laws of the same country in which the CFC was created; and (2) has a substantial part of its assets used in a trade or business located in such same foreign country.

Additionally, in the early 1960's, foreign subsidiaries of U.S. multinationals typically operated only in their country of incorporation, in part because each country presented a unique market. With the rise of globalization, the falling of trade barriers (e.g., the economic integration of the EU countries), and improvements in technology, foreign subsidiaries can now more efficiently and effectively conduct business on a regional or even global basis. For example, many multinational groups now seek to centralize functions in regional hubs or service centers. However, Subpart F imposes a tax cost on foreign subsidiaries that operate outside their country of incorporation, and as a result, they are penalized for acting in the most economically efficient manner (e.g., by operating on a regional basis). Accordingly, U.S. multinationals are forced to either pay the extra tax cost or to needlessly duplicate functions in multiple foreign countries. The Subpart F related person provisions create unnecessary complexity, which leads to excessive taxpayer compliance costs, increased IRS audit costs, and additional burdens on the courts.

The revenue effects of the Subpart F base company rules are not strictly revenue generating for the U.S. Treasury. In cases where Subpart F income is generated by activities in high tax countries, foreign tax credits can eliminate any residual U.S. tax liability.

As companies continue to adopt integrated business models dictated by the global marketplace, such provisions act as a hindrance to U.S. competitiveness.

An interesting proposal that was considered, but rejected, in 1962 when Subpart F was enacted would have treated the European Economic Community (now the European Union) as a single country for purposes of the Subpart F related persons provisions.

According to the legislative history, the basis for this decision was the fact that, although the European countries had formed a common market, they did not yet have a unified tax system.

Recent proposals introduced to simplify Subpart F include provisions relating to the treatment of the EU as one country. For example, in H.R. 2018 (106th Congress), the Secretary of the Treasury would have been tasked with analyzing the impact of treating the EU as one country for purposes of applying the same country exceptions under Subpart F.

This treatment makes even more sense today than it did in 1962. Greater political and economic integration among EU countries has been achieved over the last forty years, including adoption of the euro as a common currency by most member countries. Furthermore, the EU has been working to achieve tax harmonization. For the past three years, the EU members have been negotiating a "code of conduct" with respect to tax matters, in order to eliminate harmful tax competition among member states. More recently, the EU Commission has begun investigating whether certain member state tax regimes constitute unlawful state aids.

There are several ways that repeal of the base company rules would encourage U.S. exports. First, if the base company rules apply to purchases from the U.S. that are exported to foreign customers, then an export transaction probably bears more U.S. tax as a result of the Subpart F base company rules.

Second, if the foreign subsidiaries of U.S. multinational companies are healthy and competitive, the U.S. parent company almost always prospers as well. Since the U.S. foreign base company rules have not been duplicated by other countries (unlike the passive income rules), foreign subsidiaries of U.S. companies face greater complexity and higher taxes than the foreign companies in whose home markets they are trying to compete. Since such foreign subsidiaries of U.S. companies are the conduit into foreign markets for most U.S. exports, the healthier they are the greater the prospects for U.S. exports.

Exclude Active Software Royalties from Passive Income

An important policy goal of ETI replacement legislation should be to provide benefits to those U.S.-based taxpayers that previously qualified for FSC/ETI benefits. Since software rents and royalties expressly qualify for ETI benefits today, any reform of Subpart F should include relief for active business income from rents and royalties.

The software industry is unique in that it delivers its products and services to customers via delivery methods that, depending on the facts of the transaction, produce either rents, royalties, sale of goods income or services income. In all cases, the vendor company is engaged in essentially the same business activity of developing, marketing and supporting its products. The reason a software company may have rent and royalty income therefore is due to its choice of delivery methods, and does not imply that the company is not engaged in an active trade or business.

Accordingly, to achieve parity with other industries which deliver their products only by means of sales of goods, any Subpart F reform should amend section 954(c)(2)(A) both to eliminate the current complete prohibition on deferral for related party rents and royalties and to rationalize the active trade or business test. These reforms would place software companies on a tax parity with other U.S. companies, and would allow Congress to meet the policy goal of matching the beneficiaries of the proposed legislation as closely as possible with the groups that historically benefited from FSC/ETI.

Two primary concerns have been expressed concerning whether this proposal would be appropriate—that rents and royalties are somehow by their very nature indicia of passive activity, and that even if some reform is appropriate, the scope of qualifying rents and royalties should be appropriately limited.

With respect to the concern that all rents and royalties are inherently passive, it is important to emphasize that the classification of income as active or passive based merely on whether it is characterized as a sale of goods, rents or royalties is not necessarily appropriate, at least in the software context. It would be inconsistent and unfair from a policy perspective to treat transactions that arise from the same business activity differently, based solely on their nominal classification.

Also, it should be possible to create an active trade or business test which appropriately distinguishes between rents and royalties derived in the conduct of an active business, and income from more passive, investment oriented activities. This test almost certainly should refer to activities conducted by other members of the group to characterize a revenue stream as active or passive, as is currently provided for in certain other contexts. Perhaps the most straightforward approach would be to limit the scope of any reform to those industries that historically have derived rents and royalties through active business operations, and retain current law for other income such as real property rents. This approach would be consistent with other statutory provisions reflecting the Congressional desire to equalize the treatment of computer software royalties and other forms of active business income. One possible means to narrowly limit the scope of the proposal is to apply the proposal only to rents and royalties which currently qualify for FSC/ETI benefits. Another possible approach is to define a qualified recipient as an entity engaged in an active software business based on some appropriate measure, such as the presence in the affiliated group of substantial development, marketing, and/or other business activities.

Increase Foreign Tax Credit Carryforward Period from 5 Years to 10 Years

Reform of the foreign tax credit (“FTC”) carryover rules is needed to provide for an effective operation of U.S. tax laws intended to protect against double taxation. The AeA further recommends that the ordering rules be amended such that credits would be used first from carryforwards to such taxable year, second from the current year, and third from carrybacks.

U.S. taxpayers may claim FTCs against U.S. tax in order to avoid double taxation of income. The amount of FTCs 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 the amount of creditable taxes of 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, the 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 FTCs 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 of the 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.

This modification would allow U.S. taxpayers that had accrued or paid foreign taxes additional time to utilize their FTC carryovers.

In addition, with the enactment of transfer pricing legislation in many foreign jurisdictions, U.S. multinational corporations are required to recognize income and pay foreign taxes in foreign jurisdictions even when they have losses on a consolidated basis. The vagaries of the economy and other business cycles are additional factors that sometimes prevent utilization of FTCs before their expiration.

Remove 90% Limitation on Claiming Foreign Tax Credits from 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. Only 90 percent of the alternative minimum tax (“AMT”) may be offset by FTCs that would otherwise be available. This rule causes double taxation of foreign income and thwarts a fundamental and long-standing principle of U.S. tax policy.

The Joint Committee on Taxation April 2001 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 a 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 FTCs, 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-á-vis their foreign competitors in overseas markets.

Chairman MCCRERY. Thank you, Mr. Kostenbauder. Mr. McLaughlin.

STATEMENT OF GARY L. MCLAUGHLIN, SENIOR DIRECTOR, INTERNATIONAL TAX, WAL-MART STORES, INC., BENTONVILLE, ARKANSAS, ON BEHALF OF INTERNATIONAL MASS RETAIL ASSOCIATION

Mr. MCLAUGHLIN. Thank you, Mr. Chairman. I appear here today on behalf of the International Mass Retail Association (IMRA). The IMRA is the world's leading alliance of retailers and their product and service suppliers. As IMRA retailers have expanded into the EU, Mexico, China, and other international markets, there has been an unleashing of pent-up demand for affordable U.S. products. Most of our U.S. vendors that supply the U.S. retail products we sell overseas export through and realize the meaningful benefits of FSC/ETI. The U.S. tax that vendors and retailers pay impacts the price we charge our customers worldwide. Thus, IMRA has a vested interest in FSC, FSC alternatives, or ETI and the solutions that Congress is considering.

Retailers and our vendors are clearly the largest employers in the United States and by being able to compete worldwide we generate dollars to invest in the United States for job growth and economic expansion.

In announcing these hearings, Mr. Chairman, you noted that Congress cannot replicate the benefits of FSC and ETI and that these hearings will focus on tax proposals which promote the competitiveness of U.S. companies while respecting our international obligations under WTO. The United States is not a low-tax country for corporations. With U.S. taxation, of worldwide income and the flaws in our deferral and foreign tax credit mechanisms, the most meaningful action that Congress could take to enhance the international competitiveness of U.S. corporations would be to reduce the U.S. corporate income tax rate.

However, I realize that such reduction may not be feasible in today's environment, and I will therefore focus on various changes that could and should be made to the subpart F and the foreign tax credit provisions of the Tax Code. These changes will both enhance American competitiveness and simplify the operation of those provisions. There are four specific change proposals in my written submission which are illustrative rather than comprehensive, but do reflect the manner in which the current foreign tax provisions of the Tax Code compromise American international competitiveness. I will summarize the two most important from the retailer perspective.

First, due to the cyclical nature of the retail business and the associated large amounts of working capital required to address such, the current de minimis exception of section 954 creates a situation where in many cases U.S. retailers' income from working capital is taxed currently in the United States even though such working capital is required for the active conduct of our businesses in the international arena. For these reasons, section 954 should be amended to preserve deferral for working capital of a CFC attributable to active business operations. This could be accomplished by either returning the current threshold to its original 1962 level or Congress could create a working capital exception from the section 954 foreign base company income inclusion provisions.

Second, under subpart F certain intercompany sales and services income of a CFC is classified as foreign base company income and is thus not eligible for deferral even though the income is generated in the active conduct of a trade or business with the exception of transactions within the same country. This same country exception which permits deferral should be revised in the case of member countries within the EU or within China, Hong Kong. The income encompassed by the foreign base company sales and services income rules is active business income of the type frequently not taxed on a current basis by other countries that have enacted anti-deferral regimes. Such income should not be subject to current U.S. tax.

The remaining points in my submission focus on the need to revise the stacking rules for foreign tax credit utilization and the interest allocation rules in order to assure double taxation is avoided, as my colleagues have mentioned, and aid in international competitiveness for all U.S. multinational corporations. Additionally, the carryforward period for unused foreign tax credits should be increased from 5 to 10 years.

Thank you, Mr. Chairman and Subcommittee Members.

Chairman MCCRERY. Thank you, Mr. McLaughlin. Mr. Sprague.

STATEMENT OF GARY D. SPRAGUE, PARTNER, BAKER & McKENZIE, PALO ALTO, CALIFORNIA, ON BEHALF OF SOFTWARE INDUSTRY COALITION FOR SUBPART F EQUALITY

Mr. SPRAGUE. Mr. Chairman and Members of the Subcommittee, it is my pleasure to speak with you this morning about possible subpart F reforms that will enhance the competitiveness of American business internationally. I am a partner in the law firm of Baker & McKenzie in Palo Alto, California, and as such fully endorse the Chairman's remark that these are times when one enjoys, actually enjoys being an international tax lawyer. I am testifying today on behalf of the Software Industry Coalition for Subpart F Equality, which includes many of the country's, indeed the world's leading software companies. A list of coalition members is attached to my written testimony.

One of the proposals before you is to exclude foreign base company sales and services income from subpart F. This reform would enhance the competitiveness of American business while respecting our WTO obligations. Although we strongly support these changes, it is essential that any modifications to subpart F not be biased against computer software companies solely because of the unique characteristics of the income earned by these companies.

My testimony today will address those special features of how software companies deliver their products to users which demand revisions to our 40-year-old rules in subpart F. I believe this is exactly the question raised by Mr. Foley a few minutes ago. Computer software companies are engaged in active businesses just like traditional manufacturing companies. Unlike traditional manufacturers, however, computer software companies generally deliver their products under license agreements rather than contracts of sale. I am sure each Member of this Subcommittee has carefully read and thoughtfully considered the license agreements included with all of your personal software.

This contractual form is necessary for reasons of intellectual property law and other business considerations completely unrelated to taxation. Because of this contractual form, however, and due to the evolving business models of this industry, income earned by a company from exactly the same software program may be characterized as rents, royalties, sales of goods, or services depending on the facts of the particular transaction.

Let's take, for example, a word processing program. When the program is sold through a retail distribution channel under a shrink wrap license, the transaction, despite the form of license, is nevertheless treated as a sale of goods for tax purposes. At the same time, if the software company selects a distribution channel for exactly the same software program involving arrangements allowing the distributor to duplicate the software, revenue from that transaction, from the same program, is treated as a royalty. Furthermore, if the software company chooses a model which requires a user to make periodic payments for the continued right to use the program, that revenue is characterized as a rent. Finally, software may be made available to users in hosting arrangements, which frequently gives rise to services income.

In all four cases, the software company is engaged in essentially the same business activity of developing, marketing, delivering, and supporting its products, but earns four different types of revenue for tax purposes. Subpart F, however, currently treats those four revenue streams in dramatically different ways. The software company's sale of goods and services income would fall within the purview of the foreign base company sales and services income rules while the rent and royalty income, in contrast, is within the scope of the foreign personal holding company regime. Foreign personal holding company income, however, is intended as a policy matter to represent passive investment income. Therefore, it includes interest, dividends, capital gains, and rents and royalties.

Subpart F, like many other parts of the Tax Code, discriminates against rent and royalty income on the policy basis that those income items presumably constitute passive investment type income. One element of that discrimination is a near complete ban on deferral for software rents and royalties received from related parties, which is a rule that is not mirrored in the sale of goods and services context. As a result, different revenue streams of a single software company can receive highly disparate treatment under subpart F despite the fact that all revenues are derived in the context of a company's single active business.

Accordingly, subpart F must be modernized to eliminate the inconsistent and inequitable treatment of software income and to achieve parity for the software industry relative to other industries that deliver their products only by traditional means. Congress can ensure that active business income earned by software companies is treated in the same way regardless of its nominal classification by doing two things: one, amending the definition of foreign personal holding company income to eliminate the current complete prohibition on deferral for related party software rents and royalties, and two, rationalizing the active trade or business test under the foreign personal hold company rules.

I note that other speakers today have supported this reform of the rent and royalty rules in their oral or written testimony.

This reform also would allow Congress to meet the policy goal of matching the beneficiaries of proposed reform as closely as possible with those groups which have historically benefited from ETI.

Thank you again for the opportunity to testify today. I will be happy to answer any questions you may have and ask that my written statement be made a part of the record of this meeting.

[The prepared statement of Mr. Sprague follows:]

Statement of Gary D. Sprague, Partner, Baker & McKenzie, Palo Alto, California, on behalf of Software Industry Coalition for Subpart F Equality

Mr. Chairman and Members of the Committee, it is my pleasure to appear before you today to discuss legislative alternatives to the FSC/ETI regimes that will comply with international trade rules and enhance the global competitiveness of U.S. companies.

I am testifying today on behalf of the Software Industry Coalition for Subpart F Equality, which includes many of the world's leading software companies. A list of the members of the Coalition is attached.

As other witnesses have testified today, it is imperative that the U.S. tax system does not hinder United States companies from effectively competing in the global markets. This was the primary intent of the Foreign Sales Company (FSC) and Extraterritorial Income (ETI) regimes; the competitiveness concerns that led to the enactment of the FSC/ETI regime are no less pressing today. Therefore, FSC/ETI replacement legislation should provide benefits to those U.S. taxpayers, including computer software companies, which have previously qualified for FSC/ETI benefits.

I. Importance of the Software Industry

The software industry is one of the fastest growing sectors of the global economy, generating revenues of more than $150 billion every year.[1] Its importance to the U.S. economy's current health and future prosperity is undisputed. In 1998, information technology contributed 8% to the U.S. gross domestic product ("GDP"),[2] and it is estimated that by 2006 industries that heavily utilize or produce information technology will employ 49% of the U.S. private sector workforce.[3] Today, nine of the world's ten biggest software companies are located in the United States.[4]

Congress demonstrated its commitment to supporting the competitiveness of U.S. software companies in 1997 by clarifying that FSC benefits specifically include income from software licenses as qualifying income under the FSC/ETI regime. Although FSC/ETI benefits are not generally available for income derived from transfers of intellectual property, Congress recognized the importance of the software industry to the U.S. economy by clarifying that the FSC rules apply to "computer software (whether or not patented)." This provision carried over to the ETI regime. Therefore, any replacement for the FSC/ETI regime must include the computer software industry.

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[1] www.hoovers.com/industry/snapshot/profile, June 6, 2002.
[2] Taylor, Paul, *Financial Times*, "Reaping the Rewards of IT Growth" September 1, 1999.
[3] *Id.*
[4] www.hoovers.com/industry/snapshot, June 6, 2002.

II. Subpart F Relief

Congress is considering various proposals for replacing FSC/ETI. One set of proposals involves an amendment to Subpart F of the Internal Revenue Code that excludes foreign base company sales income and foreign base company services income from the definition of Subpart F income. This would be a significant reform of U.S. tax laws that would increase the international competitiveness of U.S. corporations and respect the United States's obligations under the GATT. Subpart F discriminates against U.S. companies that operate abroad in many ways by, for example, currently taxing income earned by foreign subsidiaries without giving equal treatment to losses. We support these changes.

Although we support the goal of reforming Subpart F, any modification of the Subpart F provisions must take into account taxpayers, such as computer software companies who derive income from licensing intellectual property that can be classified as income derived from the conduct of an active business rather than from passive activities. My testimony will focus on the special features of the computer software industry that must be taken into account when considering Subpart F reform.

III. Unique Features of the Software Industry

Subpart F, which was enacted at a time when intellectual property played a smaller role in the economy, uses heavy manufacturing as its business model. Since that time, intellectual property has come to play a major role in the economy as business models have changed. For example, the computer software industry, which did not exist when Subpart F was enacted, is now an important part of the economy and a major U.S. exporter.

Computer software companies generally earn income by developing computer programs, which are protected by copyrights and patents, and delivering these programs to their customers. These delivery methods may produce rents, royalties, sale of goods income, or services income, depending on the facts of the transaction. The development process frequently involves thousands of highly trained professionals and the expenditure of many millions of dollars and years of effort to create new software that may or may not be commercially successful. As one commentator on the international provisions of the Code has observed, in the context of distinguishing between taxpayers engaged in an active trade or business from mere passive investors, "we can readily sense a difference between the activities of those who dig, plow, shape, make, buy, sell, cajole, and those who merely glance at a market quotation in the newspapers or perhaps merely remove a check from an envelope with fingers left slender and pale from the absence of toil."[5] By this standard, the software industry is no less of an active business than the heavy manufacturing that was Congress's paradigm when Subpart F was enacted.

The software industry is unique among active businesses, however, in that that it delivers its products and services to customers via delivery methods that produce rents, royalties, sale of goods income and services income, depending on the facts of the transaction. In this respect, software companies are unlike manufacturers, which only earn income from the sale of goods. For example, computer software companies frequently deliver their products under commercial arrangements structured as licenses for reasons of intellectual property law and other business reasons that are completely unrelated to taxation. Many software companies deliver their products through time-limited licenses, or through hosting arrangements, which may produce revenue properly characterized under the tax law as rents and service fees, respectively. In all cases, the company, be it a software company or a steel mill, is engaged in essentially the same business activity of developing, marketing and supporting its products. Thus, even if a software company earns income that is characterized as rent or royalty income, it does not imply that the company is not engaged in an active trade or business. In addition, developments in communications technology now allow multinational businesses to operate in an integrated manner that would not have been possible when Subpart F was enacted.

IV. Today Subpart F Discriminates Against the Software Industry

Subpart F of the Code requires a "United States shareholder" of a "controlled foreign corporation" (CFC) to include currently in its gross income its *pro rata* portion of the CFC's "subpart F income" as a deemed dividend. Subpart F income includes foreign personal holding company income, foreign base company sales income, and foreign base company services income. Foreign base company sales income includes

[5] Joseph Isenbergh, *International Taxation: U.S. Taxation of Foreign Persons and Foreign Income* § 20.2 (3d ed. 2002).

income derived from transactions in inventory property if the property was purchased from, or sold to, a related party and the property was neither manufactured, nor sold for use, in the CFC's country of incorporation and certain other conditions are met. Foreign base company services income includes income arising from services performed outside the CFC's country of incorporation that are performed for or on behalf of a related person, including under a regulatory interpretation of the statute, services for which a related person provides "substantial assistance."

Foreign personal holding company income, which is intended to represent passive income, includes interest, dividends, rents, royalties, and capital gains. Subpart F, like many other areas of the Code, discriminates against rent and royalty income by generally treating them as a type of passive income. Subpart F attempts to limit its discriminatory treatment of rent and royalty income by providing a limited exception for certain active rents and royalties. This provision excludes from foreign personal holding company income rents and royalties that are both derived in the active conduct of a trade or business and received from an unrelated person.

Although this active rent and royalty exception clearly shows Congress' intent to distinguish income that is earned through active business activity from passive income derived solely from the ownership of intangible property, the regulations make this determination with respect to each CFC on a stand-alone basis. This separate application of Subpart F to each CFC was appropriate in the era when Subpart F was enacted because foreign subsidiaries were likely to operate on a stand-alone basis. However, computer software companies, like most knowledge-based companies, operate in an integrated global manner, unlike the manufacturing companies that were the norm when Subpart F was enacted. Through the use of new communications technology and business models, a software company's domestic and foreign subsidiaries work together in developing new products, entering into global sales contracts with multinational customers, and supporting their products around the clock. This business model is far different from the country-specific model that was the norm when Subpart F was enacted.

V. Software Income Should Be Kept on a Par with Other Active Industries

In order for the computer software industry to obtain parity with other industries that deliver their products only by means of sales of goods, subpart F reform must be modernized to eliminate the inequitable treatment of software rent and royalty income. Congress can achieve this result by amending Code section 954(c)(2)(A) to (i) eliminate the current complete prohibition on deferral for related party software rents and royalties, and (ii) rationalize the active trade or business test by including the activities performed by members of the CFC's group of corporations and activities performed by third parties on behalf of the CFC.

These reforms would provide software companies with tax parity with other U.S. companies, and would allow Congress to meet the policy goal of matching the beneficiaries of the proposed legislation as closely as possible with the groups that historically benefited from FSC/ETI.

VI. Our Proposal Will Not Lead to Inappropriate Tax Deferral

Some have expressed concern that this proposal would lead to inappropriate tax deferral, namely (i) that rents and royalties are somehow by their very nature indicia of passive activity and thus should not enjoy deferral at all, and (ii) that even if some reform is appropriate, the scope of qualifying rents and royalties should be appropriately limited.

With respect to the concern that all rents and royalties are inherently passive, it is important to emphasize that the classification of income as active or passive based merely on whether it is characterized as sale of goods income, rents or royalties is not a valid assumption, at least in the software context. The income derived by software companies normally is not passive income, but rather is active income that is classified in a variety of ways, including as sales, rents, royalties or services income, based on the facts and circumstances of each transaction. It would be inconsistent and unfair from a policy perspective to treat transactions that arise from the same business activity differently, based solely on their nominal classification.

The factors that cause an item of income arising from a computer software transaction to be either sale of goods income, on one hand, or rent or royalty income, on the other, have no bearing on whether the income is active or passive. The characterization of an item of software revenue can be affected by the period of time that the customer can utilize the software without making an additional payment or whether the customer is granted the right to make derivative works based on the software. For example, a transfer of a copy of a computer program will be classified as a sale of goods transaction if the customer makes a single payment in exchange for the right to use the software in perpetuity but will be classified as a rental transaction if the customer is required to make periodic payments in order to continue using the software. Alternatively, if the customer has the right to use the software in perpetuity but obtains a significant right to make a derivative work based on the original software, the transaction will be classified as a license of copyright rights instead of a sale of goods. These factors can cause an item of software income to be treated as rents or royalties, instead of sale of goods income, which are treated differently under current Subpart F rules. However, these factors have no relationship to whether the income was earned in an active business. Congress should eliminate these distinctions and put the software industry on a level playing field with all other active businesses.

We also note that the U.S. transfer pricing rules are entirely adequate to prevent any inappropriate allocation of income to CFCs earning software revenues. U.S. transfer pricing rules have become much more sophisticated since Subpart F was enacted forty years ago. Modern transfer pricing rules are based on the functions performed by each entity and not the label assigned to that entity's income. These rules take into account the need for multiple operating locations in an integrated global business. In many cases, a CFC earning software revenue also will be subject to transfer pricing scrutiny under the various foreign laws of the market jurisdictions.

With respect to the second point, namely the desire to appropriately limit the scope of this provision, we are confident that it will be possible to create an active trade or business test which appropriately distinguishes between rents and royalties derived in the conduct of an active business, and income from more passive, investment oriented activities. This test almost certainly should refer to activities conducted by other members of the group for purposes of characterizing a revenue stream as active or passive, as is currently provided for in certain other contexts.

Perhaps the most straightforward approach would be to limit the scope of any reform to those business activities which historically generated rents and royalties through active business operations, and retain current law for other income such as real property rents. This approach would be consistent with other statutory provisions reflecting the Congressional desire to equalize the treatment of computer software royalties with other forms of active business income. One possible means of limiting the scope of the proposal is to define a qualified recipient as an entity engaged in an active software business based on some appropriate measure, such as the presence in the affiliated group of substantial development, marketing, and/or other business activities.

In closing, it is important to note that, if FSC/ETI is repealed, these Subpart F reform proposals will not completely make up any lost FSC/ETI benefit to the U.S. software industry. However, these reforms will provide a portion of the lost benefit and will significantly improve the international competitiveness of U.S. industry.

Thank you for the opportunity to testify today. I will be happy to answer any questions you may have, and I ask that my written statement be made a part of the record of this hearing.

The Software Industry Coalition for Subpart F Equality

Adobe Systems Incorporated
Amazon.com
Attachmate Corporation
BMC Software
Citrix Systems, Inc.
i2 Technologies, Inc.
IBM Corporation
J.D. Edwards & Company
Microsoft Corporation
Network Associates, Inc.
Novell, Inc.
Onyx Software Corporation
Oracle Corporation
Parametric Technology Corporation
Peregrine Systems, Inc.
Rational Software Corporation
Symantec Corporation
VERITAS Software Corporation

Information Technology Association of America (ITAA)[6]
Business Software Alliance (BSA)[7]
Software Finance & Tax Executives Council (SoFTEC)[8]

Chairman MCCRERY. Certainly will, Mr. Sprague. Thank you for your testimony. Mr. Cowen?

STATEMENT OF ROBERT COWEN, SENIOR VICE PRESIDENT AND CHIEF OPERATING OFFICER, OVERSEAS SHIPHOLDING GROUP, INC., NEW YORK, NEW YORK, ON BEHALF OF INTERNATIONAL SHIPHOLDING CORPORATION, NEW ORLEANS, LOUISIANA

Mr. COWEN. Thank you, Mr. Chairman, and thank you to all the Members of the Subcommittee for affording us the opportunity to testify today on these important issues. My name is Bob Cowen. I am Senior Vice President and Chief Operating Officer of Overseas Shipholding Group (OSG). My testimony today focuses on the significant hardship created for U.S.-based shipping companies by the present subpart F rules. My testimony today is endorsed by International Shipholding Corporation, headquartered in Louisiana, which also operates in our business.

My company, OSG, is a major international shipping business domiciled in Delaware and headquartered in New York. Through our subsidiaries we own a diversified fleet of oceangoing oil tankers and other bulk cargo vessels which operate in both the U.S. flag and international flags markets. The OSG is the sixth largest tanker owner in the world today.

Precisely because OSG is a U.S. company, we face an overwhelming tax disadvantage as we compete in the global shipping marketplace. As a result of legislation enacted in 1975 and 1986, the United States imposes tax currently on the income earned abroad by OSG's subsidiaries. By contrast, our foreign competitors typically are not taxed at all on their shipping income.

The shipping industry is a prime example of the issues that are the subject of this hearing and also of the debate over so-called corporate inversion transactions. It is telling that the treatment of shipping income was the first example of anti-competitive U.S. tax law that was cited by the Treasury Department in its report on inversion transactions. I note that Barbara Angus this morning in her testimony also alluded to our problem. As the Treasury Department noted, the disadvantages under present law mean U.S.-based shipping companies have less after tax income to reinvest in their business, which means basically less growth. Put differently, OSG's ships would be more valuable today if they were owned by a foreign company.

[6] ITAA provides global public policy, business networking, and national leadership to promote the continued rapid growth of the information technology industry. ITAA consists of over 500 corporate members throughout the U.S., and has a global network of 46 countries' IT associations called the World Information Technology and Services Alliance (WITSA).

[7] The Business Software Alliance (BSA) is a leading organization dedicated to promoting a safe and legal online world. BSA educates computer users on software copyrights and cyber security; advocates public policy that fosters innovation and expands trade opportunities; and fights software piracy. BSA members represent the fastest growing industries in the world.

[8] The Software Finance and Tax Executives Council (SoFTEC) is a trade association providing software industry focused public policy advocacy in the areas of tax, finance and accounting.

You might ask what does it matter if U.S.-based carriers are taxed more heavily than their foreign competitors. There is a simple and compelling answer. If the law is not changed, there will be fewer and fewer U.S.-based carriers and fewer and fewer U.S.-controlled ships to meet America's national security and economic security needs. Indeed, U.S. participation in international shipping is already in a state of dramatic decline. In a world where almost all bulk seagoing transportation is conducted on foreign flag vessels, the number of U.S.-owned foreign flag vessels has declined by over 60 percent since 1974. From 1988 to 2000, the number of U.S.-owned foreign flag tankers was cut nearly in half from 246 to only 126 ships. Today U.S.-owned foreign flag vessels constitute barely 3 percent of the world merchant fleet, an astonishing figure.

Because of the unfavorable tax treatment of U.S. companies competing in foreign trade, we have seen the ownership of two leading U.S. container operators, American President Lines (APL) and Sea-Land move offshore. In 1997, APL was taken over by Neptune Orient Lines of Singapore and in 1993 the A.P. Moller group of Denmark acquired Sea-Land. In 1998, OMI, a U.S.-domiciled tanker company, moved offshore to the Marshall Islands in order to avoid the adverse competitive effects of the subpart F rules.

Unless we change the subpart F rules a further decline in U.S. ownership of international merchant fleets is inevitable. The dramatic decline in U.S.-owned international fleets raises significant national security and economic concerns for our Nation. In times of emergency, the U.S. military relies on its ability under law to requisition these U.S.-owned foreign flag tankers, bulk carriers, and other vessels to carry oil, gasoline, and other materials in defense of the U.S. interests overseas.

The sharp decline in this fleet since the 1975 and 1986 tax law changes and the adverse implications to U.S. strategic interests are expected to be confirmed soon in a study commissioned by the U.S. Navy.

Our national security also depends on America's ability to maintain adequate domestic oil supplies in times of emergency. One-half of every gallon of oil consumed in the United States is imported on foreign-owned vessels. This growing dependence on foreign parties who may not be sympathetic to American interests and who have the ability to choke off our vital supplies of oil in times of global crisis is cause for alarm and must be addressed.

As Congress considers ways to make the U.S. international tax system more competitive, whether in conjunction with the FSC/ETI issue or the inversion debate, OSG would respectfully submit that changes to the treatment of shipping income should be at the top of list.

The OSG is encouraged that bipartisan legislation that would seek to address the problems created by current law has been introduced by Representative Weller and three other Members of this Subcommittee, Mr. Lewis, Mr. Foley, and Mr. Jefferson. We respectfully urge Congress to enact legislation as soon as possible that will help level the playingfield for U.S.-based carriers operating abroad. Such action will assure the United States has an adequate available fleet in times of global crisis, both to meet our military requirements and to protect our economic security.

The OSG looks forward to working with all interested parties to fashion a solution that will not only help U.S. companies reclaim their share of the global shipping markets, but will also help preserve and enhance U.S. flag shipping.

Thank you for your attention, and I would be glad to answer any questions you might have.

[The prepared statement of Mr. Cowen follows:]

Statement of Robert Cowen, Senior Vice President and Chief Operating Officer, Overseas Shipholding Group, Inc., New York, New York, on behalf of International Shipholding Corporation, New Orleans, Louisiana

I. Introduction

On behalf of the Overseas Shipholding Group, Inc. ("OSG"), I appreciate the opportunity to testify today before the Subcommittee on Select Revenue Measures on international competitiveness issues raised by the U.S. tax system. My testimony focuses on the significant problems created by the present-law rules under subpart F of the Internal Revenue Code applicable to shipping income. The views expressed in this testimony are endorsed by the International Shipholding Corporation, headquartered in Louisiana.

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 recently has noted, 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 50 vessels with an aggregate carrying capacity of more than 7.4 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 10 vessels aggregating approximately 665,000 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 40 foreign flag vessels, amounting to almost 7 million deadweight tons. These foreign flag vessels include 38 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, are expected to be confirmed soon in a study that has been commissioned by the U.S. Navy. This study is likely to conclude that the current EUSC fleet is not large enough to satisfy U.S. strategic needs.

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

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[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.

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:

[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 U.S. 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 U.S. 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

[3] National Security Directive 28, October 5, 1989.
[4] According to the 1962 legislative history, this exclusion for shipping income was provided "primarily in the interests of national defense."
[5] General Explanation of the Tax Reform Act of 1986, at 970.

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]

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 "runaway headquarters" transactions like those described above and therefore little or no remaining U.S.-controlled international shipping. Treasury Secretary O'Neill put it well when he released the corporate inversion report:

In addition, if the Tax Code disadvantages U.S. companies competing in the global marketplace, then we should address the anti-competitive provisions of the Code. I don't think anyone wants to wake up one morning to find every U.S. company headquartered offshore because our Tax Code drove them away and no one did anything about it. This is about competitiveness and complications in the Tax Code that put U.S.-based companies out of step with their foreign competitors.

OSG is encouraged that bipartisan legislation that would seek to address the problems created by current law has been introduced in this Congress by Rep. Jerry Weller (R–IL) and co-sponsored by Representatives Charles Rangel (D–NY), Phil Crane (R–IL), Ron Lewis (R–KY), Mark Foley (R–FL), William Jefferson (D–LA), John Shimkus (R–IL), and Judy Biggert (R–IL).[7] 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.

[6] Price 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 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.

[7] "The Restore Access to Foreign Trade Act," (H.R. 3312).

Exhibit A

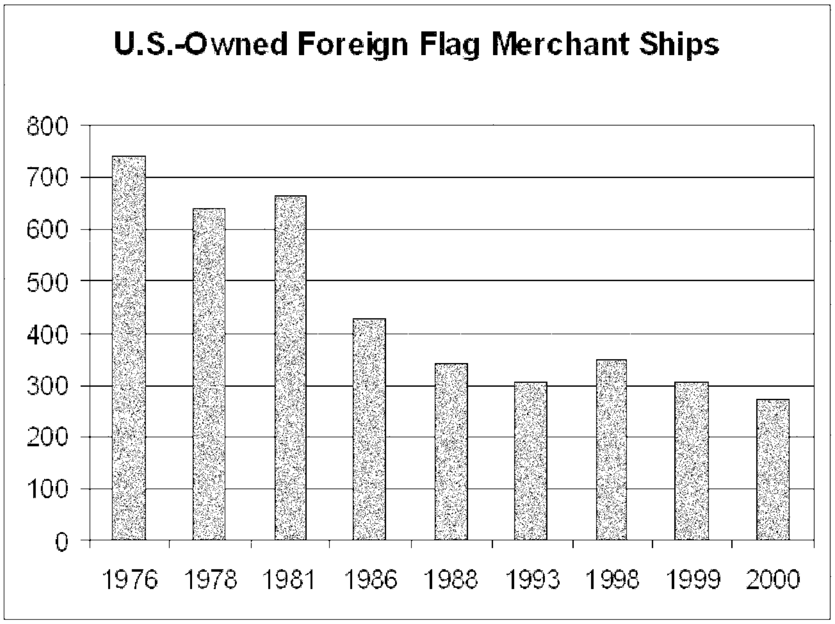


Exhibit B

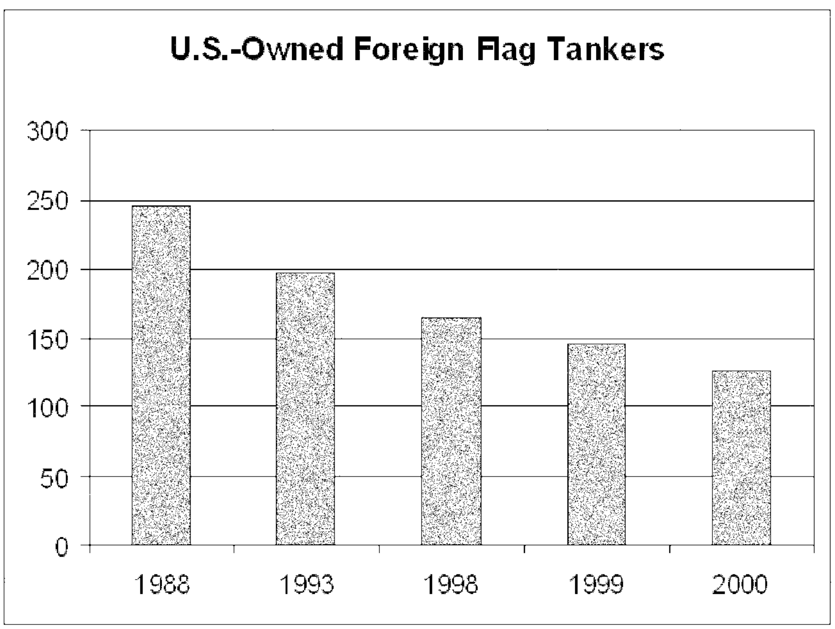
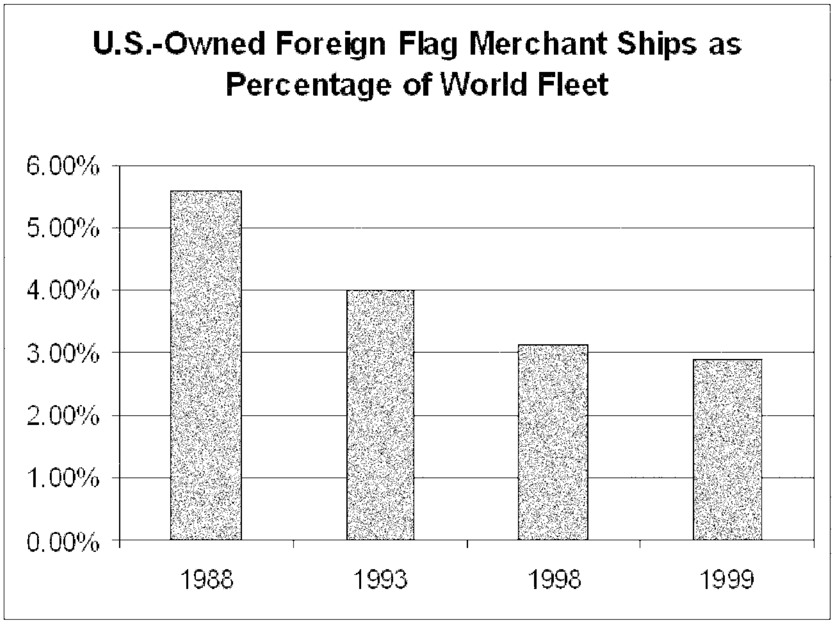


Exhibit C



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.

Chairman MCCRERY. Thank you, Mr. Cowen. Mr. Parsons?

STATEMENT OF DOUG M. PARSONS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, EXCEL FOUNDRY AND MACHINE, INC., PEKIN, ILLINOIS, ON BEHALF OF NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. PARSONS. Well, good afternoon now, Chairman McCrery and Members of the Subcommittee, I want to thank you for the opportunity to appear before you today and present the views of Excel Foundry and Machine, and the National Association of Manufacturers (NAM) on the way to promote the competitiveness of U.S. companies while respecting international obligations under the World Trade Organization agreement.

I am Doug Parsons, and I am President and Chief Executive Officer of Excel Foundry and Machine, and before I go on with that I just want to interject a few points, and that is I am a pretty small fish in this room. I am a manufacturing company, do about $12 million in revenue, and I just want you to know that the elimination of the FSC/ETI benefit would greatly impact my company. A third of my business is international and a lot of those countries I try to get product into have tariffs on my product and some very tough competition.

So, I just want to get that across in that this isn't all about big huge multinational organizations. This is about small manufacturing companies that are looking to international markets not just to grow but to survive.

The National Association of Manufacturers is the Nation's largest industrial trade organization, representing 14,000 member companies, including 10,000 small and mid-sized companies and 350 member associations serving manufacturers and employees in every industry sector in all 50 States.

Headquartered in Washington, D.C., the NAM has 10 additional offices across the country. Excel Foundry and Machine supplies precision machines, bronze and steel parts for heavy equipment-related industries, such as mining, crushing, and mineral processing. Founded in 1929, the company had $12 million in sales in 2001 and projects $14 million in 2002. Excel, which operates a subchapter S corporation, has 95 employees at its facility in Pekin, Illinois.

The current extraterritorial income regime as well as its predecessors, the DISC and FSC, have been integral factors in increasing export activities by U.S. manufacturers. According to the IRS, of the roughly 4,300 FSCs in existence in 1996, 89 percent of them exported manufactured products. Congress first created the DISC in 1971 to level the playingfield for U.S. companies, large and small, selling their products overseas. These three types of tax incentives created over the past three decades were designed to neutralize some of the tax advantages enjoyed by our foreign competitors located in countries with territorial tax systems which generally exempt income earned outside of the country from income tax and exports from value added and other consumption taxes.

Traditionally, much of the attention in this area has been focused on FSCs used by large companies. The FSC benefits also are important to small and mid-sized manufacturers that export. In fact, exporting goods overseas is more than a sideline for many of these small companies, essentially it's a necessity of staying in business. Smaller companies often turn to export tax incentives to effectively compete in global marketplaces. According to the NAM survey in 2000, small and mid-sized manufacturers save on average about $124,000 annually by using the FSC.

It is critically important to continue to encourage export activity by these small companies. Of all the exporting manufacturers in America, 93 percent are small and mid-sized manufacturers. These firms, which individually employ anywhere from 10 to 2000 employees, together employ roughly 9.5 million people. Small and mid-sized manufacturers add jobs 20 percent faster than firms that remain solely domestic and are 9 percent less likely to go out of business.

For my company, Excel Foundry and Machine, selling products in an international market means more than reaching a few additional customers. International sales contribute to the growth and health of the company, allowing us to expand by adding new space, hiring more employees, and making capital investment. International sales account for one-third of our revenue and these sales are responsible for the tremendous growth of the company, 30 percent over the last 4 years, and we anticipate 20-percent growth this year. They have enabled the company to begin building a 20,000 square foot expansion.

In the past Excel used a foreign sales corporation, and we currently use the extraterritorial income regime. The benefit provided by FSC/ETI justified the additional efforts to go into these overseas markets to compete. For example, the tax system in some South American countries heavily favor local suppliers. The FSC/ETI have leveled the playingfield and you just can't pull that incentive away from us.

Moreover, the loss of tax incentives like those provided by FSC/ETI would have a tremendous impact on the company, affecting revenues and employment. There are many hidden costs in doing business internationally. In markets where margins are already thin we would lose sales due to an uneven playingfield. If these sales slump, Excel would likely have to cut between 3 and 5 percent of its workforce.

With the June 17, 2002, scheduled release date for the WTO arbitration panel's sanctions report fast approaching, we are pleased that the EU recognizes the difficulties of the situation and has agreed to delay imposing sanctions until at least 2003. However, 6 months is not enough time. It is clear the international tax issues involved are complex and a considerable amount of time will be required to develop and implement appropriate legislative response.

Let me skip to the end here.

Really, no consensus has been found yet on an appropriate solution, and the current proposals vary considerably, ranging from substituting other changes in the international tax area for the FSC/ETI to a legislative framework and timeline to achieve compliance with WTO rulings.

As a small U.S.-based manufacturer, I am concerned that some of the proposed solutions are targeted to multinational corporations with subsidiary operations and employees outside the United States. These changes will not benefit small exporters like Excel with operations only in the United States and thus will not serve as an adequate substitute for FSC/ETI.

I want to thank you for your time today and just for providing the tools for American manufacturers, large and small, to effectively compete with their foreign counterparts.

Chairman MCCRERY. Thank you, Mr. Parsons. Mr. Newlon?

STATEMENT OF T. SCOTT NEWLON, MANAGING DIRECTOR, HORST FRISCH INCORPORATED

Mr. NEWLON. Thank you, Mr. Chairman and Members of the Subcommittee, for giving me the opportunity to testify before you today. My name is Scott Newlon. I am a Managing Director of Horst Frisch Incorporated, an economics consulting firm. For the record, I am testifying today on my own behalf and not as a representative of any organization.

My testimony focuses on the international provisions of the Tax Code, which is an area in which there is certainly great scope for improvement and reform. There are of course worthy policy options that should be considered in the context of a broader reform of corporate taxation within the United States, such as fixing the alternative minimum tax and integration of the corporate and individual tax systems.

In considering policy options, we should not lose sight of the fact that there are various valid objectives in developing tax policy. Those include of course competitiveness, the ability of U.S. firms to compete successfully with foreign firms in domestic and international markets. There is economic efficiency, which is generally understood to mean that the tax system should affect as little as possible the allocation of resources to the most productive investments. In other words, to the greatest extent possible, the tax system should stay out of the way of the decisions of individuals and businesses.

There is preservation of the tax base. The U.S. international tax regime should not undermine our ability to collect tax on the U.S. tax base, whatever we decide is the appropriate U.S. tax base.

Finally there is simplicity. Complexity in tax provisions can create substantial costs of compliance for taxpayers and Administration for the IRS.

These objectives, while sometimes they go together, often they are competing, and there have been tradeoffs made in the development of tax policy. Over the years, in the development of international tax policy, I think we have seen a lot of focus on the first three of those objectives that I mentioned: Competitiveness, economic efficiency, and preservation of the tax base. The simplicity objective has received short shrift. As a result, over the years we have ended up with a hodgepodge of international tax rules that are complex and difficult to administer.

Given the limited amount of time I have for my comments, I wanted to summarize my principal conclusions. First, and maybe I am a little bit alone here but I will state it, I think if the WTO decision on FSC/ETI results in the repeal of those provisions, I think we are ahead of the game in terms of the welfare of the American people in general. These provisions are an export subsidy that distorts trade. It may benefit particular companies and to some extent their workers, but in terms of the overall economy and the American people, it makes us poorer than a free trade policy would.

Second, the current U.S. international tax regime represents a mixed bag in terms of its effects on competitiveness, economic efficiency, and protection of the tax base. In general, there is actually relatively little U.S. tax that is collected on foreign source income of U.S. companies from active nonfinancial foreign investment. This suggests that at least in this area the actual tax burden from payments of tax is not so much the issue as other issues. At the same time, in certain other areas our tax system does present more of a burden in terms of direct tax payments. Those are areas in which investment and activities have been thought to be more mobile in the past and we have developed tax provisions that maybe didn't give enough weight to competitiveness concerns, particularly with the increasing integration of markets and globalization of competition.

The U.S. international tax regime clearly fails on simplicity grounds, and in many cases U.S. companies face onerous burdens of compliance with exceedingly complex rules. Changes that reflect a rebalancing of our objectives in favor of simplicity could have beneficial effects in terms of economic efficiency and competitiveness as well.

Finally, in considering the options, one of the options would be a territorial tax regime. That could have some attractive features, but we should keep in mind that its impacts on U.S. multinationals would vary. For broad classes of companies it would not necessarily lower their tax burden. In addition, the prospects for simplification may not be significantly better under such a system than they are under the current system.

Thank you.

[The prepared statement of Mr. Newlon follows:]

Statement of T. Scott Newlon, Managing Director, Horst Frisch Incorporated

Mr. Chairman and Members of the Committee:

Thank you for inviting me to testify today on changes to the Tax Code to promote the international competitiveness of U.S. companies in the light of the WTO ruling. My name is Scott Newlon. I am a managing director of Horst Frisch Incorporated, an economics consulting firm. Throughout my career my work has focused on the economic analysis of international tax issues in academic research, policy analysis while at the Treasury Department, and in my consulting practice working with multinational companies and tax authorities. For the record, I am testifying today on my own behalf and not as a representative of any organization.

I. Objectives and Principal Conclusions

In the announcement of this hearing, Chairman McCrery stated that the purpose of the hearing was to "explore a third possible response to the WTO's ruling, namely making changes to the Tax Code to promote the international competitiveness of U.S. companies." In my comments today, I would like to focus on responses involving the international provisions of the Tax Code, an area in which there is certainly room for improvement. In considering such responses, we should not lose sight of the fact that there are various objectives possible for U.S. domestic and international tax policy:

- Competitiveness: Which is generally understood to mean the ability of U.S. firms to compete successfully with foreign firms in domestic and international markets. This includes competition by U.S. firms from operations in the U.S. to serve domestic and foreign markets and competition by U.S. firms through their foreign subsidiaries and branches.
- Economic efficiency: Which is generally understood to mean that the tax system should affect as little as possible the allocation of resources to the most productive investments. In the international context, this means that the tax system ideally would not favor foreign investment over domestic investment or vice versa.
- Preservation of the tax base: The U.S. international tax regime should not undermine our ability to collect tax on the U.S. tax base.
- Simplicity: Complexity can create substantial costs of compliance for taxpayers and administration for the IRS.

These objectives cannot always (or, realistically, ever) be met simultaneously, and the attempt to satisfy at least the first three of these competing concerns, or at least to pay homage to them, has over the years created the current hodgepodge of international tax rules. The one objective that has received short shrift in this process is certainly simplicity. Simplicity is related to, and can at times be complementary with some of the other objectives. In particular, simplicity can improve competitiveness and efficiency by reducing burdensome compliance and planning costs.

With these objectives in mind, I will focus in the remainder of my testimony on three areas. First, I will discuss briefly the effect the WTO ruling and its implications for the objectives we discussed above. Second, I will discuss the current tax system and how it measures up in terms of competitiveness concerns and the other objectives discussed above. Finally, I will discuss one of the principal alternatives to the current system that is currently under discussion, some form of a territorial tax system.

To summarize my principal conclusions:

- If the WTO decision results in the repeal of the extraterritorial income regime (ETI), we should be grateful to the WTO for forcing us to do something that will benefit Americans as a whole. The ETI represents an export subsidy, which distorts trade. It may benefit particular companies and possibly their workers, but overall it makes us poorer than a free trade policy would.
- The current U.S. international tax regime represents a mixed bag in terms of its effects on competitiveness, economic efficiency and protection of the tax base. In general, relatively little U.S. tax is collected on foreign source income of U.S. companies from active non-financial foreign investment. This suggests that, in terms of the direct burden of U.S. taxes, the competitiveness objective is most close to being satisfied. At the same time, in specific areas in which location of investment is often considered more mobile, such as financial services, the rules emphasize efficiency and tax base protection over competitiveness. However, given the increasing global integration of these markets and the ease with which companies operate across borders, it may be time to give competitiveness concerns greater weight.
- The current U.S. international tax regime clearly fails on simplicity grounds. In many cases U.S. companies face onerous burdens of compliance with exceedingly complex rules. Changes that reflect a rebalancing of competing objectives in favor of simplicity could result in net improvements in competitiveness and economic efficiency, without substantially undermining the U.S. tax base.
- A realistic territorial tax regime could have some attractive features, however, its impacts on U.S. multinationals would vary, and for broad classes of companies, it would not necessarily lower tax burdens. In addition, the prospects for simplification may not be significantly better than under the current system, if we continue to care about preventing erosion of the U.S. tax base.

II. The WTO Decision

As I have stated, the WTO ruling should be considered a victory for Americans, assuming that the extraterritorial income regime (ETI) is repealed and the tax revenues thereby saved are used for some more worthy policy objective. The ETI is in fact an export subsidy, which distorts trade by subsidizing the consumption of U.S. products by foreigners. If the subsidy increases exports at all, it has to be because the price of U.S. exports falls relative to foreign imports. Thus, at least a part of the benefit from this subsidy is passed through to foreigners, and Americans as a whole are made poorer as a result. The shareholders and workers of particular companies may get some of the benefit from the subsidy if it increases company profits and/or wages, but if exports are increased at all it has to be because part of the benefit goes to foreigners.

Eliminating trade distortions like the ETI and following a policy of free trade is likely to lead to a higher standard of living for Americans as a whole.

III. Current U.S. Policy Towards Foreign Income

The United States taxes its resident corporations and individuals on their worldwide income. For U.S. multinational corporations, this system is complicated and sets up varying incentives for foreign investment and income repatriation depending on the particular circumstances of the U.S. parent corporation.

A. Key Elements of the System

The key elements of the system are deferral, the foreign tax credit, the allocation of expenses to foreign income, and the income source rules.

Deferral

The timing of the imposition of U.S. tax on the income of U.S. companies from their foreign operations depends upon the way in which the foreign operation is organized. If it is organized as a branch of the U.S. corporation, then the income of the branch is taxed as it accrues. If it is organized as a controlled foreign corporation (i.e., it is separately incorporated in the foreign country), then the income (with some important exceptions) is not generally taxed until it is remitted to the U.S. parent. This delay in the taxation of a subsidiary's profits until they are actually remitted is known as deferral.

Under the current tax rules deferral is limited by anti-deferral rules that are targeted at certain types of income that are considered to be particularly mobile or low-taxed. These anti-deferral rules (largely the subpart F provisions) are the source of considerable complexity.

Foreign Tax Credit

To avoid double taxation, a credit against U.S. tax is provided for foreign taxes paid on foreign source income. The credit covers both taxes incurred directly on payments of income from abroad, such as withholding taxes on dividends, interest and royalties, and, for income from a controlled foreign corporation (i.e., a separately incorporated subsidiary of a U.S. company) the foreign taxes on income out of which a dividend distribution is made to the U.S. parent company. The foreign tax credit is limited to the amount of U.S. tax payable on the foreign income. If the foreign tax exceeds the U.S. tax payable, excess credits are created. These excess credits may be carried back two years or forward five years to offset U.S. tax payable on foreign income in another tax year.

The limitation on the foreign tax credit operates to a large extent on an overall basis, that is, income from different sources can be mixed together and excess credits from a source of income that faces a high foreign tax rate may be used to offset U.S. tax from a source of income that faces a low foreign tax rate. This "cross-crediting" is limited by the placement of various different types of foreign source income into nine different "baskets" that are each subject to a separate foreign tax credit limitation. Most foreign source income falls into the general limitation basket. The separate limitation categories generally include types of income that are subject to low foreign taxes or are considered to be particularly mobile and thus easily located in low-tax locations.

The large number of separate limitation baskets creates a substantial degree of complexity and imposes costly recordkeeping burdens.

Expense Allocation

The allocation of expenses to foreign source income has the objective of determining the appropriate amount of foreign source net income, which feeds into the calculation of the foreign tax credit limitation. In principle, only expenses that support the earning of the foreign source income should be allocated to foreign source income. Since the allocated expenses are typically not deductible in the foreign jurisdiction, the effect of allocating expenses against foreign source income is to reduce the foreign tax credit limitation. If the taxpayer has excess foreign tax credits at the margin the allocation of expenses to foreign source income in this case effectively represents a denial of the deduction.

The rules regarding allocation of interest expense merit specific discussion. These rules provide for what is referred to "water's edge fungibility." This means that U.S. interest expense is allocated between domestic and foreign source income. The idea is that the U.S. borrowing supports both the U.S. and foreign operations. However, as is widely understood, this method ignores the fact that a foreign subsidiary of a U.S. company may be supported by its own external borrowing.

Source Rules

Any system that treats foreign source income differently from domestic income (e.g., by allowing a foreign tax credit or exemption) requires source rules to determine what income should be considered foreign source. The only aspect of these rules which I will comment on is the sales source rule. This rule permits U.S. companies that manufacture in the United States and export their products to treat 50 percent of the income from those exports as foreign income. For those companies that have excess foreign tax credits, this amounts to an exemption of this income from U.S. tax.

This rule effectively amounts to an export subsidy similar to (and more generous than) the ETI, but of benefit only to U.S. companies that have excess foreign tax credits. The same analysis applies to this subsidy as to the ETI: It may benefit particular firms, but it is a distortion of trade that is likely to harm Americans as a whole.

B. Effects of the Current System

How does the current system measure up in terms of competitiveness and the other objectives I listed above?

Standard economic analysis indicates that economic efficiency is promoted if U.S. firms face the same tax on investment income, whether that income is earned from a domestic investment or a foreign investment. This is generally referred to as "capital export neutrality." On the other hand, competitiveness is promoted if U.S. firms investing abroad face the same tax as local firms. This is generally referred to as "capital import neutrality." The current rules regarding deferral and the foreign tax credit reflect a compromise between the competitiveness and efficiency objectives and the objective of preserving the U.S. tax base.

If we only cared about competitiveness, that objective could be achieved by exempting foreign source income from U.S. tax. In that case, the only tax that would apply would be the local tax.[1] In many cases, the current system in effect works like an exemption system. If excess foreign tax credits are available for cross-crediting, investment in a low-tax jurisdiction will in fact bear no additional U.S. tax. Even if there are no excess foreign tax credits, if the U.S. tax on low-tax foreign earnings can be deferred through reinvestment abroad, its present value is reduced. If the deferral is for a sufficiently long period of time, it is virtually equivalent to exemption.

In fact, studies indicate that non-financial U.S. companies do a good job of avoiding substantial U.S. tax on their foreign earnings. Using tax return data, Rosanne Altshuler and I found that non-financial U.S. companies as a whole paid little in the way of U.S. taxes on their foreign earnings.[2] We found that the average U.S. tax rate on the foreign source income of these companies was only 3.4 percent in 1986. Harry Grubert and John Mutti performed similar, but more sophisticated calculations using data from 1990 and found an effective U.S. tax rate of only 2.7 percent on income paid back to the United States and 1.9 percent on total foreign income, both repatriated and unrepatriated.[3] These data of course only deal with non-financial companies, and they are bound to mask considerable variation across companies in terms of their mix of business and tax position. However, they suggest that for many U.S. companies the direct U.S. tax burden on their foreign source income is small.

We have anti-deferral rules for two reasons. One is the concern about potential erosion of the U.S. tax base if tax can be deferred indefinitely on highly mobile types of income. If deferral were available on passive income, for example, foreign subsidiaries could be used essentially as mutual funds that could invest passively and avoid U.S. tax on earnings indefinitely. There was also a concern that in the case of business activities that were considered to be particularly mobile, such as foreign base company sales and services operations and financial services, deferral would provide too great an incentive to shift activities to low-tax jurisdictions. This raised concerns in regards both to tax base erosion and efficiency in the allocation of investment between the United States and low-tax foreign locations.

However, competitiveness concerns may be particularly relevant in respect of the taxation of financial services income. Integration of international financial markets has placed U.S. financial institutions in increasingly direct competition with foreign financial institutions. The current U.S. taxation of foreign source financial services income may disadvantage the U.S. firms relative to some of their foreign competitors.

In any case, both the U.S. anti-deferral regime and the foreign tax credit regime involve substantial complexity. Simplifying them could bring benefits in terms of reduced compliance burdens. While there would be some potential trade-off with competing objectives, given the extreme complexity of the current rules, there are worthwhile trade-offs to be made.

As noted above, the current interest expense allocation rules generally amount to a partial disallowance of U.S. interest deductions if the U.S. parent company has excess foreign tax credits. This raises the cost of borrowing through the U.S. company and provides a strong incentive to shift borrowing to foreign subsidiaries. This may harm the firm if borrowing through foreign subsidiaries involves higher costs. A better approach would be to allow the allocation of worldwide interest expense for a multinational group.

IV. The Territorial Income Tax Alternative

About half of the OECD countries have a territorial system under which dividends a company receives from foreign subsidiaries are exempt from tax. If the United States were to adopt such a system, it is not clear whether this would be beneficial it terms of the criteria we have discussed: competitiveness, efficiency, preservation of the tax base or and simplicity.

The typical territorial approach in other countries exempts only dividend income from active businesses. Dividends from portfolio investments and all interest and

[1] As discussed further below, this ignores taxes on deductible payments back to the United States, such as intercompany royalties, fees and interest.

[2] See Rosanne Altshuler and T. Scott Newlon, "The Effects of U.S. Tax Policy on the Income Repatriation Patterns of U.S. Multinational Corporations," in *Studies in International Taxation*, ed. A. Giovannini, G. Hubbard, and J. Slemrod, pp. 77–115, Chicago: University of Chicago Press, 1993.

[3] See Harry Grubert and John Mutti, "Taxing Multinationals in a World with Portfolio Flows and R&D: Is Capital Export Neutrality Obsolete?" *International Tax and Public Finance*, 2, No. 3, November 1995, pp. 439–57.

royalties are taxed when they are paid, with a foreign tax credit provided for foreign taxes paid only on these items of income. In addition, to varying degrees these countries also may have their own anti-deferral regimes that tax certain income earned by foreign subsidiaries as it accrues.

It is only natural that these countries limit the exemption in this way. They are concerned about preservation of their tax base and do not wish to provide their companies with inordinate incentives to invest abroad. Exempting foreign source royalties from taxation would make it enormously rewarding for companies to transfer intangible assets such as patents, technology and know-how to a foreign subsidiary, since the returning royalty could be largely untaxed. Similarly, exempting interest receipts from foreign subsidiaries would make it enormously rewarding for companies to push down the income of the subsidiary by financing the subsidiary largely with debt, effectively avoiding any tax.

Given that substantial categories of income would still be taxed on a worldwide basis, with a foreign tax credit, and that anti-deferral measures would remain necessary, it is unclear that an exemption system would necessarily be any simpler than the current system.[4]

Perhaps surprisingly, moving to a territorial system along these lines would likely increase U.S. tax payments for many companies. This would occur for three reasons. First, many companies currently use excess foreign tax credits from highly taxed foreign source income to offset U.S. tax on foreign source royalties. Under an exemption system, these companies would continue to pay the same high foreign taxes on their operations, but they would no longer be able to shelter their foreign source royalties from U.S. tax with foreign tax credits. Second, and similarly, many companies now benefit from the sales source rule—but they only do so because they have excess foreign tax credits to offset U.S. tax on the sales income that is treated as foreign source under this rule. Under an exemption system there would be no foreign tax credits, so this benefit would disappear. Finally, currently allocations of U.S. interest and overhead expenses against foreign source income result in an effective disallowance of these deductions only when a company has overall excess foreign tax credits. Under an exemption system, these allocations would virtually always result in a disallowance of the deduction, since there is no tax on the foreign source income and it would be difficult to get many foreign tax authorities to accept a deduction against their own tax for expense allocations of this nature. Together, these effects are so substantial that Harry Grubert has estimated that substituting an exemption system for the current system would actually raise tax revenue.[5]

Companies that operate predominately in low-tax jurisdictions would be more likely to benefit directly from a territorial system, since they are not able under the current system to cross-credit to shield their low-tax foreign income from U.S. tax. Because of this, there would be increased incentives for companies to shift operations from high-tax to low-tax locations. To the extent this reduces total foreign taxes paid, it is a benefit to the United States. On the other hand, to the extent that there is a substantial tax-induced shift of investment out of the United States to low-tax locations, this would be harmful both in terms of the economic efficiency of the allocation of our capital stock and because of erosion of the U.S. tax base.

The ultimate effects of moving to a territorial system would depend on the specific provisions of the system as adopted. Given that there are competing valid policy objectives, and the impacts of moving to such a system would likely vary across companies and industries, it is unclear at this point what such a system might end up looking like if it were actually implemented. Therefore we should be cautious about comparing the current international tax system to an idealized territorial system.

Chairman MCCRERY. Thank you, Mr. Newlon, and thank all of the witnesses for your testimony. I have got a lot of questions, but before I get to any of these specific concerns, it just seems to me, listening to this array of witnesses, that pretty well cuts across our industrial base, our manufacturing base, and to some extent services, and, Mr. Newlon, it just strikes me that we policymakers and those before us maybe, have not done a good job in keeping our Tax

[4] For a complete discussion of issues in the implementation of an exemption system, see Michael J. Graetz and Paul W. Oosterhuis, “Structuring an Exemption System for Foreign Income of U.S. Corporations,” *National Tax Journal*, 44, No. 4, December 2001, pp. 771–86.

[5] See Harry Grubert, “Enacting Dividend Exemption and Tax Revenue,” *National Tax Journal*, 44, No. 4, December 2001, pp. 811–28.

Code modern, current. A lot of these tax rules were written 30, 40 years ago when things were a lot different in terms of how we make a living and the kind of business we do, the kind of products we sell, where we sell them.

So, I don't know about ripping the Tax Code out by its roots, but it seems to me that there is a lot of spade work that needs to be done.

We are the guys to do it.

So, Mr. Newlon, would you agree with that—that our Tax Code is somewhat antiquated in view of the changes that have taken place in the market over the last 10, 15, 20 years?

Mr. NEWLON. I think certainly over time that the Tax Code—to some extent, I would say we started out with a base that we have added to along the way. In adding to that, in some respect we lose sight of the overall principles, and we end up with sort of a camel that doesn't get to any of our objectives or maybe doesn't have the appropriate tradeoffs we would want moving forward into the future.

Chairman MCCRERY. The subpart F exceptions and—not the exceptions; the subpart F rules were written at a time when we manufactured widgets and sold widgets. Now, we have got software. We have got all kinds of services that just don't seem to fit very well under our current subpart F. That is just one example where it seems to me we have been asleep at the switch here.

Mr. REINSCH. That is a good example. I am going to say something that fundamentally agrees with you, Mr. Chairman.

Globalization, which has been a long-term development, really has changed the way that we do business in a lot of significant ways. Free flow of capital, free flow of technology, in particular, has made it possible for companies to do many things now that they couldn't do before. We used to think of trade as we export, which means the good is made here and is shipped over there; or we import, vice versa. Now companies have many different options, as you have seen by the comments made here, and the subpart F rules, in particular, haven't kept up.

At the same time, one of the things that I learned in watching our coalition work—and I confess, as will be obvious if you ask me any detailed questions, I am a trade person not a tax person, and you know there is a big difference. What I learned in watching this coalition develop is that there remain in this country a number of very significant companies and sectors that are still fundamentally exporters. For a variety of reasons, they have not chosen or are not able to, or in the case of defense-related companies are not allowed to, take significant portions of their activities offshore.

One of the reasons we developed the proposal the way we did is because of our realization that dealing only with subpart F and the base rules accommodate the concerns of a number of people who have adjusted to the changes reflected. There are a significant number of sectors, primarily aerospace and agriculture, that are simply not in a position to take advantage of the trends that I have been talking about, and those are sectors we ought to worry about too.

Chairman MCCRERY. Well, thank you. Let me get to your proposal since you spoke up.

I have some concerns about some of the particulars with regard to WTO compliance, and so I just want to throw a few of these things out and give you a chance to respond. I am sure our staff will be working with folks from your industry to flesh out some of these concerns and get responses more in detail.

Just to give you some idea of some of the things we are looking at—let's see. Your list for wage credits, for example. How did you pick the goods eligible for the wage credit? Why didn't you include all products that are exported, like wood products and so forth? How did you pick just that list of goods eligible for the wage credit?

Mr. REINSCH. Well, I think there are probably two things to say about that, Mr. Chairman. One, if we had attempted to focus exclusively on industries that exported, or on exports, we would probably have the same WTO problem that we have run into with ETI. So we explicitly couldn't do that, and had to take a different direction.

As to why we chose what we chose, I mean, to be quite frank about it, we have a coalition, and the members of the coalition put together the industry codes that were of interest to them. If other people would like to join the coalition, we would be happen to listen to them.

I would point out, there are revenue implications to that one in particular. That is another reason why we put in an overall cap.

Chairman MCCRERY. Thank you.

Also in your Footnote 59 proposal, there are a number of things that you propose—expanded version of the ETI rules to determine what is an export transaction, references to an ETI cap, provisions permitting a tax-tree transfer of marketing intangibles and election to use in the provision, a definition of foreign source income including any goods susceptible to tax and not actually subject to tax.

Did you all scrub all of these things individually and in terms of WTO compliance? It just seems to me that some of those might present a problem.

Mr. REINSCH. Well, if by "scrub" you mean, did we consult with the European Commission, no. Did we—yes, in terms of working with our own counsel, our trade counsel as well as our tax counsel, yes, we did. We believe they are compliant.

With respect to just one of them, because I don't want to use up all of your time, Mr. Chairman, but the cap that we employ is not really related to—we don't think, in particular, that presents a WTO problem. It is an effort to determine the total amount of benefit that would accrue, but it is based on the past amount of the tax benefit, not based on exports. It is not based on current company activity, and so we think that it wouldn't raise a compliance problem.

Our judgment at the end of the day on the Footnote 59 provision was that it would be compliant. If you would like, we can present you in writing with a longer analysis of that subject.

Chairman MCCRERY. Sure.

[The information is being retained in the Committee files.]

Mr. REINSCH. At the same time, I am constrained to say, Mr. Chairman, it is my view from a trade policy standpoint that whatever you ultimately do is likely to be challenged by the European Commission regardless of what you or I think is complaint.

Chairman MCCRERY. That may be the case. That is why I want to make sure that we scrub all of these provisions and make sure that we have the best possible case when it is, or when it might be challenged. So, I appreciate your response.

We would like to see maybe a little more detailed explanation of how you think these provisions would be in compliance, and then we might take the opportunity later to actually meet with some of your folks to go over all of that.

Mr. REINSCH. We would be glad to provide it. We would be delighted to meet.

[The information is being retained in the Committee files.]

Chairman MCCRERY. Thank you. Mr. McNulty.

Mr. MCNULTY. Thank you, Mr. Chairman. I thank all of the witnesses for their testimony.

Mr. Newlon, in your opinion, how competitive are U.S. companies right now, today, internationally?

Mr. NEWLON. Well, I think obviously that varies from company to company. Clearly the U.S. economy and U.S. companies are some of the most competitive in the world. Obviously, the U.S. economy has been the envy of most of the world, over the last decade at least.

Mr. MCNULTY. Under a territorial system, who, in your opinion, are the winners or the losers?

Mr. NEWLON. It is a little bit difficult to say until we actually have a particular proposal for a specific territorial system. If we went to the sort of territorial system that you see in a lot of the other OECD countries that have territorial systems, in which an exception was provided for active business income, dividends effectively, or branch income, I think that what you might see are companies that currently have excess foreign tax credits from high-tax, foreign income, active—that are in our active, the general limitation basket—I don't want to get too technical here—but also have a lot of income coming back in the same basket that doesn't face much foreign tax at all, in particular, royalties, or intercompany interest that might be in that basket.

Many of those companies are able to shelter that royalty income, those deductible payments from abroad, from U.S. tax using the excess foreign tax credits that they get from their operations in high-tax foreign locations. That is a big benefit to them.

There are also benefits in terms of the sales source rule, where excess foreign tax credits may shelter U.S. income on exports. Those benefits could be lost to those companies if we move to a territorial system. A reasonable, logical territorial system wouldn't exempt foreign royalties coming back, but you would no longer have the excess foreign tax credits to shelter that income from U.S. tax.

There would also be issues relating to allocations of U.S. expenses against foreign income under a territorial system, and how that gets sorted out could affect different companies differently.

Mr. MCNULTY. Do you see any viable proposals on the table right now to replace the ETI?

Mr. NEWLON. I would have to say, given my testimony that what I would really be looking for myself in this area is a broader perspective in terms of, if we are looking at the international tax rules, going at them there is a lot of scope for reforms that are clear winners in terms of good tax policy. That is what I would look to if we want to use this opportunity to improve our tax rules.

Mr. MCNULTY. Thank you, Mr. Chairman.

Chairman MCCRERY. Just following up quickly on the competitiveness issue, you said that during the nineties the U.S. economy was the envy of the world, and certainly our manufacturers and so forth were very competitive.

Let's go back to the seventies. Was the picture the same then, late seventies, early eighties?

Mr. NEWLON. No, it was not at that time.

Chairman MCCRERY. These things come and go. Some of it is due to macroeconomic events that we can't control here. Some of it is due to tax policy. In the early eighties, when we allowed the manufacturing sector very liberal expensing rules, they rebuilt, became much more efficient, became competitive with the Japanese, and so forth.

I mean, there are a lot of things that go into this, but I think it is incumbent upon us to continually review this and make sure, or try to make sure, that the things we can control, like tax policy, don't impede our domestic industries as they try to stay competitive. We can't just rest on our laurels and say we are good, so we will just say that way forever.

So, I just wanted to throw that in. Mr. Ryan.

Mr. RYAN. Thank you, Mr. Chairman.

Mr. Reinsch, I have a question on your subpart F proposal, and I just want you to clear up something for me, if you could. Your subpart F base company proposal permits base company income from exports to be repatriated to the United States tax free, but would not allow the same tax-free repatriation for nonexport-based company income.

Why do you distinguish between the two? Don't you create a WTO problem by doing that?

Mr. REINSCH. Well, as I mentioned to Mr. McCrery, Mr. Ryan, I am a trade policy person.

I would like to ask Ms. LaBrenda Garrett-Nelson to comment on that—she was the consultant that developed that piece of our proposal—with your permission.

Ms. GARRETT-NELSON. That element of what is a conceptual proposal is, based on the rationale of Footnote 59, that you can permit an exemption for that type of income. That is why we did not believe it would present a WTO compliance problem.

Mr. RYAN. It changes the tax treatment on exporters vs. nonexporters. So, if a U.S. company is building it here and selling it there, they can repatriate the income tax free, but if they build it there, sell it there, they get taxed on it?

Ms. GARRETT-NELSON. That is the correct reading of it.

Mr. RYAN. You don't think that that appears to be——

Ms. GARRETT-NELSON. Well, part of the problem, this is why Mr. Reinsch was suggesting that we would need to work with the Committee and its staff. Part of the problem is that we are dealing with language in a WTO opinion that really is dicta, because what it had before it was a system that did not fit within the exception, but they acknowledged that there is an exception. So there is some uncertainty; short of the EC blessing a package, there will be uncertainty.

Mr. RYAN. We are having these discussions because their definition of indirect and direct taxes are different than our definitions, and so we are going down this road. I guess we will just talk about this later.

It doesn't seem to be WTO compliant to me, but maybe I am wrong. I would love to learn more about the proposal.

Ms. GARRETT-NELSON. We would love to share more about it with you.

Mr. RYAN. Thank you.

Mr. Newlon, I want to ask you a quick question. When you summarized your testimony a minute ago, and correct me if I am wrong, you said that it would be better for U.S. competitiveness to simply eliminate the ETI, period, and that we would need to go to, down the road, fundamental tax reform, making our international rules more competitive.

Is that your testimony? Are you suggesting that ETI only benefits a handful of companies and that if we eliminated ETI, it would be make us more competitive, in and of itself?

Mr. NEWLON. What I would say, I don't think we need to go to a necessarily—to fundamental tax reform to have improvements that would help our competitiveness more generally and just represent good tax policy.

In the international tax area there are lots of things that can be done. Simplify the system to eliminate some disadvantages potentially in some areas where we may have had a lot of concerns about the location of investment that may have now been overtaken by developments in the global economy.

In terms of the ETI/FSC, obviously it depends on what you do with the money that comes out of that. You know, if the money is thrown away or used for something that is bad tax policy, we could end up worse off. My view is that FSC/ETI isn't good tax policy in itself. So eliminating that, we have the opportunity to do a lot better.

Mr. RYAN. Something needs to replace it to end the double taxation on the income, correct?

Mr. NEWLON. I don't think that there is a double-taxation-of-income issue necessarily there. I would say there is plenty of opportunity here to replace—if we want to view it in that way, use those revenues for things that will help the American economy and help the American people, improve the productivity of our economy.

Mr. RYAN. Okay. Well, I have many follow-ups, but I see my time has run out, so I will yield.

Chairman MCCRERY. Thank you, Mr. Ryan.

I would tell the Members, if you desire a second round of questioning, we certainly can do that. Mr. Neal.

Mr. NEAL. Can we get Mr. Hubbard to come back?

Thank you. I want to agree with Jim McCrery in his comments a couple of moments ago about the changes that have taken place and what it had done to promote the economic growth of the nineties. I don't think we should discount deficit reduction and debt reduction either; that had a huge impact on what happened throughout the nineties.

Mr. Reinsch, in your June 11 report you say that you are against the territorial tax system. I bet you were surprised at the amount of attention given to this subject in the Administration's testimony on the prior panel.

Is it your understanding that territoriality is one of the options that the Treasury Department is seriously considering to replace the current system of taxation?

Mr. REINSCH. We have not thus far believed that that was the case. I think that the signals we have gotten from them in our meetings with them, and that includes the witnesses that you had, were primarily that they intend to work closely with your Committee and would be guided in part by where you all want to go.

We have not had the sense that they are dying to go down that road.

Mr. NEAL. Fair enough.

I also noted that Ingersoll-Rand is a member of this study group that issued the report. Is the National Foreign Trade Council, representing U.S. multinational businesses, aware that Ingersoll-Rand is a Bermuda company, having forsaken U.S. citizenship to avoid taxes?

Mr. REINSCH. They are on our board. Yes, I am aware of it. They are—well, let me just stop there.

Mr. NEAL. You don't have to.

Mr. REINSCH. Prudence would dictate. Let me just say they are not a member of the FSC/ETI coalition. They did participate in the territorial study.

Mr. NEAL. Thank you.

Mr. Cowen, the Chairman of the Subcommittee, Mr. McCrery, and I, we have worked very hard, we have done it hand in glove with the issue of trying to reform subpart F of the Tax Code. So, we hear what you are saying.

In the past years, the industry does not always present, as you know, a united front. So let me ask just three specific questions.

Do you have an idea of the cost to the Treasury Department of making a tax change to benefit your industry?

Mr. COWEN. My understanding is that there is no current estimate available, and we are in the process of providing information to the staff so that one can be obtained.

Mr. NEAL. How many jobs do you estimate would be created for American citizens by that tax change?

Mr. COWEN. Well, of course I would have to make certain assumptions as to the amount of increased activity there would be in our business.

I would only say this. I believe that if we create an opportunity for American companies to be competitive in the foreign trades, we will see business created here, we will see capital flow in, we will see companies based in the United States with shore-side staffs and technical expertise.

We will also see, I believe, a U.S. flag component of that, with U.S. jobs, because when the companies are here with that expertise and those headquarters, they are going to actually be looking at U.S. business the same way that we do today.

Mr. NEAL. Fair enough. The last part of it, number three, does organized labor support the proposal?

Mr. COWEN. We are in discussions with our unions. I am optimistic that they will come along with us, because in the long run, OSG has demonstrated, and some of our competitors have demonstrated too, that if you are strong on the foreign side, you can also be there on the American side, to do the Jones Act, to build the ships we need for the Jones Act trade and the Alaska trade and other activities domestically.

Mr. NEAL. Thank you.

Chairman MCCRERY. Mr. Cowen, let me follow up. You pointed out in your testimony that there have been a number of high-profile transactions in which foreign shippers have bought American shippers, and they have become foreign-owned companies. You talk about the tax policy that contributes to that.

Are there other reasons besides tax policy that we have seen so many American shippers leave or be bought?

Mr. COWEN. I think in our case it is really that simple; it is driven by tax policy. The normal flow of capital would suggest that with the high level of interest in the United States in the movement of oil and movement of bulk commodities worldwide, you would expect there to be a flow of capital here into unto that activity. It is simply the fact that the incentives are turned upside down, and our foreign competitors have different economics than we have, because of the tax law that the United States has in place today under subpart F.

I think that really goes a long way in explaining why we don't see the U.S. companies staying here, but we have seen a lot of companies bought out or move.

Chairman MCCRERY. Thank you.

Mr. Kostenbauder, you talked a little bit about the foreign-based company sales and services rules and how Hewlett-Packard might be affected by those changes. Can you expand upon that a little bit—how you might arrange your business activities in Europe, for example, differently if those rules were repealed?

Mr. KOSTENBAUDER. Sure. Let me make a point about the general European environment.

Certainly it is a very big market. We have a lot of very powerful competitors, and they are free to organize themselves considering tax, as well as their normal business considerations, in a way that optimizes their performance. The way our competitors organize themselves might focus on lowering taxes, but it could also focus on reducing other kinds of costs, concentrating headquarters activities in a particular location, or other considerations.

Our competitors there have the ability to do that as European companies focusing on the European tax environment. A company like Hewlett-Packard, which is subject to the subpart F rules, can try to maximize its efficiency and organize itself much like our European competitors. Our foreign competitors are often organized in a way that the subpart F rules would be applicable if they were subject to them, but they are not. So, U.S. companies would never be able to achieve the same kind of simplification and reduction of costs and tax expense because subpart F puts a 35-percent automatic tax on most such cost reductions.

I joined HP in 1980, so it is about half the lifetime ago of subpart F, and one of the things that happened in my experience with a company like HP—I think it was very typical of most companies—was that activity used to be very country-based.

So, we had a German subsidiary. It basically dealt with the German marketplace, and a French subsidiary dealt with the French marketplace.

Today, as a company, HP is trying to become much more active in services. The whole electronics industry, instead of selling people computers or software, is trying to sell solutions. So if you think about solutions, there is not a German or a British solution, but rather there is a solution for the financial services sector, or the retail sector, or for manufacturers. So increasingly, we have expertise related to financial institutions that may be headquartered in London.

Well, everybody is using network software, computers, and so forth. What is different? Well, the financial services customers really need security. They really need encryption, they need a lot of powerful fire walls.

There may be a concentration in France of employees who have an expertise in retail. So you have some concern about security in a retail context, but you really want to have all of those cash registers out there collecting all of that point of sale information, on a realtime basis putting that in a database.

Well, our people that sell those things have expertise in those different areas, and other kinds of expertise that might relate to manufacturing. So today, and as I look at HP's future, we are going to have a lot more of these kinds of market focused activity that are going to be headquartered in one country with people traveling to other countries. As I mentioned earlier, when services are purchased from one affiliate and delivered in another country, you have that combination of a related party transaction and some activity outside of the country of incorporation which triggers subpart F foreign base company rules.

Our European competitors would not need to worry at all about the subpart F rules. They also wouldn't have to worry one little bit about the compliance and even the planning for it. When we do some of these things, again that European companies can do, based upon European considerations, our U.S. tax department has to be involved to oversee that and to try to make sure that we are, in fact, complying with the requirements of U.S. laws as well.

Chairman MCCRERY. Mr. Sprague, how about the software manufacturers? Would repeal of the base company sales and service rules be beneficial to you?

Mr. SPRAGUE. Yes, very much so, essentially for the same reasons that Dan mentioned with respect to HP. The software industry also is heading toward business models that involve regionalized locations—software development located in a certain place, software support services being provided from a different place, along with intangible property being licensed between related entities in order to allow distribution of products.

When you think about what subpart F addresses, it addresses or it impacts any transaction that goes across country borders. So, subpart F puts a real burden on any company that tries to centralize functions in one place, but provides value, whether it is goods, services, licensing, or whatever, across country borders.

It is still the case that, from a local perspective, you tend to want a separate German entity and a separate French entity and a separate Japanese entity for labor law reasons and all sorts of other things. When you overlay that separate company or separate country entity regime on top of a globalized and regionalized distribution system, you run into subpart F complications every which way from Sunday.

So, the repeal of foreign base company sales income, and services income also, would benefit the software industry.

The additional point about the need to also reform the rent and royalty rules comes from the situation that we have a law that was enacted 40 years ago when the software industry just did not exist. Today, it is a $150 billion a year industry around the world, with business models that just were not within the contemplation of Congress when subpart F was enacted. We need to do the right thing to bring the law into the 21st century.

There is one other point I would like to make. The thought was inspired by some of Mr. Neal's questions.

In subpart F today, there does exist an active trade or business test, in the context of rents or royalties, that attempts to distinguish between more active rent and royalty income versus investment-type rent and royalty income. Today that rule has real perverse incentives. It operates today to give incentives to U.S. companies to locate value-added activities overseas in foreign subsidiaries.

So, what I would like to see happen is that the active rent or royalty rule be revised so that there is not an incentive for U.S. software companies to locate development activity or marketing activity in foreign countries.

Chairman MCCRERY. Thank you.

Mr. McLaughlin, you mentioned that Wal-Mart owns a 6-percent share of a large Japanese retailer, and you have the right to purchase up to 66 percent of that Japanese retailer.

To what extent would your decision about expanding your Japanese holdings be affected by how the Congress responds to the WTO ruling in the ETI case?

Mr. PARSONS. Of course, the retail industry does not directly use FSC/ETI, as I mentioned in my testimony, but rather it is our vendors and suppliers that take advantage of these benefits. To the extent that they are not addressed, it would drive up the costs of our suppliers, which means it makes us more noncompetitive as we try to go in and work in that Japanese market, as we try to introduce U.S. goods.

Chairman MCCRERY. What would that do to your decision to expand your ownership share in the Japanese company?

Mr. PARSONS. We are in the process at the moment of looking at that market and doing those economics to see whether or not we will exercise those options to move up to two-thirds. I can only say that it will be an economic decision considering all of the factors, including taxes.

Chairman MCCRERY. Mr. Parsons, I understand where you are coming from. It is a problem that we have talked about on the Committee and among staff. We don't have a magic wand that we can wave and solve problems of compliance with the WTO and continue to provide the same benefits. So we are looking at other ways to assist small manufacturers to try to help.

One way that we came up with earlier this year was in the stimulus bill for the 30-percent expensing, and also we have looked at section 179 expensing. Are you able to take advantage of section 179 expenses?

Mr. PARSONS. Yes, we are.

Chairman MCCRERY. So any increase in that would help you?

Mr. PARSONS. Yes.

Chairman MCCRERY. Anything else that you can give us in a general way, outside of the export realm, that can be helpful to you?

Mr. PARSONS. Subchapter S tax relief would be greatly appreciated. Even little things like—for a small company, I don't have an international tax department. We depend a lot on sources like the National Association of Manufacturers and others.

Just to—even in collections there are currency risks that I take in doing business in countries such as Australia and doing business in South America. Just collections sometimes are very difficult, and spending 2 years collecting on an account in Peru is not exactly how I want to spend my time.

It is difficult for a small manufacturer to go out and be competitive in areas where we are hit with tariffs going in, and we have a higher cost of labor. Yet, we will continue to pound on these doors and try to generate that business, because that is where it is at.

Chairman MCCRERY. You mentioned tariffs, so another way that we can be helpful is to work through trade agreements to bring down those barriers to your products entering these countries?

Mr. PARSONS. Absolutely. If we could extend the North American Free Trade Agreement to Chile, for instance, that would be a tremendous benefit for us.

Chairman MCCRERY. Okay. Well, thank you. Again, I want to thank all of the witnesses today. I thank Mr. McNulty for his participation today.

Gentlemen, we will, I am sure, be talking with you again as we search for a solution to this problem and the inversion problem. Thank you.

[Whereupon, at 12:55 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of the Coalition of Service Industries

The European Commission ("Commission") filed a World Trade Organization ("WTO") challenge against the Foreign Sales Corporation ("FSC") regime in 1997. The United States replaced the FSC with the extraterritorial income (or ("ETI") regime) in 2000, after the WTO Appellate Body ruled that the FSC was a prohibited export subsidy. On January 14, 2002, the WTO Appellate Body issued a final report finding that the ETI regime also violates WTO agreements to which the United States is a party. The June 13, 2002 hearing was held to explore "making changes to the Tax Code to promote the international competitiveness of U.S. companies," as a possible response to the WTO's ruling.

CSI welcomes the opportunity to submit its comments for the record of the June 13, 2002 hearing. CSI's members represent a broad range of service sectors, including financial services, transportation services, accounting, legal, and other professional services as well as telecommunications, energy, and information technology. CSI members entered into cross-border leasing transactions that utilized the foreign sales corporation ("FSC") or the ETI tax rules.

Introduction

Before enactment of the ETI regime, a taxpayer could utilize a FSC to facilitate exports by entering into leasing transactions, particularly long-term leases of heavy equipment, U.S.-manufactured airplanes, rolling stock, *etc*. Consistent with the general practice of the Congress, the ETI Act included grandfather provisions to cover such cases. Grave economic harm would result to U.S. exporters and U.S. financing companies that entered into these transactions if the grandfather provisions enacted in 2000 as part of ETI are not continued in any future legislation. Taxpayers should be able to proceed on the assumption that the transition rules for leasing transactions involving a FSC will be continued.

Similarly, if the Congress determines that ETI should be replaced, equivalent transition relief should be extended to leasing transactions that qualified under ETI. The taxpayers in these ETI transactions priced their leases in reliance on the assessment of the Congress—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.[1] A similar analysis applies to taxpayers who entered into long-term FSC leases containing lessee options which, while not binding on the lessor, were also priced in reliance on FSC benefits should the options be exercised by the lessee and accepted by the lessor—these FSC leases and options are today eligible for tax benefits under the ETI regime. Similar to the applicable legislative history, the Administration's "Appellant Submission" to the WTO argued that the ETI regime was drafted to comply with the applicable WTO agreements.[2] The Congress should seek to ensure the provision of transition relief that will fairly treat taxpayers who have detrimentally relied on the U.S. Government's assessment regarding the validity of current law.

The Congress should make clear that the Administration would be expected to negotiate with the Commission and insist on the Commission's acceptance of prospective effective dates and reasonable transition rules in any legislative response to the WTO FSC–ETI dispute. This is particularly appropriate in view of the fact the United States is in the position of considering amendments to its tax law because of a ruling handed down by an international body—not because U.S. lawmakers determined that a policy change was in order. Indeed, as the Administration observed in its Appellant Submission to the WTO, "in requiring a sovereign country to subject its taxpayers to such a shift, the WTO rules cannot have been intended to further require that the country deny its taxpayers the right to an orderly shift through transition relief consistent with it practice."[3]

The FSC Transition Rules Honor Binding Contracts Entered into by FSCs or Related Parties before the Enactment of ETI

The United States' repeal of the FSC was required to "have effect from October 1, 2000." Many affected leases are long-term in nature, some with terms as long as 20 years. The repeal of the FSC transition rules would wreck the economics of an existing lease that was priced by taking into account the FSC benefit to the lessor or its affiliate (resulting in lower rentals).

The repeal of the FSC provisions was a fundamental change in tax policy, and—as such—should not apply on a mandatory basis to contracts that were entered into before the date of enactment. Any other treatment could result in an unwarranted retroactive tax increase and be totally inconsistent with past Congressional practice.

Transition Rules Included in the ETI Act Preserved the Benefits of the FSC Regime for Leasing Transactions

In considering the transition from the FSC rules to the ETI regime, the Congress recognized the need for a general transition rule that took account of existing leasing contracts. For FSCs that were in existence on September 30, 2000, and at all times thereafter, the amendments made by the ETI Act did not apply to any transaction in the ordinary course of trade or business involving the FSC that occurred—

(a) Before January 1, 2002, or

[1] For example, the "Reasons For Change" in the Report of the House Committee on Ways and Means, H.R. Rep. No. 106–845, 106th Cong., 2d. Sess., includes the following statement: "The Committee strongly believes that the substantial modification to the U.S. tax law provided in this bill is WTO compliant." *See also* S. Rep. No. 106–416, 106th Cong., 2d Sess. page 5, regarding the statement that the ETI "legislation addresses both the broader issue of U.S. taxation of income derived from foreign sales, *i.e.*, "extraterritorial income," as well as complying with the WTO rulings."

[2] *See United States—Tax Treatment for "Foreign Sales Corporations*, Appellant Submission of the United States, (November 1, 2002) paragraph. 67.

[3] *United States—Tax Treatment for "Foreign Sales Corporations*, Appellant Submission of the United States, (November 1, 2002) paragraph. 262.

(b) After December 31, 2001, pursuant to a binding contract that—
  (1) Is between the FSC (or any related person) and any person that is not a related person, and
  (2) Is in effect on September 30, 2000, and at all times thereafter.

For purposes of this general transition rule, a binding contract included a purchase option, renewal option, or replacement option that was included in such contract and which was enforceable against the seller or lessor. Thus, transition relief was provided to preserve the benefits of the current FSC regime for: The remaining term of existing leases; The term of a new lease entered into pursuant to a renewal option; The term of a replacement lease entered into pursuant to a replacement option; The sale of property pursuant to a purchase option; and other lease options that would have been eligible for FSC benefits.

The WTO's View of the Transition Rules is Simply Unacceptable

The United States must weigh the WTO Appellate Body's ruling—that "a member's obligation to withdraw prohibited export subsidies ... cannot be affected by contractual obligations which private parties may have assumed *inter se* in reliance on laws conferring prohibited export subsidies," (¶ 230 of the AB Report)—against the fundamental unfairness inherent in significant tax law changes that have an adverse economic impact on taxpayers who relied on their government's assessment of current law to their detriment.

As the Administration pointed out in its Appellant Submission to the WTO, "without such transition rules, taxpayers lose confidence that the tax treatment they expect will in fact prevail. The absence of such certainty affects the ability of taxpayers to plan for their businesses, either in the long term or even in the short term. Failure to maintain a consistent practice of transition relief would result in significant and inefficient transaction costs as taxpayers are required to factor in the risk of tax changes into their transactional planning."[4]

U.S. practice in the development of tax law changes is to accommodate contracts that relied on the law as it existed when the contract was made. Thus, while it probably will be necessary to seek the Commission's agreement to continue the FSC transition rules and provide similar rules for ETI transactions, we believe the Administration should strive to respect congressional precedents and the contractual obligations of the parties who entered into leasing transactions. Any other treatment would result in an unwarranted retroactive tax increase and be totally inconsistent with past Congressional practice.

In the Interests of Fairness and Equity, The United States Should Not Abandon It's Long-standing Practice of Promulgating Transition Rules When Repealing Significant Tax Legislation

The United States rarely enacts retroactive tax provisions. Generally, retroactivity is reserved for situations where affected transactions are viewed as "abusive" *and* some significant Congressional action has already occurred by the effective date.

The FSC transition rules were enacted because the ETI Act effected a fundamental change in the treatment of foreign sales transactions. The United States generally provides transition rules when taxpayers can demonstrate that they had already taken steps in reliance on existing law on or before the date on which a proposed change is effective. There are numerous precedents for providing transition rules on the basis of a binding contract, even if subject to a condition if the condition is not within the control of the affected taxpayer. Note that even tax treaties typically have one-year transition provisions under which you can continue to apply the old treaty if you choose.

There is also ample precedent for providing specific grandfather rules for leasing transactions, mainly in the context of legislation affecting capital cost recovery provisions. For example, the effective date of the 1984 Tax-exempt Leasing rules[5] was for property "placed in service" after the relevant date, thus excluding property already under lease. Also under a provision in the 1984 legislation that applied the effective date to property *leased* after the relevant date, a lease was "not treated as entered into or renewed ... merely by reason of the exercise of the lessee of a written option" that was enforceable against the lessor on the effective date and at all times thereafter.

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[4] *United States—Tax Treatment for "Foreign Sales Corporations*, Appellant Submission of the United States, (November 1, 2002) paragraph. 265.

[5] See page 76 of the *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, prepared by the staff of the Joint Committee on Taxation (December 31, 1984).

Conclusion

As noted above, U.S. financing companies and other parties to leasing transactions fully acknowledge that the WTO decision found fault with the FSC transition rules, and the WTO maintained that these transition rules should be withdrawn. Nevertheless, we believe the United States should protect U.S. taxpayers who relied on U.S. law and regulations from retroactive changes in this area after the tax benefits have already been irrevocably factored into the economics of leases. We urge the Congress and the Administration to include appropriate transition rules in any legislation that moves forward to otherwise repeal the ETI statute. We also pledge to work vigorously with this Committee and the Administration to help obtain the Commission's support for continuing these transition rules as part of any final resolution of the FSC/ETI matter.

Statement of the Equipment Leasing Association, Arlington, Virginia

The Equipment Leasing Association (ELA) is submitting this statement for the record to express our views on the need for Congress to retain the FSC leasing transition rules in any FSC/ETI legislation enacted by Congress, and to protect lease transactions done pursuant to the Extraterritorial Income Act. ELA has over 800 member companies throughout the United States who provide financing for all types of businesses in all types of markets. Large ticket leasing includes the financing of transportation equipment such as aircraft, rail cars and vessels. Middle market lessors finance high-tech equipment including mainframe computers and PC networks, as well as medical equipment such as MRIs (magnetic resonance imaging) and CT (computed tomography) systems. Lessors in the small ticket arena provide financing for equipment essential to virtually all businesses such as phone systems, pagers, copiers, scanners and fax machines.

Prior to the enactment of the Extraterritorial Income Regime, U.S. leasing companies were able to facilitate the financing of exports by utilizing a foreign sales corporation (FSC). At the time a FSC transaction was closed, both the lessor and lessee relied upon the law in existence at the time of the transaction in pricing the lease. When Congress enacted the ETI Act, it correctly included grandfather provisions. It is imperative that leasing companies which entered into FSC/ETI transactions be able to proceed on the assumption that the transition rules for FSC leasing transactions will be continued in any future legislation. The failure to grandfather FSC and ETI leasing transactions will have grievous consequences for both U.S. exporters and leasing companies which relied on the tax regimes in existence at the time they entered into the transactions, as by their nature, these types of leasing transactions are long-term and take numerous years to complete.

Our position that existing FSC and ETI lease transactions be grandfathered is consistent with the approach Congress took in considering the original transition from the FSC rules to the ETI regime, wherein Congress provided a general transition rule taking into account existing lease contracts. Pursuant to the general transition rule adopted by Congress, a binding contract included a purchase option, renewal option, or replacement option that was included in such contract and which was enforceable against the seller or lessor. Thus, transition relief was provided to preserve the benefits of the current FSC regime for: the remaining term of existing leases; the term of a new lease entered into pursuant to a renewal option; the term of a replacement lease entered into pursuant to a replacement option; the sale of property pursuant to a purchase option; and other lease options that would have been eligible for FSC benefits.

It is common practice for Congress to provide transition rules in situations where taxpayers can show that they relied on existing law when entering into a binding contract on or before the date on which a proposed change may become effective. Therefore, we strongly urge the U.S. Government to protect and defend U.S. taxpayers who entered into binding contracts and priced those transactions based on existing U.S. law as Congress moves forward in addressing the FSC/ETI replacement issue.

Statement of the Leasing Coalition

I. INTRODUCTION

The Leasing Coalition, a group of U.S. businesses operating in the global leasing marketplace, appreciates the opportunity to present this written statement to the

Select Revenue Measures Subcommittee in conjunction with its June 13, 2002, hearing on proposals to modify the Tax Code to promote the competitiveness of U.S. companies.

In these comments, the Leasing Coalition discusses the significant competitive disadvantage created for the U.S. leasing industry by the so-called "Pickle" rules under present law. We urge the Congress, as part of its examination our international tax rules, to repeal the limitations on depreciation under these rules for equipment leased by U.S. taxpayers to foreign parties. These rules are a specific detriment to U.S. exports. Repealing them is one of the few changes that Congress can make in the tax area that would benefit U.S. exports and still comply fully with our obligations under the World Trade Organization.

II. IMPORTANCE OF THE LEASING INDUSTRY

The leasing industry is important to the American economy. U.S. manufacturers use leasing as a means to provide financing for exports of their goods in overseas markets, and many have leasing subsidiaries that arrange for such financing. Many U.S. financial companies also arrange for lease financing as one of their core financial intermediation services. Ultimately, the activities of these companies support U.S. jobs and investment.

To put the size of the leasing industry into perspective, it has been estimated that approximately 30 percent of all equipment investment is financed through leasing rather than outright acquisition.[1] Approximately 80 percent of U.S. companies lease some or all of their equipment.[2] Currently, more than 2,000 companies act as equipment lessors, and equipment leasing is estimated to be a $240–280 billion industry.[3]

Leasing also promotes exports of U.S. equipment, and thus helps U.S. companies compete in the global economy. Many lease transactions undertaken by U.S. lessors are cross-border leases, i.e., leases of equipment to foreign users. These involve all types of equipment, including tankers, railroad cars, machine tools, computers, copy machines, printing presses, aircraft, mining and oil drilling equipment, and turbines and generators. Many of these leases are supported in one form or another by the Export-Import Bank of the United States, which insures the credit of foreign lessees.

III. ADVERSE IMPACT OF THE "PICKLE" RULES

The Deficit Reduction Act of 1984 enacted the "Pickle" rules (named after one of the sponsors of the provision, then-Representative J.J. Pickle), which reduce the tax benefits of depreciation in the case of property leased to a tax-exempt entity. The Pickle rules generally provide that, in the case of any "tax-exempt use property" subject to a lease, the lessor is entitled to depreciate the property using the straight-line method and a recovery period of no less than 125 percent of the lease term.[4] Tax-exempt use property, for this purpose, generally is tangible property leased to a tax-exempt entity, which is defined to include any foreign person or entity.[5]

The present-law Pickle rules place the American leasing industry and U.S. products at a severe competitive disadvantage in overseas markets. Because of the adverse impact of the Pickle rules on cost recovery, U.S. lessors are unable in many cases to offer U.S.-manufactured equipment to overseas customers on terms that are competitive with those offered by foreign counterparts. Many European countries, for example, provide favorable lease rules for home-country lessors leasing equipment manufactured in the home country. In France, for example, government approval of leveraged leases is contingent on the investment providing an economic and social benefit for France.[6]

There is no compelling tax policy rationale for maintaining the Pickle rules as they apply to export leases. The Pickle rules were enacted in part to address situations where the economic benefit of accelerated depreciation and the investment tax credit were indirectly transferred to foreign entities not subject to U.S. tax through reduced rentals under a lease. That rationale no longer applies. The investment tax credit was repealed in 1986, and property used outside the United States generally is no longer eligible for accelerated depreciation.

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[1] U.S. Department of Commerce.
[2] Equipment Leasing Association.
[3] Equipment Leasing Association.
[4] I.R.C. section 168(g).
[5] I.R.C. section 168(h).
[6] "Long Live le Leveraged Lease," *Asset Finance*, July/August 2001.

IV. REFORMS NEEDED TO STRENGTHEN COMPETITIVENESS OF U.S. LEASING INDUSTRY

The global leasing markets have greatly expanded since 1984. The competitive pressures on U.S. businesses from their foreign counterparts also have increased dramatically. Repealing the Pickle rules as they apply to leases to foreign parties, as has been proposed by Subcommittee Chairman Jim McCrery (R–LA) in H.R. 1493 and by Ways and Means Committee Member Bob Matsui (D–CA) in H.R. 1492, will strengthen the competitiveness of the U.S. leasing industry and promote U.S. jobs and investment.

The World Trade Organization's rulings against the foreign sales corporation ("FSC") and extraterritorial income ("ETI") regimes have only bolstered the rationale for repeal of the Pickle rules as they apply to export leases. On balance, U.S. exports are likely to be harmed by legislation that replaces the ETI rules with provisions that do not confer a specific export subsidy. While the Pickle repeal bills discussed above would benefit U.S. exports, they could not be read to provide a prohibited subsidy. Rather, they simply would remove a blatant disadvantage for export leases under U.S. law compared to domestic leases. Surely, removing overt current-law tax burdens on U.S. exports would be an advisable course of action in response to the WTO's rulings.

Statement of Donald V. Moorehead, Partner, and Aubrey A. Rothrock III, Partner, Patton Boggs LLP

This statement is submitted for inclusion in the record of the hearings held by the Subcommittee on Select Revenue Measures on June 13, 2002 concerning possible changes to the Internal Revenue Code of 1986, as amended (the "Code"), in light of the recent decision of the World Trade Organization (the "WTO") with respect to the extraterritorial income provisions of the Code. We understand that, in fashioning a legislative response to the WTO decision, consideration may be given to making numerous changes to the provisions of the Code governing the taxation of income earned by U.S.-based businesses from their international operations. In this statement, we describe two proposals that should be included as part of such a legislative package.

Passive Income Attributable to Assets Held to Match CFC Pension Liabilities

In the United States and many foreign countries, employers may establish pension plans for their employees and fund those plans through annual contributions to a separate trust or its equivalent. Employees and their beneficiaries generally are taxed only when the benefits are paid to them. In some countries such as Germany, however, the use of a trust or similar funding mechanism would result in the imposition of tax on the employees prior to the commencement of distributions to them upon retirement.

Under German law, if an employer creates a pension plan for its employees, it is required by law to establish a reserve on its balance sheet to reflect liabilities under the plan and to make annual additions to the reserve to reflect the discounted present value of its future obligations under the plan. Although the basic benefits provided under the plan are insured, the insurance is payable only if the employer is unable to pay the benefits as they fall due. Employers may not formally fund these plans, through an irrevocable trust or similar arrangement without adverse tax consequences to their employees.

In some instances, both as a matter of financial prudence and to foster good working relationships with their employees, an employer may seek to "match" its pension obligations (and offset its balance sheet liability) through the purchase of investment assets. German law implicitly encourages such practices by providing special tax treatment for certain types of investments.

When the employer is a controlled foreign corporation (a "CFC"), the purchase of assets to match pension obligations can create adverse U.S. tax consequences. Specifically, the passive income generated by such investments will be treated as foreign base company income under the subpart F provisions of the Code and thus, unless it is de minimis in amount, will taxed to the U.S. shareholders of the CFC (e.g., the U.S. parent corporation) in the year earned by the CFC. Moreover, that income will be allocated to the "passive" basket for purposes of computing the foreign tax credit limitation, even though it is incidental to the active business operations of the CFC.

We believe this is an inappropriate result as a matter of policy. The investment of earnings to fund retirement plans has long been recognized as desirable from a public policy standpoint and Congress itself has sought to provide relief in most instances through section 404A of the Code. Where, however, the host country does not permit the use of a trust or other similar arrangement without adverse tax consequences to employees, section 404A provides no relief if assets are acquired to "match" the liability represented by the pension reserve.

We recommend that, in the case of a CFC engaged in the active conduct of a trade or business, income attributable to investment assets purchased to match pension reserves should be placed in the same foreign tax credit "basket" as the income attributable to the CFC's active business operations. We also recommend that such income be excluded from the definition of foreign base company income and thus not taxed to the U.S. shareholders of the CFC unless and until distributed to them as a dividend or invested in U.S. property.

Foreign Tax Credit "Stacking" Rules

Because U.S. businesses are taxed on their worldwide income, the income they earn from international operations is potentially subject to double taxation: once by the foreign country in which it is earned and a second time by the U.S. Depending upon the character of such income and whether it is earned directly by the U.S. business or indirectly through a CFC, the U.S. tax on foreign source income will be payable either in the year it is earned or deferred until the income is distributed as a dividend to the U.S. shareholders or invested in U.S. property.

The foreign tax credit provisions of the Code are intended to reduce the actual incidence of such double taxation and the effectiveness with which this objective is achieved is critical to the competitive position of American businesses in the world's markets. By reason of the operation of certain of these foreign tax credit provisions, a U.S. corporation may in fact be unable to claim credits on a current basis for all of the foreign taxes paid with respect to the foreign source income included in its U.S. tax return. This is true even where the applicable foreign tax rates are less than the U.S. corporate rate of 35 percent.

In such situations, the excess credits may be carried back to the two preceding taxable years and then forward to the succeeding five taxable years. If they cannot be used during this carryover period, they expire. Under current law, however, excess credits that are carried over to another taxable year may in fact be used only after the credits used in that taxable year have been fully utilized. This stacking rule thus increases the likelihood that otherwise valid credits for foreign taxes actually paid on foreign source income that is subject to U.S. tax will not be used and expire.

We believe this is inappropriate as a matter of policy. Credits for foreign taxes actually paid on income that is subject to U.S. tax should in our view be permitted to be used at the earliest possible date and the Code should be structured so that expiration is only a remote possibility. This is particularly true since many U.S. corporations are in "excess credit" positions largely because of provisions of the Code that reduce foreign source income artificially (e.g., the over allocation of interest expense to foreign source income) or otherwise make it difficult to use credits in the first year they are available (e.g., the allocation of types of foreign source income to different "baskets" and the prohibition on the use of credits earned with respect to income in one basket to offset the U.S. tax on income in another basket).

For these reasons, we recommend that section 904(c) of the Code be amended to provide that, with respect to any taxable year, foreign tax credits would be applied in the following order: (1) credits carried *forward* to that year; (2) credits earned in that year; and (3) credits carried *back* to that taxable year. This approach was taken in prior proposed bipartisan international tax simplification legislation and, is we believe, a more direct solution to the problem than that contained in H.R. 4541. The proposed change would enable the foreign tax credit to achieve its objective more effectively and would reduce the incentive now inherent in section 904(c) for taxpayers to engage in transactions principally to enable them to use foreign tax credits that might otherwise expire.

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