

CURRENT U.S. INTERNATIONAL TAX REGIME

HEARING BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES ONE HUNDRED SIXTH CONGRESS

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CURRENT U.S. INTERNATIONAL TAX REGIME

TUESDAY, JUNE 22, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to notice, at 1:03 p.m., in room 1100, Longworth House Office Building, Hon. Amo Houghton (Chairman of the Subcommittee), presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE

CONTACT: (202) 225-7601

June 14, 1999

No. OV-8

Houghton Announces Hearing on Current U.S. International Tax Regime

Congressman Amo Houghton (R-NY), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the complexity of the current U.S. international tax regime. The hearing will take place on Tuesday, June 22, 1999, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 1:00 p.m.

Oral testimony at this hearing will be from invited witnesses only. Invited witnesses include representatives from the U.S. Department of the Treasury, Tax Executives Institute, National Foreign Trade Council, financial services industry, software industry, heavy equipment manufacturing industry, pharmaceutical industry, and high-technology manufacturing industry. 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:

The United States employs a "worldwide" system of taxation on income of U.S. corporations and its foreign affiliates. A U.S.-parent corporation incurs income taxes on the income of its affiliates earned abroad to the extent that the affiliates repatriate that income either through dividends or deemed dividends. This worldwide-tax system has become a maze of complex rules for sourcing and timing foreign income and expenses.

The laws enacted by Congress and regulations promulgated by the Internal Revenue Service over the past 40 years have introduced an amount of complexity which some believe has made the international tax regime unworkable and has resulted in an increasing amount of double taxation of U.S. corporations' foreign income. According to this viewpoint, the competitiveness of U.S. corporations vis-a-vis their international competitors thus is disadvantaged.

United States corporations remain the most competitive in the world as a result of superior technology and access to skilled labor. However, the current international tax regime may adversely affect the competitive advantages that such corporations now hold.

On June 7, 1999, Chairman Houghton and Rep. Sander Levin introduced H.R. 2018, the "International Tax Simplification for American Competitiveness Act of 1999."

In announcing the hearing, Chairman Houghton stated: "In an increasingly competitive global market, Congress must examine whether the complexity of the U.S. international tax regime puts U.S. corporations and their employees at a competitive disadvantage. Congressman Levin and I have introduced legislation to address several of these concerns."

FOCUS OF THE HEARING:

The Subcommittee will review problems faced by domestic corporations in complying with the complexity of the current U.S. international tax regime as well as proposals to change the law.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label, by the *close of business*, Tuesday, July 6, 1999, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, by close of business the day before the hearing.

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. All statements and any accompanying exhibits for printing must be on an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, typed in single space and may not exceed a total of 10 pages including attachments. **Witnesses are advised that the Committee will rely on electronic submissions for printing the official 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. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at [HTTP://WWW.HOUSE.GOV/WAYS_MEANS/](http://WWW.HOUSE.GOV/WAYS_MEANS/).

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 HOUGHTON. The hearing will come to order.

Good afternoon, ladies and gentleman; delighted to have you here. The Ways and Means Committee holds a unique position, as

you know, in forming policies that will drive economic growth in the next century. The committee has jurisdiction over tax and trade matters, and each are intricately intertwined with the other.

Since I have been on this Committee, Congress has passed a variety of trade laws, including the Omnibus Trade and Competitiveness Act of 1988, the implementing bills for NAFTA, and the Uruguay Rounds Agreements. Each year, the committee leads the effort in Congress to preserve normal trade relations with China. Within the last month, the committee has passed the African Growth and Opportunities Act and the Caribbean Basin Initiative. The policy behind each of these bills has been to break down trade barriers, so that we can expand export opportunities for U.S. firms and workers. The U.S. market, as you know, is the most open in the world; yet, more than 96 percent of the world's population lives outside our borders. So, it is important that we secure market access beyond our 50 States in order to sustain our record of economic growth and job creation, as we look out at a new millennium within 6 months.

Unfortunately, over the last 40 years, since the inception of Subpart F, the disconnect between trade and tax policy has widened. With one hand, Congress passes laws to help U.S. business expand and become competitive around the globe. With the other, Congress hobbles these same businesses through double taxation and a variety of obstacles to capital formation in markets abroad. These mixed messages to U.S. businesses are not helpful.

So, as I looked over the prepared testimony, I noticed a couple of things. First of all, the diversity of industries that are represented here today—banking, pharmaceutical, software, high-tech, heavy manufacturing, and oil and gas. We have to be very proud as these U.S. companies are world leaders in their fields. We also have to keep an eye on the future to make sure that these companies and the industries they represent remain world leaders. And, so that means that we need to build a coherent link between trade and tax policy. We need to understand the correlation between the two and work to pass laws with that understanding in mind, our goal is to help expand jobs, not throw boulders in their path.

The second thing that I noticed was despite the impressive brain power of these men and women and the tax professionals that support them, each witness speaks of the incredible complexity of the tax code and the burden it places on their companies. How did we get where we are today with such a hodgepodge of tax laws that put the U.S. businesses at such a disadvantage in the global marketplace? Isn't it time to rework that system so it helps U.S. businesses? A strong economy in the United States is driven mainly by how competitive our companies are around the globe. Today, the international tax laws stand in their way.

The tax code should be designed to tax income fairly and uniformly. With these goals in mind, Mr. Levin—who is sitting over here to my left—and I have introduced H.R. 2018, the International Tax Simplification for American Competitiveness Act of 1999. We believe that this bill takes important steps to help ensure that U.S.-owned businesses will not be subject to double or premature taxation. Only when these concerns are addressed will our tax and trade laws be in line.

I am pleased now to yield to our Ranking Democrat, Mr. Coyne. Mr. COYNE. Thank you, Mr. Chairman, and I want to thank you for having these hearings. I have a written statement I would like to submit for the record, and I yield the balance of my time to the gentleman from Michigan, Mr. Levin.

[The opening statement follows:]

Opening Statement of Hon. William J. Coyne, a Representative in Congress from the State of Pennsylvania

Our hearing today will focus on problems faced by domestic corporations in complying with the complexity of the current U.S. international tax system. I want to commend Chairman Houghton and Congressman Levin for their leadership in this area and for the introduction of H.R. 2018, the "International Tax Simplification for American Competitiveness Act of 1999." This bill is sponsored, on a bipartisan basis, by many Members of the Ways and Means Committee. H.R. 2018 proposes changes to various aspects of our international tax rules.

I share Chairman Houghton's concern that, given an increasingly competitive global market, the Congress must examine whether the complexity of the U.S. international tax regime puts U.S. corporations and their employees at a competitive disadvantage. Consequently, I believe that it is timely that the Oversight Subcommittee review our international tax rules to see how they might be reformed and simplified. Consideration of H.R. 2018 is a good first step toward understanding the problems of international taxation and industries' proposals for reform.

Also, our hearing today will serve as an excellent introduction to the full Committee's hearing, next week, to review the impact of U.S. tax rules on the international competitiveness of U.S. workers and businesses. I look forward to hearing the testimony of the witnesses who support H.R. 2018, including the Tax Executives Institute, the National Foreign Trade Council, and representatives of the financial services, software, heavy equipment manufacturing, pharmaceutical, and high-technology industries.

Finally, international tax systems are typically evaluated in terms of efficiency (whether tax considerations are sufficiently neutral to investment and employment decisions); equity (whether domestic businesses are treated fairly in comparison to foreign-based firms); growth (whether the tax system promotes economic growth); simplicity (whether the tax system imposes unnecessary complexity and administrative burdens on taxpayers; and, harmonization (whether the tax system conforms with international norms and promotes dealings with foreign countries). I have a particular interest in the effect U.S. international tax law has on workers and the retention of jobs in the U.S. I hope that the witnesses today will address that issue as well in their testimony.

Thank you.

Chairman HOUGHTON. Mr. Levin.

Mr. LEVIN. Thank you very much, Mr. Coyne, and to you, Mr. Chairman, thank you for your holding this hearing and also for your leadership. It is a pleasure to collaborate with you on this and other matters.

I have a statement. Let me, if I might, just go through it, because I think it may help us to frame the issue. This bill that you and I have introduced is an effort to rationalize and simplify further the international tax provisions of U.S. tax laws by streamlining foreign tax credits, encouraging exports, providing incentives for the performance of research and development in the United States, enhancing overall U.S. competitiveness, and minimizing revenue loss.

International tax policies were created at a time when the focus was on preventing tax avoidance, not promoting international competitiveness. In the early sixties, for example, U.S. companies focused their manufacturing and market strategies in the United

States, which at the time was, by far, the largest consumer market in the world. U.S. companies generally could achieve economies of scale and rapid growth, selling exclusively or almost so into the domestic market. In the early 1960's, foreign competition in U.S. markets generally, therefore, was inconsequential.

Yet, increasingly, it has become vital for American businesses and workers to compete beyond our borders. In response, the United States generally tries to raise revenue in a neutral manner; that is, one that does not discriminate in favor of one investment over another. In the international arena, this means the United States seeks to apply the same tax burden on income from both domestic and foreign investment. Accordingly, the United States generally taxes U.S. companies on their worldwide income with a credit for taxes paid to foreign jurisdiction.

There is one important exception, and this applies to foreign subsidiaries of U.S. companies. Because these subsidiaries would face substantially higher tax rates than their local competitors if worldwide taxation were strictly enforced, U.S. law defers tax on the subsidiary's income until it is repatriated. But with that, there is one problem, and that is that the deferral of a foreign subsidiary's tax until repatriation can create an incentive for U.S. companies to keep their profits abroad even when the profits are not plowed back to an active business operation. To counteract this incentive to keep profits abroad for non-business reasons, Congress, over the years, has eliminated deferral and imposed current taxation on various forms of passive investment income. Thus, active foreign operations are exempt from tax until repatriation so that U.S. companies are taxed at the same level as their foreign competitors in a given market, but passive income earned abroad generally is taxed currently. However, this structure, as we all know so well, has developed increasing complexities.

So, over the last few years, a number of us have tried to achieve greater simplification and equity. This is, I think, our fourth bill on this issue and the third with our Senator counterparts, Orrin Hatch and Max Baucus. We made some progress in the 1977 act; most importantly, giving foreign sales corporations treatment to software, simplifying reporting rules for 10/50 companies, and eliminating overlap in passive foreign investment companies, PFIC—you have to know the acronyms in this field, and controlled foreign corporation, CFC, rules. Last year, we were able to include a 1-year change in the rules for active financing income. We are now trying to get that provision to extend its 1-year life.

These are important reforms—technical but important—which have enabled American businesses and workers to be more competitive abroad. I am pleased by how far we have come, but there is still more work to be done, and then I would lay out a bit of where we have to go, Mr. Chairman.

And I conclude with you and I and others believe that by saying simplifying our existing rules, we can achieve our goals of increasing competitiveness and fairness for our American companies in the global marketplace.

Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you very much, Mr. Levin.

So, you understand the thrust of this meeting. We appreciate your being here.

I would like to introduce the first panel—Mr. Joe Luby, Assistant General Tax Counsel of Exxon and Chair of the Tax Committee of the National Foreign Trade Council, and, also, Mr. Lester Ezrati, General Tax Counsel of Hewlett-Packard in Palo Alto on behalf of The Tax Executives Institute.

Mr. Luby, would you give your testimony?

STATEMENT OF JOE O. LUBY, JR., ASSISTANT GENERAL TAX COUNSEL, EXXON CORPORATION, IRVING, TEXAS, AND CHAIR, TAX COMMITTEE, NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. LUBY. As you said, I am here on behalf of the National Foreign Trade Council. I am accompanied by Fred Murray who is our vice president of Tax with NFTC. I will concentrate my remarks on the impact of the U.S. tax system on the ability of U.S. multinationals to compete with foreign-based competition. While I cannot state that the U.S. system is solely responsible for the decline in rank of U.S. multinationals, I submit it had a major role in the United States going from 18 of the world's 20 largest corporations in 1960 to just 8 by the mid-1990's. I do not have new statistics, but recent events will probably result in an even lower number now that Amoco is a British company; Chrysler, a German company, and Bankers Trust, a German bank.

I will concentrate on how two of the provisions you have included in your bill impact competitiveness. Your bill would accelerate and grant look-through treatment for 10/50 companies. An example will show you the adverse impact of 10/50 on competitiveness. Assume a U.S. company's 10/50 affiliate is competing with a French company for an investment in Singapore. The project calls for a \$1 billion investment, and it is projected to earn \$150 million before tax or a 15 percent return. Singapore grants tax holidays, so there is no foreign tax. Our French competitor would project a 15 percent after-tax return, because France does not tax active business income from foreign sources. In contrast, the U.S. company would have projected a 9.8 percent return because of the 10/50 provisions imposing a U.S. tax of \$52.5 million. The return advantage of 5.2 percent enjoyed by the French competitor may allow it to preempt the U.S. bid. In any event, the 5.2 percent detriment may drive the return below the level that would allow the U.S. company to even entertain the project.

The granting of full look-through and acceleration of repeal will enhance U.S. competitiveness by eliminating the kind of adverse impact on project returns I have just illustrated. Our members are still walking away from investments, deferring investments, or taking less than optimal ownership positions in foreign ventures due to the 10/50 rules. Thus, we welcome your acceleration in look-through treatment for 10/50.

Section 907 came into the code in 1975 in reaction to the first oil crisis and to the suspicion that some U.S. oil companies might be taking foreign tax credits at rates so high that they may be inclusive of royalties. In 1983, this concern was addressed in IRS regulations to provide a formula for splitting the amount paid the for-

eign government into a tax component and a royalty component. These regulations have never been controversial and have worked well. Despite that fact, section 907 remains in the code requiring that taxpayers determine the amount of their extracted income versus their oil-related income and the foreign taxes associated with each category. This requires determining the point at which income changes from extracted to oil-related, also determining the associated cost for every oil well in every foreign country. No foreign country where we operate has these kinds of rules.

It also requires that the IRS audit such determinations. This is a complete waste of shareholder and taxpayer money since from its inception, section 907 has raised little if any tax revenue for the U.S. fisc. An API study indicated that no major U.S. company in our industry has paid tax under 907 from its inception in 1975 through the tax year 1997. Spending money to comply with a provision that has essentially been useless and has been superseded by subsequent law changes does not make sense or enhance U.S. competitiveness.

Do compliance costs make a difference? Let us give you a couple of examples based on my own company's experience. We have 121 people in tax departments all over the world doing nothing but trying to comply with U.S. international tax rules; 25 of them do section 907. This does not include people who are comptrollers and other departments that also much assist. We have an average of 30 IRS auditors in our office every business day of the year. The information document requests have ranged from 944 for the 1980 to 1982 audit to 2,232 in our most recent audit. In contrast, our affiliates in Japan file a tax return at the end of March, are visited by five auditors, and within 2 months the audit is completed. In the Netherlands, an audit for our 1991 to 1994 tax years was handled by one auditor and took 6 months. Finally, in the U.K., most audits are handled by two auditors, and we have had an issue raised that required litigation in over 20 years.

So, that you will know the size of those audits and that they are about substantial companies when you compare, our sales in Japan total \$16.5 billion and \$3.5 billion in tax; the Netherlands, \$9.5 billion in sales and \$1.9 billion in tax, and the U.K., sales of \$16.4 billion and \$6 billion in tax.

NFTC thanks you for the opportunity to present its views and especially for your efforts to bring to the international tax rules some semblance of common sense in regard for the ability of U.S. companies to compete abroad.

[The prepared statement follows:]

Statement of Joe O. Luby, Jr., Assistant General Tax Counsel, Exxon Corporation, Irving, Texas, and Chair, Tax Committee, National Foreign Trade Council, Inc.

Mr. Chairman, and distinguished Members of the Subcommittee:

My name is Joe Luby. I am Assistant General Tax Counsel of Exxon Corporation. As Chairman of its Tax Committee, I am appearing today as a witness for the National Foreign Trade Council, Inc.

The National Foreign Trade Council, Inc. (the "NFTC" or the "Council") is appreciative of the opportunity to present its views on simplification of the international tax system of the United States. The NFTC also wishes to congratulate you, Mr. Chairman, and Mr. Levin, and Mr. Sam Johnson, as well as the other Members who have joined you—Mr. Crane, Mr. Herger, Mr. English, and Mr. Matsui—in the introduction of H.R. 2018, the International Tax Simplification for American Competi-

tiveness Act of 1999. As I will further elaborate below, the provisions of the bill, if enacted, will do much to affect the concerns we express in this testimony and would significantly lower the cost of capital, the cost of administration, and therefore the cost of doing business in the global marketplace for U.S.-based firms.

The NFTC is an association of businesses with some 550 members, originally founded in 1914 with the support of President Woodrow Wilson and 341 business leaders from across the U.S. Its membership now consists primarily of U.S. firms engaged in all aspects of international business, trade, and investment. Most of the largest U.S. manufacturing companies and most of the 50 largest U.S. banks are Council members. Council members account for at least 70% of all U.S. non-agricultural exports and 70% of U.S. private foreign investment. The NFTC's emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities and anomalies. International tax reform is of substantial interest to NFTC's membership.

The founding of the Council was in recognition of the growing importance of foreign trade and investment to the health of the national economy. Since that time, expanding U.S. foreign trade and investment, and incorporating the United States into an increasingly integrated world economy, has become an even more vital concern of our nation's leaders. The share of U.S. corporate earnings attributable to foreign operations among many of our largest corporations now exceeds 50 percent of their total earnings. Even this fact in and of itself does not convey the full importance of exports to our economy and to American-based jobs, because it does not address the additional fact that many of our smaller and medium-sized businesses do not consider themselves to be exporters although much of their product is supplied as inventory or components to other U.S.-based companies who do export. Foreign trade is fundamental to our economic growth and our future standard of living. Although the U.S. economy is still the largest economy in the world, its growth rate represents a mature market for many of our companies. As such, U.S. employers must export in order to expand the U.S. economy by taking full advantage of the opportunities in overseas markets.

United States policy in regard to trade matters has been broadly expansionist for many years, but its tax policy has not followed suit.

There is general agreement that the U.S. rules for taxing international income are unduly complex, and in many cases, quite unfair. Even before this hearing was announced, a consensus had emerged among our members conducting business abroad that legislation is required to rationalize and simplify the international tax provisions of the U.S. tax laws. For that reason alone, if not for others, this effort by the Subcommittee, which focuses the spotlight on U.S. international tax policy, is valuable and should be applauded.

The NFTC is concerned that the current and previous Administrations, as well as previous Congresses, have often turned to the international provisions of the Internal Revenue Code to find revenues to fund domestic priorities, in spite of the pernicious effects of such changes on the competitiveness of United States businesses in world markets. The Council is further concerned that such initiatives may have resulted in satisfaction of other short-term goals to the serious detriment of longer-term growth of the U.S. economy and U.S. jobs through foreign trade policies long consistent in both Republican and Democratic Administrations, including the present one.

The provisions of Subchapter N of the Internal Revenue Code of 1986 (Title 26 of the United States Code is hereafter referred to as the "Code") impose rules on the operations of American business operating in the international context that are much different in important respects than those imposed by many other nations upon their companies. Some of these differences, noted in the sections that follow, make American business interests less competitive in foreign markets when compared to those from our most significant trading partners:

- The United States taxes worldwide income of its citizens and corporations who do business and derive income outside the territorial limits of the United States. Although other important trading countries also tax the worldwide income of their nationals and companies doing business outside their territories, such systems generally are less complex and provide for "deferral"¹ subject to less significant limita-

¹The foreign income of a foreign corporation is not ordinarily subject to U.S. taxation, since the United States has neither a residence nor a source basis for imposing tax. This applies generally to any foreign corporation, whether it is foreign-owned or U.S.-owned. This means that in the case of a U.S.-controlled foreign corporation (CFC), U.S. tax is normally imposed only when the CFC's foreign earnings are repatriated to the U.S. owners, typically in the form of

tions under their tax statutes or treaties than their U.S. counterparts. Importantly, many of our trading partners have systems that more closely approximate “territorial” systems of taxation, in which generally only income sourced in the jurisdiction is taxed.

- The United States has more complex rules for the limitation of “deferral” than any other major industrialized country. In particular, we have determined that: (1) the economic policy justification for the current structure of subpart F has been substantially eroded by the growth of a global economy; (2) the breadth of subpart F exceeds the international norms for such rules, adversely affecting the competitiveness of U.S.-based companies; and (3) the application of subpart F to various categories of income that arise in the course of active foreign business operations should be substantially narrowed.

- The U.S. foreign tax credit system is very complex, particularly in the computation of limitations under the provisions of section 904 of the Code. While the theoretic purity of the computations may be debatable, the significant administrative costs of applying and enforcing the rules by taxpayers and the government is not. Systems imposed by other countries are in all cases less complex.

- The United States has more complex rules for the determination of U.S. and foreign source net income than any other major industrialized country. In particular, this is true with respect to the detailed rules for the allocation and apportionment of deductions and expenses. In many cases, these rules are in conflict with those of other countries, and where this conflict occurs, there is significant risk of double taxation. We further address one of the more significant anomalies, that of the allocation and apportionment of interest expense, later in this testimony.

- The current U.S. Alternative Minimum Tax (AMT) system imposes numerous rules on U.S. taxpayers that seriously impede the competitiveness of U.S. based companies. For example, the U.S. AMT provides a cost recovery system that is inferior to that enjoyed by companies investing in our major competitor countries; additionally, the current AMT 90-percent limitation on foreign tax credit utilization imposes an unfair double tax on profits earned by U.S. multinational companies—in some cases resulting in a U.S. tax on income that has been taxed in a foreign jurisdiction at a higher rate than the U.S. tax.

As noted above, the United States system for the taxation of the foreign business of its citizens and companies is more complex than that of any of our trading partners, and perhaps more complex than that of any other country.

That result is not without some merit. The United States has long believed in the rule of law and the self-assessment of taxes, and some of the complexity of its income tax results from efforts to more clearly define the law in order for its citizens and companies to apply it. Other countries may rely to a greater degree on government assessment and negotiation between taxpayer and government—traits which may lead to more government intervention in the affairs of its citizens, less even and fair application of the law among all affected citizens and companies, and less certainty and predictability of results in a given transaction. In some other cases, the complexity of the U.S. system may simply be ahead of development along similar lines in other countries—many other countries have adopted an income tax similar to that of the United States, and a number of these systems have eventually adopted one or more of the significant features of the U.S. system of taxing transnational transactions: taxation of foreign income, anti-deferral regimes, foreign tax credits, and so on. However, after careful inspection and study, we have concluded that the United States system for taxation of foreign income of its citizens and corporations is far more complex and burdensome than that of all other significant trading nations, and far more complex and burdensome than what is necessitated by appropriate tax policy.

U.S. government officials have increasingly criticized suggestions that U.S. taxation of international business be ameliorated and infused with common sense consideration of the ability of U.S. firms to compete abroad. Their criticism either directly or implicitly accuses proponents of such policies of advocating an unwarranted reaction to “harmful tax competition,” by joining a “race to the bottom.” The idea,

a dividend. However, subpart F of the Code alters these general rules to accelerate the imposition of U.S. tax with respect to various categories of income earned by CFCs.

It is common usage in international tax circles to refer to the normal treatment of CFC income as “deferral” of U.S. tax, and to refer to the operation of subpart F as “denying the benefit of deferral.” However, given the general jurisdictional principles that underlie the operation of the U.S. rules, we view that usage as somewhat inaccurate, since it could be read to imply that U.S. tax “should” have been imposed currently in some normative sense. Given that the normative rule imposes no U.S. tax on the foreign income of a foreign person, we believe that subpart F can more accurately be referred to as “accelerating” a tax that would not be imposed until a later date under normal rules.

of course, is that any deviation from the U.S. model indicates that the government concerned has yielded to powerful business interests and has enacted tax laws that are intended to provide its home-country based multinationals a competitive advantage. It is seldom, if ever, acknowledged that the less stringent rules of other countries might reflect a more reasonable balance of the rival policy concerns of neutrality and competitiveness. U.S. officials seem to infer from the comparisons that what is being advocated is that the United States should adopt the lowest common denominator so as to provide U.S. businesses a competitive advantage. Officials contend this is a “slippery slope” since foreign governments will respond with further relaxations until each jurisdiction has reached the “bottom.”

The inference is unwarranted. Let us look at our subpart F regime, for example. The regimes enacted by other countries that we have studied all were enacted in response to, and after several years of, scrutiny of the United States’ regimes. They reflect a careful study of the impact of our rules in subpart F, and, in every case, embody some substantial refinements of the U.S. rules. Each regime has been in place for a number of years, giving the government concerned time to study its operation and conclude whether the regime is either too harsh or too liberal. While each jurisdiction has approached CFC issues somewhat differently, as noted, each has adopted a regime that, in at least some important respects, is less harsh than the United States’ subpart F rules. The proper inference to draw from the comparison is that the United States has tried to lead and, while many have followed, none has followed as far as the United States has gone. A relaxation of subpart F to even the highest common denominator among other countries’ CFC regimes would help redress the competitive imbalance created by subpart F without contributing to a race to the bottom.

The reluctance of others to follow the U.S. may in part also be attributable to recognition that the U.S. system has required very significant compliance costs of both taxpayer and the Internal Revenue Service, particularly in the international area where the costs of compliance burdens are disproportionately higher relative to U.S. taxation of domestic income and to the taxation of international income by other countries.

There is ample anecdotal evidence that the United States’ system of taxing the foreign-source income of its resident multinationals is extraordinarily complex, causing the companies considerable cost to comply with the system, complicating long-range planning decisions, reducing the accuracy of the information transmitted to the Internal Revenue Service (IRS), and even endangering the competitive position of U.S.-based multinational enterprises.²

Many foreign companies do not appear to face the same level of costs in their operations. The European Community Ruding Committee survey of 965 European firms found no evidence that compliance costs were higher for foreign source income than for domestic source income.³ Lower compliance costs and simpler systems that often produce a more favorable result in a given situation are competitive advantages afforded these foreign firms relative to their U.S.-based counterparts.

In the 1960s, the United States completely dominated the global economy, accounting for over 50% of worldwide cross-border investment and 40% of worldwide GDP. As of the mid-1990s, the U.S. economy accounted for about 25% of the world’s foreign direct investment and GDP.

The current picture is very different. U.S. companies now face strong competition at home. Since 1980, the stock of foreign direct investment in the United States has increased by a factor of 6, and \$20 of every \$100 of direct cross-border investment flows into the United States. Foreign companies own approximately 14% of all U.S. non-bank corporate assets, and over 27% of the U.S. chemical industry alone. Moreover, imports have tripled as a share of GDP in the 1960s to an average of over 9.6% over the 1990–1997 period.

That the world economy has grown more rapidly than the U.S. economy over the last 3 decades represents an opportunity for U.S. companies and workers that are able to participate in these markets. Foreign markets now frequently offer greater growth opportunities to U.S. companies than the domestic market. In the 1960s, foreign operations averaged just 7.5% of U.S. corporate net income; by contrast, over the 1990–1997 period, foreign earnings represented 17.7 percent of all U.S. corporate income. A recent study of the 500 largest publicly-traded U.S. corporations

²See Marsha Blumenthal and Joel B. Slemrod, “The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications,” in *National Tax Policy in an International Economy: Summary of Conference Papers*, (International Tax Policy Forum: Washington, D.C., 1994).

³*Id.*

finds that sales by foreign subsidiaries increased from 25 % of worldwide sales in 1985 to 34% in 1997. From 1986 to 1997, foreign sales of these companies grew 10% a year, compared to domestic growth of just 3% annually. In fact, many of our members tell us that foreign sales now account for more than 50% of their revenue and their profits.

However, this growth in foreign markets is much more competitive than in earlier decades. The 21,000 foreign affiliates of U.S. multinationals now compete with about 260,000 foreign affiliates of multinationals headquartered in other nations. Over the last three decades, the U.S. share of the world's export market has declined. In 1960, one of every \$6 of world exports originated from the United States. By 1996, the United States supplied only one of every \$9 of world export sales. Despite a 30% loss in world export market share, the U.S. economy depends on exports to a much greater degree. The share of our national income attributable to exports has more than doubled since the 1960s.

Foreign subsidiaries of U.S. companies play a critical role in boosting U.S. exports—by marketing, distributing, and finishing U.S. products in foreign markets. In 1996, U.S. multinational companies were involved in 65% of all U.S. merchandise export sales. U.S. industries with a high percentage of investment abroad are the same industries that export a large percentage of domestic production. And studies have shown that these exports support higher wages in exporting companies in the United States.⁴

Taking into account individual as well as corporate-level taxes, a report by the Organization for Economic Cooperation and Development (OECD) finds that the cost of capital for both domestic (8.0 percent) and foreign investment (8.8 percent) by U.S.-based companies is significantly higher than the averages for the other G-7 countries (7.2 percent domestic and 8.0 percent foreign). The United States and Japan are tied as the least competitive G-7 countries for a multinational company to locate its headquarters, taking into account taxation at both the individual and corporate levels.⁵ These findings have an ominous quality, given the recent spate of acquisitions of large U.S.-based companies by their foreign competitors.⁶ In fact, of the world's 20 largest companies (ranked by sales) in 1960, 18 were headquartered in the United States. By the mid-1990s, that number had dropped to 8.

Short of fundamental reform—a reform in which the United States federal income tax system is eliminated in favor of some other sort of system—there are many aspects of the current system that could be reformed and greatly improved. These reforms could significantly lower the cost of capital, the cost of administration, and therefore the cost of doing business for U.S.-based firms.

In this regard, for example, the NFTC strongly supports the International Tax Simplification for American Competitiveness Act of 1999, H.R. 2018, recently introduced by you Mr. Chairman, and Mr. Levin, and Mr. Sam Johnson, and joined by four other Members: Mr. Crane, Mr. Herger, Mr. English, and Mr. Matsui. We congratulate you on your efforts to make these amendments. They address important concerns of our companies in their efforts to export American products and create jobs for American workers.

Against this background, the NFTC would also like to elaborate on some of the provisions in H.R. 2018 in areas that illustrate problems with significant impact on our members, as well as others that are under consideration in pending legislation yet to be introduced.

LOOK THROUGH FOR 10/50 COMPANIES

The 1997 Tax Act no longer requires U.S. companies operating joint ventures (“JVs”) in foreign countries to calculate separate foreign tax credit (“FTC”) limitations for income earned from each JV in which the U.S. owner holds at least 10 percent, but no more than 50 percent, of the JV ownership. The 1997 Tax Act now allows U.S. owners to compute FTCs with respect to dividends from such entities based on the underlying character of the entities' income (i.e., “look-through” treatment). However, the change is only effective for dividends received after the year 2002. A separate “Super” FTC basket is still required to be maintained for dividends received after 2002 but attributable to earnings and profits of the JV from years before 2003.

As stated by the Clinton Administration in its budget proposals issued earlier this year, the concurrent application of both a single basket approach for pre-2003 earn-

⁴ See, Ch. 6, The NFTC Foreign Income Project: International Tax Policy for the 21st Century, March 25, 1999.

⁵ OECD, *Taxing Profits in a Global Economy: Domestic and International Issues* (1991).

⁶ See, e.g., testimony before the Committee on Finance, U.S. Senate, March 11, 1999.

ings and a look-through approach for post-2002 earnings would result in significant complexity to taxpayers. Thus, Section 208 of your bill would offer much needed simplicity for foreign JVs by eliminating the “Super” FTC basket and accelerating the effective date for application of the “look-through” rules to all dividends received after 1999, regardless of when the earnings and profits underlying those dividends were generated. As stated earlier by Treasury, this reduction in complexity and compliance burdens will reduce the bias against U.S. participation in foreign JVs, and help U.S.-based companies to compete more effectively with foreign-based JV partners.

LOOK-THROUGH TREATMENT FOR INTEREST, RENTS, AND ROYALTIES

As just mentioned, the 1997 Tax Act extended look-through treatment to certain dividends received from 10/50 Companies after the year 2002, but it failed to extend look-through treatment to interest, rents, and royalties from these same foreign JVs. U.S. shareholders of foreign JVs are often unable (due either to government restrictions or business practices) to acquire controlling interests, especially in cases where the foreign JV partner is a foreign government, or the activity involved in is a government regulated industry. It is patently unfair to penalize such non-controlling JV partners. Thus, Section 205 of your bill extends look-through treatment to interest, rents, and royalties received from foreign JVs after this year.

Current tax rules also require that payments of interest, rents, and royalties from noncontrolled foreign partnerships (i.e., foreign partnerships owned between 10 and 50 percent by U.S. owners) must be treated as separate basket income to the JV partners. Again, this result is not good tax policy. Thus, your bill extends look-through treatment to these entities as well. Such legislative action would bring much needed consistency and fairness to this area of the tax law, by allowing look-through treatment to all forms of income streams, and to all forms of business enterprises.

LOOK-THROUGH TREATMENT FOR SALES OF PARTNERSHIP INTERESTS

Currently, gains from sales of partnership interests are also treated as separate basket passive income, even though U.S. partners owning 10 percent or more of the value of foreign partnerships can apply look-through treatment for their distributive shares of such partnership income (although not interest, rents or royalties as stated before). Consistent with our earlier comments concerning look-through treatment in general, we support your provision in Section 107, which treats gains or losses associated with the disposition of a partnership interest as a disposition of the partner's proportionate share of each of the assets of the partnership.

AMEND THE DOMESTIC LOSS RECAPTURE RULE

Currently, when a taxpayer has taxable income from U.S. sources but an overall loss from foreign sources, the foreign source loss reduces the U.S. source taxable income and U.S. tax liability by decreasing the taxpayer's worldwide taxable income on which the U.S. tax is based. When the taxpayer subsequently generates foreign source income, the prior tax benefit is recaptured by treating a portion of that foreign income as domestic source for purposes of determining the FTC limitation. Current law also provides that an overall domestic loss reduces a taxpayer's foreign source income. The U.S. loss reduces the taxpayer's U.S. tax liability and, through application of the loss against foreign income, the FTC limitation is correspondingly reduced. There is no symmetry in these rules, however, in the case where it is a domestic loss that is incurred. In contrast to the foreign provisions, taxpayers are not allowed to recover or recapture foreign source income that was lost due to a domestic loss. To prevent this inequity and remove this anomaly, Section 202 of your bill would recharacterize such subsequent domestic income as foreign source to the extent of the prior domestic loss, and therefore allow the FTC that was disallowed because of the domestic loss.

SUBPART F EXEMPTION FOR ACTIVE FINANCING INCOME

We also applaud Section 101 of your bill, which extends the one-year provision enacted last year providing deferral of U.S. tax on non-U.S. income earned in the active conduct of a banking, financial, or similar business. This provision, particularly if made permanent, would significantly assist U.S. based financial service companies to compete successfully in the international marketplace against foreign based companies. It would also bring some consistency in the U.S. tax rules by

treating active income earned by financial service companies similarly to active income earned by U.S. companies in other industries.

Let us underscore the importance of this provision—U.S. banks and financial companies have historically expanded abroad hand-in-hand with U.S. industrial and service companies. They have, however, become an endangered species, as now only two (2) are ranked in the top twenty-five (25) financial services companies in the world, ranked by asset size (Citigroup and Chase Manhattan Corporation). Recent acquisitions of U.S.-based companies, such as Bankers Trust and Republic Bank, as well as growth in foreign-based companies have changed the global landscape beyond recognition.

REPEAL THE ALTERNATIVE MINIMUM TAX 90 PERCENT LIMITATION ON FOREIGN TAX CREDITS

Current law limits the ability of taxpayers to offset their corporate AMT liability by only allowing FTCs to offset up to 90 percent of such AMT. This has the likely result of taxing certain U.S. multinationals more heavily on their foreign income than their foreign competitors, or other domestic companies that have no foreign operations. Section 207 of your bill repeals this limitation and merely permits foreign taxes actually paid to be offset up to the amount of AMT liability on foreign source income, without affecting any U.S. source tax liability. As a result, the likelihood of double and sometimes triple taxation of foreign source income would be lessened, making U.S. multinationals more competitive internationally.

RESTRICT APPLICATION OF EXCISE TAX TO AIRLINE MILEAGE AWARDS

The 1997 Tax Act imposed a 7.5 percent aviation excise tax on amounts paid to air carriers for the right to provide mileage awards (or other cost reductions) for air transportation. However, that legislation failed to specify the geographical or transactional scope of the excise tax, and has caused significant problems in the tourism industry and complaints from other governments. Your Section 307 would clarify that the excise tax does not apply to certain payments for the right to provide mileage awards predominantly to foreign persons (who are outside the taxing arm of the U.S. government).

REMOVE PIPELINE TRANSPORTATION INCOME AND INCOME FROM TRANSMISSION OF HIGH VOLTAGE ELECTRICITY FROM SUBPART F TREATMENT

In 1982, Congress expanded subpart F income to include certain types of oil related income, such as income from operating an oil or gas pipeline in a country other than where the oil or gas was extracted or sold. The expansion of subpart F was due to a concern that petroleum companies had been paying too little U.S. tax on their foreign subsidiaries' operations relative to their high revenue. Specifically, Congress thought that U.S. tax could be avoided on the downstream activities of a foreign subsidiary because the income of the subsidiary was not subject to U.S. tax until that income was paid to its shareholders. The argument was that because of the fungible nature of oil and because of the complex structures involved, oil income was particularly suited to tax haven type operations.

However, this treatment is contrary to the original intent of subpart F, which primarily was aimed at passive and other easily movable income, rather than active income. Pipeline income, on the other hand, is neither passive nor easily movable. Moreover, no other major industrial country has special rules that sweep pipeline income into its anti-deferral regime. Consequently, U.S. companies find it difficult to compete with foreign-based multinationals for pipeline projects that would generate income subject to subpart F. Therefore, we applaud Section 105 of your bill, which would no longer treat as subpart F income, any income derived from the pipeline transportation of oil or gas within a foreign country.

Similarly, Section 106 of your bill would allow U.S.-based utility companies to enter foreign markets for electricity. These complex projects often involve the construction of costly fixed transmission systems that in some cases cross national boundaries. This income is also neither passive nor easily movable. Imposition of subpart F treatment on them is not justifiable, and is counterproductive to the interests of the United States.

EXTENSION OF CARRYFORWARD PERIOD AND ORDERING RULES FOR FOREIGN TAX CREDIT CARRYOVERS

When companies invest overseas, they often receive favorable local tax treatment from foreign governments, at least in the early years of operation. For example,

companies are sometimes granted rapid depreciation write-offs, and/or low or even zero tax rates, for a period of years until the new venture is up and running. This results in a low effective tax rate in those foreign countries for those early years of operation. For U.S. tax purposes, however, those foreign operations must utilize much slower capital recovery methods and rates, and are still subject to residual U.S. tax at 35 percent. Thus, even though those foreign operations may show very little profit from a local standpoint, they may owe high incremental taxes to the U.S. government on repatriations or deemed distributions to the U.S. parent. However, once such operations are ongoing for some length of time, this tax disparity often turns around, with local tax obligations exceeding residual U.S. taxes. At that point, the foreign operations generate excess FTCs but, without an adequate carryback and carryforward period, those excess FTCs will expire.

The U.S. tax system is based on the premise that FTCs help alleviate double taxation of foreign source income. By granting taxpayers a dollar-for-dollar credit against their U.S. liability for taxes paid to local foreign governments, the U.S. government allows its taxpayers to compete more fairly and effectively in the international arena. However, by imposing limits on carryovers of excess FTCs, the value of these FTCs diminish considerably (if not entirely in many situations). Thus, the threat of double taxation of foreign earnings becomes much more likely.

Sections 201 and 206 of your bill extend the carryover period, and useful life, respectively, of FTCs. Section 201 extends the carryover period from 5 to 10 years, while Section 206 allows old carryovers to be utilized first, which results in a "freshening" of unexpired FTCs. Both of these provisions would help reduce the costs of doing business overseas for U.S. multinationals, and help eliminate competitive disadvantages suffered by U.S.-based companies versus foreign-based companies. Please keep in mind that higher business taxes for U.S. companies may result in higher prices for goods and services sold to U.S. consumers, stagnant or lower wages paid to American workers in those businesses, reduced capital investment leading, perhaps, to work force reductions or decreased benefits, and smaller returns to shareholders. Those shareholders may be the company's employees, or the pension plans of other middle class workers.

We also note that the President's Fiscal Year 1998 Budget contained a proposal to reduce the carryback period for excess foreign tax credits from two years to one year. This proposal has been and is currently being considered in the Senate as a revenue raiser for one or more pending bills. The NFTC strongly opposes this proposal. Like the carryforward period, the carryback of foreign tax credits helps to ensure that foreign taxes will be available to offset U.S. taxes on the income in the year in which the income is recognized for U.S. purposes. Shortening the carryback period also could have the effect of reducing the present value of foreign tax credits and therefore increasing the effective tax rate on foreign source income.

REPEAL OF CODE SECTION 907

Under current law, in addition to having to calculate separate foreign tax credit ("FTC") limitations for income earned from each separate category or "basket" under section 904(d) (e.g., the passive income basket, shipping income basket, etc.), multinational oil companies are also required to calculate a separate limitation on their foreign oil and gas extraction income ("FOGEI") under Code Section 907. Section 208 of your bill would repeal Code Section 907 and, thus, eliminate the additional separate limitation on FOGEI.

As background, Section 907 was originally enacted in response to a Congressional concern that oil industry taxpayers were paying amounts to foreign governments that were ostensibly "taxes" but were in reality "disguised royalties." The issue arose from the fact that in foreign countries, the sovereign usually retains the right to its natural resources in the ground. Thus, a major concern was whether payments made to foreign governments were for grants of specific economic benefits or general taxes. Congress wanted to limit the FTC to that amount of the "government take" which was perceived to be a tax payment, and not a royalty. Moreover, once the tax component was identified, Congress wanted to prevent oil companies from using excess FOGEI credits to shield U.S. tax on certain low-taxed "other" income, such as passive income or shipping income.

However, both concerns have already been adequately addressed in subsequent legislation or rulemaking. First, under Treasury Decision 7918, so-called "dual capacity taxpayer" regulations were issued which help taxpayers to determine how to separate payments to foreign governments into their income tax element and "specific economic benefit" element. Second, the 1986 Tax Act fragmented foreign source income into various FTC "baskets," restricting taxpayers from offsetting excess

FTCs from high-taxed income, including FOGEI, against taxes due on low-taxed categories of income, such as passive or shipping income.

We emphasize that compliance with the rules under Code § 907 is extremely complicated and time consuming for both taxpayers and the IRS. Distinctions must be made as to various items of income and expense to determine whether they properly fall under the FOGEI category, or the FORI (or other) category. Painstaking efforts are often needed to categorize and properly account for thousands of income and expense items, which must then be explained to IRS agents upon audit. Ironically, such efforts typically result in no or little net tax liability changes, since U.S.-based oil companies have, since the inception of section 907, had excess FTCs in their FORI income category. As a result, oil industry taxpayers, which already must deal with depressed world oil prices, also must incur large administrative costs to comply with a section of the Income Tax Code that results in little or no revenue to the Federal Treasury.

Current Section 907 clearly increases the cost for U.S. companies of participating in foreign oil and gas development. Ultimately, this will adversely affect U.S. employment by hindering U.S. companies in their competition with foreign concerns. Although the host country resource will be developed, it will be done so by foreign competition, with the adverse ripple effect of U.S. job losses and the loss of continuing evolution of U.S. technology. The loss of any major foreign project to a U.S. company will mean less employment in the U.S. by suppliers, and by the U.S. parent, in addition to fewer U.S. expatriates at foreign locations. By contrast, foreign oil and gas development by U.S. companies assures utilization of U.S. supplies of hardware and technology, ultimately resulting in increased U.S. job opportunities.

EXTENSION OF FSC BENEFITS TO EXPORTS OF DEFENSE PRODUCTS

Code Section 923(a)(5) reduces the tax exemption available to companies that sell defense products abroad to 50 percent of the benefits available to other exporters. This provision prevents defense companies from competing as effectively as they could in increasingly challenging foreign markets.

Any U.S. exporter may establish Foreign Sales Corporations (FSCs) under which a portion of their earnings from foreign sales is exempt from U.S. taxation. This provision is designed to achieve tax parity with the territorial tax systems of our trading partners, i.e., it mirrors the economic effects of European Union tax systems on their exported products, for example.

For exporters of defense products, however, the FSC tax incentive is reduced by 50 percent, compared to the full benefit for all other products. That limitation, enacted in 1976, was based on the premise that military products were not sold in a competitive market environment and the FSC benefit was therefore not necessary for defense exporters.

Whatever the veracity of that premise 20 years ago, today military exports are subject to fierce international competition in every area. Moreover, with the sharp decline in the defense budget over the past decade, exports of defense products have become ever more critical to maintaining a viable U.S. defense industrial base. The aerospace industry alone provides over 800,000 jobs for U.S. workers. Roughly one-third of these jobs are tied directly to export sales. In 1996, for example, total industry sales were \$112 billion, \$37 billion of which was for exports.

Maintaining exports of defense products is today more difficult than ever before. First, the U.S. government prohibits the sale of defense products to certain countries and must approve all others in advance. Second, European and other states are developing export promotion projects to counter the industrial impact of their own declining defense budgets by being more competitive internationally. Finally, a number of Western purchasers of defense equipment now view Russia and other formerly communist countries as acceptable suppliers, further intensifying the global competition.

No valid economic or policy reason exists for continuing a tax policy that discriminates against a particular class of manufactured products. Furthermore, repealing this section will not impact the foreign policy of the United States. Military sales will continue to be subject to the license requirements of the Arms Export Control Act.

An egregious example of how these rules discriminate against certain products involves commercial communications satellites. U.S. manufacturers are the world's leaders in the production and deployment of communications satellites. Until this year, commercial communications satellites manufactured in the United States qualified for full FSC benefits. For export control purposes, the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999 transferred jurisdiction over commercial satellite exports from the Commerce Department Commerce Con-

trol List (CCL) to the State Department U.S. Munitions List (USML), effective March 15, 1999. An unintended result of this jurisdictional change is that commercial communications satellites and related items are now "military property" for purposes of the FSC rules. This unintended result should be corrected and the full FSC benefit for commercial communications satellites should be restored. In fact, the House of Representatives Select Committee on Technology Transfers to the Peoples Republic of China, chaired by Representative Christopher Cox, recommended that satellite manufacturers should not suffer a tax increase because of the transfer from CCL to USML.

Improvement of the U.S. trade imbalance is fundamental to the health of our economy. The benefits provided by the FSC provisions contribute significantly to the ability of U.S. exporters to compete effectively in foreign markets. The FSC limitation on the exemption for defense exports hampers the ability of U.S. companies, many of whom already have access to large foreign markets, to compete effectively abroad with many of their products. Section 923(a)(5) should be repealed immediately to remove this impediment to the international competitiveness and to the future health of our defense industry.

Section 303 of your bill, Mr. Chairman, and an identical provision included in a stand-alone bill, H.R. 796, would remedy this situation. H.R. 796 currently has 54 cosponsors, including 28 of the 39 members of the Committee.

In addition to these areas of concern that have been addressed in your bill, as noted above we have significant concerns in another area that we would like to address.

ALLOCATION OF INTEREST EXPENSE

Prior to January 3, 1977, when Treasury issued its final Regulation § 1.861-8, there essentially was no requirement to allocate and apportion U.S. interest expense to foreign-sourced income. Moreover, even under these 1977 regulations, opportunities were available to minimize the impact of interest allocation. For example, interest could be allocated on a separate company basis. Thus, corporate structures could be organized so that U.S. debt could be carried only by companies in an affiliated group that had domestic source income, eliminating any allocation of interest to foreign sourced income.

The 1986 Tax Reform Act required that allocation of interest now be made on a consolidated group basis. It also eliminated the optional gross income method for allocating interest, and required that earnings and profits of more than ten percent owned subsidiaries be added to their stock bases for purposes of allocating interest under the asset-tax basis method. Also in 1986, while advancing the concept of "fungibility," Congress nevertheless failed to allow an offset for interest expense incurred by foreign affiliates. Although such a "worldwide fungibility" provision was included in the Senate-passed version of the bill in 1986, it was dropped in Conference. Similarly, a subgroup/tracing exception approved by the Senate was also dropped from the final 1986 Act. While these fungibility and subgroup/tracing provisions have appeared in later tax bills (see e.g., H.R. 2948 ("Gradison Bill") introduced in 1991 and H.R. 5270 ("Rostenkowski Bill") introduced in 1992), they have never been enacted.

The NFTC strongly suggests that Congress fix the inequitable interest allocation rules currently existing in the law. They are extremely costly and particularly anti-competitive for multinational corporations. By failing to take into account borrowings of foreign affiliates, the law results in a double allocation of interest expense. Moreover, these rules operate to impede a U.S. multinational corporation's ability to utilize the foreign tax credit for purposes of mitigating double taxation. It is simply unfair that U.S. multinationals with U.S. subsidiaries operating solely in the U.S. market, where the subsidiary incurs its debt on the basis of its own credit, must nevertheless allocate part of that interest expense against wholly unrelated foreign generated income.

One solution, of course, is simply to reinstate and codify the pre-1986 Act interest allocation rules permitting interest expense to be allocated on a separate company basis. However, due to the strong criticism of the rules in 1986, this approach is unlikely to succeed. We, therefore, suggest an alternative approach of advancing the provisions that were passed by the Senate in connection with the 1986 Act. Recall that under the earlier Senate version, interest expense of foreign affiliates would be added to the total interest expense "pot" to be allocated among all affiliates. Thus, this approach allows adoption of the "worldwide fungibility" concept of allocating interest, as opposed to the "water's edge" approach of current law. We also suggest the inclusion of an elective "subgroup" or tracing rule that allows interest expense to be allocated based on a subgroup consisting of only the borrower and its

direct and indirect subsidiaries. This approach allows interest that should be specifically allocated to a particular domestic operation to remain identified with such operation, a much more equitable approach than under current law.

IN CONCLUSION

In particular, our study of the international tax system of the United States has led us so far to four broad conclusions:

- U.S.-based companies are now far less dominant in global markets, and hence more adversely affected by the competitive disadvantage of incurring current home-country taxes with respect to income that, in the hands of a non-U.S. based competitor, is subject only to local taxation; and
- U.S.-based companies are more dependent on global markets for a significant share of their sales and profits, and hence have plentiful non-tax reasons for establishing foreign operations.
- Changes in U.S. tax law in recent decades have on balance increased the taxation of foreign income.
- United States policy in regard to trade matters has been broadly expansionist for many years, but its tax policy has not followed suit.

These two incompatible trends—decreasing U.S. dominance in global markets set against increasing U.S. taxation of foreign income—are not claimed by us to have any necessary causal relation. However, they strongly suggest that we must re-evaluate the balance of policies that underlie our international tax system.

Again, the Council applauds the Chairman and the Members of the Subcommittee for beginning the process of reexamining the international tax system of the United States. These tax provisions significantly affect the national welfare, and we believe the Congress should undertake careful modification of them in ways that will enhance the participation of the United States in the global economy of the 21st Century. We would enjoy the opportunity to work with you and the Committee in further defining both the problems and potential solutions. The NFTC would hope to make a contribution to this important business of the Subcommittee. The NFTC is prepared to make recommendations for broader reforms of the Code to address the anomalies and problems noted in our review of the U.S. international tax system, and would enjoy the opportunity to do so.

United States in the World Economy		
U.S. International Trade (percent of GDP)¹	1960-69	1990-97
Merchandise exports	3.9%	7.5%
Merchandise imports	3.2%	9.7%
Trade openness: merchandise exports plus imports	7.1%	17.2%
U.S. International Investment Position (\$ billions)²	1980	1997
Net international investment position ³	393	-1,224
Direct investment:		
U.S. investment abroad	396	1,024
Foreign investment in the United States	126	752
Private portfolio investment in securities:		
U.S. investment abroad	62	1,446
Foreign investment in the United States	90	2,240
U.S. Corporate Profits⁴	1960-69	1990-97
Share from foreign sources	7.5%	17.7%
Rate of return on assets (earnings before interest and taxes)⁵	1985	1995
Foreign subsidiaries minus domestic corporations	5.1%	2.2%
Gross Domestic Product (GDP)⁶	1965	1996
U.S. share of world total	39.9%	25.7%
Population	1965	1997
U.S. share of world total	5.8%	4.6%
Exports⁷	1960	1996
U.S. share of world total	16.6%	11.9%
Direct Investment Stock⁸	1967	1996
U.S. share of world outward direct investment stock	50.4%	25.0%
World's 20 Largest Corporations (ranked by sales)⁹	1960	1996
Number of U.S.-headquartered corporations	18	8
Table Notes:		
¹ Survey of Current Business, U.S. Department of Commerce, July 1998.		
² Survey of Current Business, U.S. Department of Commerce, July 1998. Direct investment at current cost.		
³ Includes all private and official government assets.		
⁴ Survey of Current Business, U.S. Department of Commerce, August 1998.		
⁵ World Economic Outlook, International Monetary Fund, 1997.		
⁶ International Financial Statistics, International Monetary Fund, March 1998.		
⁷ World Investment Report, United Nations Conference on Trade and Development, 1997 edition.		
⁸ Hoover's Handbook of World Business, 1998 edition.		
⁹ U.S. Department of Commerce data, PricewaterhouseCoopers calculations.		

Chairman HOUGHTON. Thanks very much, Mr. Luby.

Before we go on, I want to introduce Mr. Wes Watkins, Congressman from Oklahoma. We are delighted you are here, Mr. Watkins. And, then, Mr. Lester Ezrati, would you please testify?

**STATEMENT OF LESTER D. EZRATI, GENERAL TAX COUNSEL,
HEWLETT-PACKARD COMPANY, PALO ALTO, CALIFORNIA,
AND PRESIDENT, TAX EXECUTIVES INSTITUTE, INC.**

Mr. EZRATI. Thank you, Mr. Chairman. I am general tax counsel for Hewlett-Packard Company in Palo Alto, California. I am here today as president of Tax Executives Institute, the preeminent group of in-house tax professionals in North America. Our 5,000 members represent the 2,700 largest corporations in the United States and Canada, most of which have significant operations overseas.

TEI believes that the Code's foreign provisions need fundamental reform and simplification, and for this reason, we support H.R. 2018. Enactment of this bill will generally reduce the cost of complying with the laws without any material diminution in tax dollars flowing to the Treasury. The bill will not only reduce administrative burdens, thereby enhancing the country's competitiveness, but will also signal Congress's commitment to the simplification of the tax law generally. In addition, the bill will bring overdue reform to the foreign tax credit area where taxpayers have been especially burdened.

Mr. Chairman, the proposals in H.R. 2018 have been described as modest. It marks a beginning, not an end. For example, in the more than three decades since their enactment, the Subpart F rules have been distended to capture more and more active operating income. Reform is needed here. One solution is to remove Subpart F's artificial barriers to competitiveness by excluding foreign-based companies' sales and services income from current taxation and allowing U.S. corporations to compete more effectively. Other areas to be addressed are the translation of the deemed-paid foreign tax credit rule under section 906 and the elimination of the current interest allocation rules. These comments notwithstanding, we agree with you, Mr. Chairman, that the bill represents a significant downpayment on further reform.

I would now like to highlight two provisions in H.R. 2018 that we believe are particularly important for the reform of international tax laws.

First, TEI believes that taxpayers should be permitted to use generally accepted accounting principles to calculate the earnings and profits of controlled foreign corporations under Subpart F. Current law provides that a foreign corporation's earnings and profits is to be computed in accordance with rules substantially similar to those for domestic corporations. As a practical matter, however, a foreign corporation is frequently unable to compute E&P in the same manner as a domestic corporation. Although a domestic corporation generally calculates E&P by making adjustments to U.S. taxable income, a foreign corporation necessarily uses foreign book income as its starting point. This bill will provide significant sim-

plification by permitting taxpayers to reduce their administrative burdens by using United States' generally accepted accounting principles (GAAP) to compute E&P. In our view, however, the provision should be elective, not mandatory.

Second, TEI applauds section 207, which would eliminate the 90-percent limitation on the use of the foreign tax credit to offset any alternative minimum tax liability. Giving taxpayers the ability to offset their entire liability with their foreign taxes will not frustrate the policy underlying the AMT and will further the goal of eliminating double taxation. A taxpayer with an AMT liability and sufficient foreign tax credits to offset that liability, has already paid a significant amount of tax. Clearly, that the tax has not been paid to the United States has no bearing on the economic cost it represents to the taxpayer. We therefore support the enactment of this provision.

H.R. 2018 would also mandate two Treasury Department studies: one on the treatment of the European Union as a single country for purposes of the same-country exception to Subpart F and a second on the interest allocation rules. We commend the Chairman for recognizing that the European Community's elimination of barriers to cross-border payments places U.S. corporations at a disadvantage. We suggest, however, that companies need relief now in order to remain competitive and urge Congress to consider the immediate adoption of this proposal.

As for the interest allocation rules, we agree that they desperately need reform. In our view, the rules are not justified on economic grounds.

Finally, I would like to address an issue not included in H.R. 2018—confidentiality of advance pricing agreements. Mr. Chairman, you recently voiced support for legislation to protect APAs from disclosure. As businesses become more global, it will become increasingly important for governments and taxpayers to work together to resolve disputes in creative, cost-effective ways, such as the APA Program. TEI strongly believes that any compromise of taxpayer confidentiality will have a negative effect on the future of this important program.

Information set forth in an APA is highly fact-specific and involves sensitive financial and commercial information. Taxpayers submitted the pricing information to the IRS with the understanding that it would be kept confidential. That the IRS is preparing to disclose APAs threatens these companies' legitimate privacy interests and has already begun to undermine our relations with treaty partners and the future of the APA Program. For these reasons, TEI strongly supports enactment of legislation to protect APAs and supporting documents from disclosure.

Mr. Chairman, we commend you for recognizing that the international provisions are among the most complex provisions of the Internal Revenue Code, and we pledge our support for your efforts to effect meaningful simplification and reform.

Thank you for giving us the opportunity to testify, and I would be pleased to respond to your questions.

[The prepared statement follows:]

Statement of Lester D. Ezrati, General Tax Council, Hewlett-Packard Company, Palo Alto, California, and President, Tax Executives Institute, Inc.

Good afternoon. I am Lester D. Ezrati, General Tax Counsel for Hewlett-Packard Company in Palo Alto, California. I appear before you today as the president of Tax Executives Institute, the preeminent group of corporate tax professionals in North America. The Institute is pleased to provide the following comments on international complexity and simplification.

BACKGROUND

Tax Executives Institute is the preeminent association of corporate tax executives in North America. Our 5,000 members are accountants, attorneys, and other business professionals who work for the largest 2,800 companies in the United States and Canada; they are responsible for conducting the tax affairs of their companies and ensuring their compliance with the tax laws. Hence, TEI members deal with the tax code in all its complexity, as well as with the Internal Revenue Service, on almost a daily basis. Most of the companies represented by our members are part of the IRS's Coordinated Examination Program, pursuant to which they are audited on an ongoing basis. TEI is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. Our background and experience enable us to bring a unique and, we believe, balanced perspective to the subject of international complexity and simplification.

The international provisions of the Internal Revenue Code are among the most complicated provisions in the tax law. The last several years have seen several small steps taken to reduce tax law complexity for multinational corporations. For example, three years ago, Congress repealed section 956A of the Internal Revenue Code, which in our view was ill-conceived when it was enacted in 1993. And in 1997, Congress rectified an inequity that has existed for the past decade when it eliminated the overlap between the controlled foreign corporation and passive foreign investment company rules. Although laudable, these actions represent only a small step on the journey of simplifying the international tax provisions of the Internal Revenue Code.

TEI believes that the Code's foreign provisions need fundamental reform and simplification, and for this reason we support H.R. 2018, the International Tax Simplification for American Competitiveness Act of 1999, which was introduced on June 7, 1999, by Oversight Subcommittee Chairman Amo Houghton and several other representatives. Enactment of this bill will generally reduce the costs of preparing U.S. corporate tax returns for American companies engaged in international trade without any material diminution in tax dollars flowing to the treasury. The bill will not only reduce compliance costs—thereby enhancing the country's competitiveness—but it will also signal Congress's continued commitment to the simplification of the tax law generally. In addition, the bill will bring long overdue, albeit partial, reform to the foreign tax credit area.

Any simplification efforts will need to comprehend the changing face of the business environment, owing, among other things, to the growth of electronic commerce and business technologies. As businesses become more global and as companies strive to manage their supply chains digitally, the need for meaningful tax reform will become more and more manifest. In addition, it will become increasingly important for governments and taxpayers to work together to resolve—or forestall—disputes in creative, cost-effective ways, such as advanced pricing agreements (APAs). Accordingly, TEI is very pleased that Congressman Houghton and other members have voiced support for preserving the confidentiality of APAs. TEI strongly believes that any compromise of taxpayer confidentiality will have a negative effect on the future of the APA program.

As Congressman Houghton noted in his introductory statement, H.R. 2018 seeks reform “in modest but important ways.” We agree that, although a major leap forward, enactment of the bill will not obviate additional reform of the Code's international tax provisions—for example, in respect of Subpart F, which Chairman Houghton himself has singled out as an extremely complex area of the law. Subpart F was initially enacted as an exception to the deferral principle in order to tax the types of income considered relatively “movable” from one taxing jurisdiction to another and therefore able to take advantage of low rates of tax. In the three decades since its enactment, however, Subpart F has been distended to capture active operating income. One solution to removing Subpart F's artificial barrier to competitiveness would be to exclude foreign base sales and services income from current taxation, allowing U.S. corporations to compete more effectively on a level international

playing field.¹ Other areas that should be considered for simplification include the translation of the deemed paid tax credit under section 986, the aggregation of dividends from noncontrolled section 902 corporations in one basket, and the elimination of the interest allocation rules. These comments notwithstanding, we agree with Congressman Houghton and the other sponsors of H.R. 2018 that the bill represents a “down payment on further reform.”

H.R. 2018: A GOOD START

I. Treatment of Controlled Foreign Corporations

A. Use of GAAP for E&P Calculations. The concept of “earnings and profits” (E&P) has relevance in the foreign tax area for several reasons. For example, E&P is used in measuring the amount of Subpart F inclusions, the portion of a distribution from a foreign corporation that is taxable as a dividend, the amount of foreign taxes deemed paid for purposes of the deemed-paid foreign tax credit, and the amount of section 1248 gain taxable as a dividend.

The Code currently provides that the E&P of a foreign corporation is to be computed in accordance with rules substantially similar to those applicable to domestic corporations. As a practical matter, however, a foreign corporation is frequently unable to compute E&P in the same manner as a domestic corporation. Although a domestic corporation generally calculates E&P by making adjustments to U.S. taxable income, a foreign corporation necessarily uses foreign book income as its starting point. The ensuing adjustments become especially difficult in the case of noncontrolled foreign corporations since the U.S. shareholder of such companies may be unable to obtain all the information required to compute E&P.

Although foreign corporations do not compute U.S. taxable income, they frequently do adjust foreign book income to conform with U.S. generally accepted accounting principles (GAAP) for financial reporting purposes. There are numerous differences between GAAP and E&P, but most relate to timing differences and have at most a transitory and nominal effect on a company’s U.S. tax liability, especially in light of the requirement of the Tax Reform Act of 1986 that taxpayers compute their deemed-paid credit on the basis of a “pool” of post-1986 undistributed earnings.

Because we believe that taxpayers should generally be permitted to elect to use U.S. GAAP in computing the E&P of foreign corporations, we endorse section 104 of H.R. 2018, which would clarify the Treasury Department and IRS’s authority to provide such an election.² Enactment of this provision is needed to simplify calculations of E&P in the foreign area.

B. De Minimis Rule for Subpart F Income. Section 954(b)(3) of the Code provides that no part of a CFC’s gross income is treated as foreign-based company income (FBCI) if its FBCI and insurance income for the year is less than the smaller of (i) five percent of its gross income for the year or (ii) \$1 million. Section 103 of H.R. 2018 would increase the FBCI *de minimis* income from five to ten percent of gross income, thereby reducing the reporting requirements for many companies. The bill would also increase the \$1 million ceiling to \$2 million, a provision that would assist companies with relatively small overseas operations.

TEI endorses this provision, which would simplify the computation of FBCI. We suggest, however, that consideration be given to eliminating the dollar threshold altogether (or increasing it to \$5 million). These changes would restore the *de minimis* rule that was in effect before 1987.

C. Treatment of the European Union Under the Same-Country Exception. In 1992, the European Community created a single market now comprised of 15 countries that led to the consolidation of many European business opportunities. The resulting reduction of operating costs enhanced the competitiveness of EC-based corporations, often to the detriment of U.S.-based companies that are subject to Subpart F. The conversion of 11 currencies to the euro can only exacerbate the problem.

Under the current Subpart F rules, certain sales and services income that is earned outside a CFC’s home country is taxable, while income earned inside the home country is exempt from current taxation under the “same-country exception.”

¹The proposal in H.R. 2018 to treat the countries in the European Community as a single country for purposes of the “same-country” exception to Subpart F would also effect some relief. See the discussion of this provision at pages 7–8.

²Regulations proposed in 1992 would eliminate the need to adjust financial statements prepared in accordance with GAAP, but only with respect to uniform capitalization and depreciation for purposes of computing a foreign corporation’s E&P. The proposed regulations do not address the computation of E&P for Subpart F purposes because the IRS and Treasury question whether they have the authority to effect such a change by regulation.

Computing Subpart F income significantly increases the administrative costs for U.S.-based companies; because of the generally high European tax rates, there is most often no increase in revenues for the United States. Thus, U.S. multinationals may be forced to choose between the potential for cost-efficient consolidation of operations in Europe and higher administrative costs.

Section 102 of H.R. 2018 would provide for a Treasury Department study on the feasibility of treating all countries included in the European Community as one country for purposes of applying the same-country exception under Subpart F of the Code.³ The European Community is eliminating barriers to cross-border payments—an initiative that places U.S. corporations at a disadvantage. Accordingly, TEI believes that companies need relief now in order to remain competitive, and we regret that a study will only further delay the proper economic result: treatment of the EC countries as one country. Such a solution would permit the efficient consolidation of U.S. multinationals' European operations, thereby enhancing their ability to compete in the European Union. TEI strongly urges Congress to consider the outright adoption of this proposal.

II. Foreign Tax Credit Rules

A. Creditability against Alternative Minimum Tax. Under section 59(a)(2) of the Code, a taxpayer's foreign tax credit (FTC) may offset no more than 90 percent of the taxpayer's alternative minimum tax (AMT) liability.⁴ In contrast, a taxpayer that is subject to a regular income tax liability is not subject to the 90-percent restriction. The 90-percent limitation is presumably the result of Congress's efforts to reconcile the arguably conflicting policies underlying the FTC and AMT.

Because the United States taxes the worldwide income of its citizens and residents, the FTC was introduced to limit the incidence of double taxation—the taxation of the same income by two jurisdictions. The policy underlying the FTC has not changed over the years, though certain limitations have been imposed to prevent what has been deemed to be the improper averaging of high- and low-tax foreign source income. Thus, under the regular income tax provisions, a U.S. taxpayer may offset fully 100 percent of its U.S. tax liability on foreign-source income with its FTC. This does not mean that the taxpayer is not paying any tax, but rather simply acknowledges that the taxpayer has already paid a tax (to the jurisdiction where the income was derived) at the rate equal to or greater than the amount the United States would assess on that income.

When the AMT was enacted as part of the Tax Reform Act of 1986, Congress had “one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits.” S. Rep. No. 99–313, 99th Cong., 2d Sess. 518–19 (1986). Thus, the AMT was deemed necessary to address public perceptions about the fairness of the tax system.

TEI has serious reservations about the policy basis for the AMT generally, but we recognize that calls for its outright repeal are beyond the scope of this hearing. Accordingly, we applaud section 207 of H.R. 2018, which proceeds from the premise that, even if the AMT remains in effect, it makes no sense to retain the 90-percent FTC limitation. According a taxpayer the ability to offset its entire liability with its foreign taxes would not frustrate the legitimate policy underlying the AMT. Unlike the other items that may serve to reduce a taxpayer's regular tax liability (which taxpayers are not permitted to take fully into account for AMT purposes), the foreign tax credit represents precisely what its name suggests: a tax. A taxpayer with an AMT liability and sufficient FTC to offset that liability has already paid a significant tax. Clearly, that the tax has not been paid to the United States has no bearing on the economic cost it represents to the taxpayer. Moreover, to the extent the FTC and AMT regimes do conflict, TEI submits that the policy supporting the FTC (and complementary provisions in U.S. tax treaties)—which is based upon sound economic reasoning and comports with longstanding international norms—should prevail. We therefore support the enactment of this provision.⁵

B. Expansion of FTC Carryforward and Ordering Rules. Section 904(c) of the Code currently provides that any foreign tax credits (FTCs) not used against U.S. tax in the current year may be carried back two years and forward five. In contrast, the

³Prior iterations of this bill provided for the treatment of EC countries as a single country for purposes of the same-country exception. See, e.g., H.R. 1690, 104th Cong., 2d Sess. (introduced on May 24, 1995).

⁴This limitation is imposed in addition to the foreign source income limitations of section 904 as it applies to both AMT and regular taxpayers.

⁵This provision mirrors the relief provided in H.R. 1633, which was introduced by Chairman Houghton in April.

rules for the general business tax credit (section 39) and net operating losses (section 172(b)) provide for a three-year carryback and a fifteen-year carryforward.

In addition, the ordering rules set forth in section 904(c) for FTCs require that the current year's credits be utilized before any carryovers are taken into account. By contrast, in respect of the general business tax credit, a carryover is to be used first, before the current year's credits, to afford the taxpayer the maximum opportunity for using the credit. See I.R.C. § 38(a).

The inconsistency in carryback/carryforward periods is not only inequitable, but also complicates the tax laws. The current rules create administrative burdens for the government and taxpayers alike. More fundamentally, the rules effectively penalize taxpayers that experience operating losses, thereby creating a windfall for the federal government that may "collect" a substantial portion (if not all) of the FTCs previously earned and claimed because of the unduly short carryback/carryforward period. Current law effects an especially harsh result in respect of taxpayers in cyclical industries whose ability to utilize FTCs is limited because of income fluctuations and start-up companies with initial losses.

Section 201 of H.R. 2018 would expand the FTC carryforward rules to 10 years, bringing them more in line with the rules for net operating losses and general business tax credits. Although the Institute believes that the rules for the three credits should be the same, we recognize that the proposal would limit the situations where the purpose of the FTC—the elimination of double taxation—is frustrated by unrealistically short carryover periods. We also endorse section 206, which would change the ordering rules whereby any carryover FTC would be taken into account before the current year's credit. Permitting the oldest credits to be used first would mitigate the problem of expiring credits.⁶

C. Treatment of Overall Domestic Loss. Section 904(f) of the Code provides for the "recapture" of "overall foreign losses" where the taxpayer sustains a foreign-source loss in one year and there is foreign-source income in a subsequent year; the recapture is accomplished by treating income in the later years as domestic-source income. The law does not, however, provide for similar recapture treatment when there is an overall domestic loss that is offset against foreign income in one year and in a subsequent year there is sufficient domestic income to otherwise absorb the domestic loss.

Section 202 of H.R. 2018 would apply a resourcing rule to U.S. income where the taxpayer has suffered a reduction in the amount of its FTC limitation due to a domestic loss. The bill would recharacterize into foreign-source income U.S.-source income (up to 50 percent of taxable income) earned in a year subsequent to a year in which an overall domestic loss offset foreign-source income. Adoption of this provision not only would provide parallel treatment for foreign and domestic losses, but would also foster U.S. competitiveness. TEI recommends enactment of the provision.⁷

D. "Look-Through" Rules for Dividends, Interest, Rents, and Royalties from 10/50 Companies. The 1986 Act categorized foreign affiliates that are owned between 10 and 50 percent by a U.S. shareholder as a "noncontrolled section 902 company" and created a separate FTC limitation for each such company. The requirement that dividends from each noncontrolled section 902 company be placed in a separate "basket" was generally recognized as among the most maddeningly, mind-numbingly complex rules of the 1986 Act's provisions. Last year, Congress acted to remedy this problem by permitting taxpayers to elect a "look-through" rule for dividends similar to the one provided for CFCs under section 904(d)(3). The use of this rule was delayed, however, until 2002.

Section 204 of H.R. 2018 would advance the effective date of the 1998 provision to taxable years beginning after December 31, 1999; section 205 would expand look-through treatment to include interest, rents, and royalties. TEI agrees that enactment of these provisions would alleviate some of the complexity in current law and for sophisticated taxpayers might be especially beneficial. From an administrative

⁶We recognize that legislation has been proposed (e.g., S. 1134, the Affordable Education Act of 1999, and S. 331, the Workers Incentives Improvement Act) to shorten the FTC carryback from two years to one and expand the carryforward from five years to seven. Enactment of this revenue raiser would exacerbate the double taxation caused by expiring FTCs, particularly for companies in cyclical industries.

⁷The bill's introduction of an overall domestic loss provision would remedy an inequity faced by taxpayers attempting to claim FTCs. This reform would not eliminate the need to address current section 904(f) (relating to overall foreign losses), which limits a taxpayer's ability to claim FTCs. Consideration should be given to either repealing or modifying both the overall foreign loss rules and section 864(e)'s interest expense allocation provisions, because these rules place U.S. corporations at a competitive disadvantage.

perspective, however, we suggest that a better approach would be to permit dividends from noncontrolled corporations to be aggregated into a single basket.

III. Other Provisions

A. Limitation on UNICAP Rules. As enacted in 1986, section 263A of the Code requires the uniform capitalization of certain direct and indirect costs, including interest, incurred with respect to property produced by the taxpayer or acquired for resale (the “UNICAP rules”). Although section 263A applies in the foreign context, the revenue raised by application of the UNICAP rules to foreign subsidiaries is small compared with the administrative burden they impose on taxpayers.

Section 302 of H.R. 2018 would provide that the UNICAP rules of section 263A apply to a non-U.S. person only to the extent necessary for purposes of determining the amount of tax imposed on Subpart F income or on U.S. effectively connected income. It is a simplifying provision that should be adopted.⁸

B. Study of Interest Allocation Rules. H.R. 2018 requires the Treasury Department to conduct a study of the rules under section 864(e) of the Code relating to the allocation of interest expense among members of an affiliated group.

TEI commends the Chairman for recognizing that the interest allocation rules are in desperate need of reform. In our view, the interest allocation rules were enacted as a revenue raiser in 1986 and are not justified on economic grounds. The rules have spawned not revenue so much as a series of complex transactions to minimize their effect. Hence, TEI believes that section 864(e) should be repealed. We are confident that the Treasury study will confirm that view and urge that action be taken as soon as possible.

C. Reporting Requirements for Foreign-Owned Corporations. Section 6038A of the Code sets forth reporting requirements for any corporation engaged in a trade or business in the United States that is at least 25 percent owned by a foreign person. Substantial penalties are imposed for noncompliance. The statute contains no *de minimis* reporting rule. In addition, Treas. Reg. § 1.6038A-3(f)(2) provides that documents maintained outside of the United States must be produced within 60 days of a request by the IRS and must be translated within 30 days of a request for translation.

Section 311 of H.R. 2018 would provide that a reporting corporation will not be required to report any information with respect to any foreign-related person if the aggregate value of the transactions between the corporation and the related person during the taxable year does not exceed \$5 million. In addition, the provision would expand the time in which a taxpayer may produce translations of documents from 30 days to at least 60 days. The subsection also provides that nothing shall limit the right of the taxpayer to request additional time to comply with the request for translation.

TEI supports enactment of the *de minimis* rule, which will ease the reporting burdens on taxpayers. In addition, we agree that an expansion of time in which to produce translated documents recognizes the practical difficulties inherent in a global marketplace where documents may be kept in various languages and at various locations. We suggest, however, that the proposed language—“nothing shall limit the right of the taxpayer to request additional time”—be revised to read “the Internal Revenue Service shall have the authority to grant all reasonable requests for additional time to furnish the requested translations.”

SAFEGUARDING THE APA PROCESS

Congressman Houghton has voiced support for legislation that would amend section 6103(b)(2)(A) of the Code to provide protection from disclosure for negotiated agreements between taxpayers and the IRS. Included in the proposal’s protection are advanced pricing agreements (APAs), as well as closing agreements and competent authority agreements.⁹ The bill responds to recent litigation to seeking disclosure of APAs and closing agreements.

The APA program is designed to forestall contentious and expensive transfer pricing disputes between taxpayers and the IRS. A voluntary venture, it is one of the IRS’s success stories of the 1990s and furthers the goal of eliminating unnecessary complexity in the tax law. Each APA specifies a methodology negotiated between the specific taxpayer and the IRS (and, at times, a foreign country) for the taxpayer to use in determining its intercompany pricing and thereby assure compliance with

⁸The adoption of the GAAP E&P rules discussed on pages 5–6 of this submission would render this change unnecessary.

⁹The bill would also amend section 6110(b)(1) to exclude these agreements from the definition of “written determinations” subject to disclosure.

section 482 of the Code. The information set forth in an APA—the method by which a company determines its profit margins—is highly fact specific and involves sensitive financial and commercial information. Almost 200 APAs have been negotiated since the program began in 1991 and the program has been used as a model by the international community as a means of minimizing double taxation of income and settling costly transfer pricing disputes.

Since the inception of the APA program until January 8, 1999, the IRS treated the APAs and their supporting documentation as tax return information that was not subject to disclosure. On that date—in conjunction with a suit to compel release of the APAs under the Freedom of Information Act—the IRS said it now takes the position that APAs constitute “written determinations” under section 6110 of the Code and therefore may be publicly released in a redacted form. TEI believes that the IRS’s position is wrong and we have filed a brief *amicus curiae* in the case.

As a professional association dedicated to the development and implementation of sound tax policy, TEI is concerned that the release of the APAs—even in redacted form—will adversely affect the APA program. Taxpayers submitted the pricing information to the IRS with the understanding that the information would be subject to the same confidentiality restrictions as tax returns. Companies’ legitimate privacy interests—as well as the privacy interest of our treaty partners in respect of bilateral APAs—will be compromised by the release of the APA background documents and their ability to compete effectively in the marketplace could be harmed. Moreover, the very redaction process that accompanies release of the information would be extremely difficult, burdensome, and time-consuming.

More important, the knowledge that such information will be released in the future will discourage taxpayers from seeking APAs. TEI believes that the APA program represents the best way for companies to resolve transfer pricing controversies and avoid costly and time-consuming audits and litigation. At a time when the IRS is seeking more taxpayer-friendly ways of doing business, programs such as the APA program should actively be encouraged, rather than jeopardized by a mistaken interpretation of the law.

For these reasons, TEI strongly supports enactment of legislation to protect APAs and supporting documents from disclosure.

CONCLUSION

Tax Executives Institute appreciates this opportunity to present its views on international complexity and simplification. Any questions about the Institute’s views should be directed to either Michael J. Murphy, TEI’s Executive Director, or Timothy J. McCormally, the Institute’s General Counsel and Director of Tax Affairs. Both individuals may be contacted at (202) 638–5601.

Chairman HOUGHTON. Thank you very much, Mr. Ezrati.

I am going to forego my questions until the end. I would like to pass the questioning over to Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman, and thank you for your testimony.

I would just like to ask, in considering the various provisions of H.R. 2018, I wonder if each of you would be able to tell us how the provisions would affect each of your individual firms, and I know, Mr. Ezrati, you are representing the TEI, but if you could tell us about Hewlett-Packard?

Mr. EZRATI. Certainly. If I can focus on just a few of them. The adoption of the elective GAAP E&P provisions will be a major simplification. Hewlett-Packard has about 65 foreign subsidiaries in which we employ a similar number of people like Mr. Luby does to help HP comply with these provisions. This would allow us to employ them in other active pursuits rather than complying with the tax law.

The treatment of the European Union as a single country would be key for our business in Europe. The trade barriers are coming

down in Europe for our competitors, but, right now, we are obligated to create a separate subsidiary in each one of those countries. Our businesses don't want to do business that way. They want a central spot in Europe where they can distribute all over the continent, and, right now, the U.S. tax rules make that difficult.

Mr. COYNE. Mr. Luby.

Mr. LUBY. As I mentioned, 907, of course, would save us a lot of compliance costs. The GAAP rules for Subpart F would be important. Another important provision is pipeline transportation income provision. That makes pipeline transportation income Subpart F, currently deemed up should it cross the border. That is active business income. It is very difficult to ship pipelines around, as you might expect, so that would be important to our industry. And look-through treatment for the sales of partnership interests would be a major improvement for our industry. As you know, our investments are so large, we have to do joint ventures that result in partnerships, and we think that the treatment of the sale, the partnership interests, should be the same as the underlying income.

Mr. COYNE. Could each of you give just a brief description about how your international operations would change as a result if these changes were to be implemented?

Mr. EZRATI. Again, I will focus on the European Union. I think we would see a smaller infrastructure in Europe and a greater ability to distribute products all over Europe. That would be key. Right now, customers in Europe don't want to deal with salespeople and service operations and markets in each of their countries; they want to deal with one European-wide operation, and that is what our businesses want to move to. As we move to more electronic commerce, we just want one central focal point in Europe, and we will be able to achieve that.

Similarly, operations in China would improve dramatically if there were improvements in the Subpart F arrangements, because it is very difficult to do business in China with currency controls and similar restrictions. Improvements in Subpart F would help us dramatically in that major market.

Mr. LUBY. The 10/50 provisions have hurt us enormously in various joint ventures. You have situations such as in Malaysia where they don't really want to hear about a partnership; they don't want to hear about "check the box;" they want their own kind of corporation. Therefore, we have to forego investments because of the return detriment. I used an example. We have had situations in the North Sea where we have actually had to pay our partner's share of the gross receipts tax in order to get them to agree to a partnership so that we could avoid the earnings hit of 10/50, and we have had situations in China where we have actually deferred investments because of this provision.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Thank you, Mr. Coyne. Mr. Watkins.

Mr. WATKINS. Thank you, Mr. Chairman. I am delighted you are having these oversight hearings on the international tax simplification.

I was in Congress for 14 years before being out about 6 years, and as I worked on a number of things—in fact, in the early 1980's, I put an international trade center in the State of Oklahoma, be-

cause I realized that we were not prepared, I think, in the global competitive world that we were going to be entering in. I was out about 6 years and decided I would try to come back for two reasons: No. 1, I felt like a balanced budget, that I had kind of been unfair to my children and grandchildren for not in those 14 years being able to achieve that, and the other reason was I wanted to try to do my darnest to prepare this country for a global competitive economy, a 21st century global competitive economy. You and I might be able to escape being personally involved as much as a lot, but the young people—our children and grandchildren—have no choice; they are thrust into that. And by a 21st century global competitive economy, I mean one that has got less taxation, a more simplified or fair way to work things through on taxation. No. 2, less regulation that we have to try to uncomplicate that situation as much as we can, and, third, less litigation. I just read something, Mr. Chairman, coming up here that in Japan, they have got about 16,000 lawyers and we have got over 900 and some odd thousand, nearly a million, and lots of times that is dealing with a lot of liability

But I guess what I am concerned about is—or I would say that I know the Chairman here and also our Ranking Members want to make sure we have a less complicated and more workable allowing us to be competitive overseas, and I kind of mentioned those three things, because I think that gives us, within that structure, we have got an overburden—what I call an overburden in the oil patch—an overburden of being able to do business overseas.

So, are you involved in pipeline construction, multinational pipeline construction, overseas, Mr. Luby, at your company?

Mr. LUBY. Yes, we are, and we are also users of pipelines owned by others, so that the change in the bill, for example, would, hopefully, either lower our investment costs or lower the costs of renting space in the pipeline.

Mr. WATKINS. I think that this question is asked kind of indirectly, but probably the three most general changes that we could look at, I mean, that would affect all businesses and industry, so to speak, allowing us to be more competitive in that global economy, what would your thoughts be? What three?

Mr. LUBY. I would substantially reform the Subpart F rules to a major extent. I believe that since pay-go became the watch word here that policy flew out the window and basically the foreign area didn't have a constituency, and, therefore, a lot of the pay-fors for domestic initiatives, be they child care credits or what—and I am not criticizing child care credit; I am just using that as an example—have been paid for out of our international rules with no policy justification. That is why we have 10/50; that is why we have the PFIC overlap; that is why we have 956A that you repealed in 1997 due to these gentlemen's efforts. So, that is one area that I think needs to really be reworked.

And the other area in international is the various foreign tax credit baskets. There is a chart right here; we have got nine of them. There is no reason on Earth that we need to have nine separate foreign tax credit baskets in order to determine whether we owe a residual U.S. tax on foreign source income. It is just non-

sense, and it wastes money on compliance. Those are the major things.

Mr. WATKINS. We appreciate those. Any quick thoughts you might have on—

Mr. EZRATI. Absolutely. The only thing I would add is that the adoption of the elective GAAP E&P would greatly simplify things, and removal of the 90-percent limitation on using the foreign tax credits to offset U.S. alternative minimum tax would remove all double taxation in that area.

Mr. WATKINS. I appreciate those comments on that, and, again, I want to thank the Chairman for having these, because we truly are in this global competitive world, and we have got to streamline some things, and I think it has got to begin with taxes and then regulatory policies we have and also the litigation situation we are confronted in trying to do that and conduct that business. So, Mr. Chairman, thank you so much.

Chairman HOUGHTON. Thanks, Mr. Watkins.

Mr. Levin.

Mr. LEVIN. Mr. Chairman, should I defer to Ms. Dunn, if she would like. I am not on the Subcommittee, so maybe I should—I don't want to be chivalrous but also abide by protocol.

Chairman HOUGHTON. Sure. Ms. Dunn has joined us. Would you like to inquire?

Ms DUNN. I simply want to thank you gentleman for coming over. I had lunch, Mr. Luby, with one of the folks who works for your company today at a speech that I gave, and, so greetings from her, and thank you for coming and testifying on something that is critically important as we look at the rules we set up to become more competitive through industry.

Chairman HOUGHTON. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman.

If I might just make a couple of comments, because this is really interesting testimony, and I believe it relates to my first comment. There is a lot of skepticism here on this level and the next level about simplification that it can ever occur. In this field, it does seem feasible. Some steps you can take, but further steps can be taken that are sound tax policy. They simply can be made much less complex.

Second, I would hope that you could help us inspire some discussion of this. I think the Chairman of the Full Committee is interested in international tax issues. I think that is true on both sides of the aisle. It is unclear what is going to be the life of the tax bill here, and I do think that we need to foster some further discussion to ensure that the international tax area is part of the next.

So, if you could continue to raise these issues. It is not easy, because these are detailed provisions, but you have been able to give a few concrete examples in response to Mr. Coyne's excellent questions as to what it would mean for your company within the parameters of sound tax policy, and, Mr. Chairman, I would guess you would share my sentiments that we need all the help we can get to try to boil these issues down so that they are understandable, and we avoid having people choose up sides as happens too much around here kind of an automatic or stereotypical basis. These provisions are good for basic economic operations in this

country, and therefore can have a positive impact on both business and workers, the business community and workers.

So, your testimony has been very salient, and I hope you will help us spread the word.

Mr. EZRATI. Absolutely.

Chairman HOUGHTON. Thank you, Mr. Levin.

We have been joined by Mr. Neal. Mr. Neal, would you like to—

Mr. NEAL. I don't have any questions.

Chairman HOUGHTON. No questions. OK, well, I have some questions. They are really sort of generic questions.

You know, Mr. Levin and I have got a bill out there, and I would really like you to sort of coalesce your ideas into what are the two or three things in that bill that really are going to help you. And then, also, secondly, where do we go from here? What other things—what more should we be doing? So, I throw those questions to both you gentleman for an answer.

Mr. EZRATI. I don't want to repeat myself too much, but here are three things: adoption of the GAAP E&P provisions, removal of the 90-percent limitation on the foreign tax credit for the alternative minimum tax, and go beyond studying to treat the European Union as a single country for purposes of Subpart F. Not just for my company, but I think for the majority of the 5,000 members of TEI and the 2,700 companies they represent, it will make a huge difference.

And let me echo Mr. Luby. If you want to know where to go from there, it's to those nine foreign tax credit baskets that we enacted in 1986 and that are the worst complexities we face today. Repeal those nine baskets, and the world would be a lot easier, and U.S. business would be more competitive.

Chairman HOUGHTON. Do you feel the same about the Far East as you do about the European Union?

Mr. EZRATI. I think it is a little more difficult in the Far East; it is not one economic trade block. I could see it actually happening in Latin America more quickly than in the Far East. As the Mercisol countries move together to form one trade block, we are finding that U.S. companies will be less competitive in Latin America, and so I could see the same thing happening there, especially after NAFTA where you removed those trade barriers, only to erect, as Mr. Levin said, tax barriers. It is going to be a little more difficult in Asia, because they haven't come together as one trade block. So, as I said, substantially reforming Subpart F will make things lots easier in China to do business there.

Chairman HOUGHTON. All right. Mr. Luby.

Mr. LUBY. In addition to the items I have already mentioned—which I won't bore you with going over again—I would mention that for our membership doing something again on active financing income would be very helpful, and I know that you have a witness in another panel that will address that much more eloquently than I ever could. Extending the foreign tax credit carryover provision would be of great assistance. Because of the mismatch between foreign law and U.S. law, we sometimes end up under the current system with credits expiring. That is not the purpose of the credit system. The purpose is to eliminate double taxation. And we appreciate your including a call for an interest allocation study. That is

definitely needed. Something needs to be done there. The way that works today, it rigs the system so that we are in effect double taxed. So, those would be the items that I would mention in addition to the earlier items in response to other questions.

Chairman HOUGHTON. OK, thanks very much.

We have been joined by Mr. Weller. Would you like to ask questions?

Mr. WELLER. Thank you, Mr. Chairman.

I guess as we look this year at what type of tax cut we are going to provide—and, of course, we have opportunity in this year's budget for almost a \$770 billion tax cut over 10 years—I am one of those who advocates that as we put together those tax provisions in this year's budget, we should focus on simplifying and bringing fairness to the code, and many in the business community have said,

Well, you know, when you have these temporary extenders that every year have to reauthorize, that is really an issue of fairness, because it is hard to make a decision on how to move forward.

And, of course, the Subpart F treatment of financial services with overseas income, I was wondering can you give some examples of whether or not it is fair to annually extend that provision for financial services?

Mr. LUBY. We don't have—my company, personally, doesn't have a problem in that area, because we are not in that particular business, but I would say that based on the way we do our corporate plans, we look beyond the next quarter, obviously; we look 3 to 5 years out in planning our business and in planning where we may want to budget our investments. If I have a provision that hurts me competitively, that is renewable annually, then that is going to definitely crimp my plans beyond that one-year outlook, and when I am looking at projects or investments that are very substantial in the context of what I have available—the shareholders' money at risk—it can cause me to make wrong or less than optimum decisions, so that is about as much detail as I could give you on that point.

Mr. WELLER. Mr. Ezrati.

Mr. EZRATI. We have looked at that financial services provision, and the company has thought about adjusting the way we finance products, and we do a lot of financing, though the provision does nothing for us at the moment, because it is so narrowly crafted and so complex. But we have asked, "Should we adjust the way we do business to take advantage of that provision? Will that make us more competitive in financing our products versus our competitors?" And you say, "But is it worth it? It will take us 6 months to gear up for it, and it is a year provision." Thus, I do think it is terribly unfair that those provisions are enacted year-by-year, and you need to guess whether they will be there next year. In fact, this provision itself, when it was originally enacted, was different from the one you extended last year. It is even more difficult when it is different each year.

Mr. WELLER. I am one who believes that we should, of course, make that provision permanent; same with the R&D tax credit or opportunity tax credit, because businesses are making decisions, having to invest large amounts of money, trying to make decisions,

and, of course, the consequence in not knowing if that provision in the tax code is going to be there long-term. If we are unable to make Subpart F permanent, what is the minimum number of years you feel is necessary, really, from a management standpoint when you are considering how to invest millions of dollars?

Mr. LUBY. In the context of our company, I would say a minimum of 3 years.

Mr. WELLER. A minimum of 3? Would you agree, Mr. Ezrati?

Mr. EZRATI. I think I would like to go even longer. You mentioned the research and experimentation tax credit, and I think that has never been longer than about 5 years. I now hear that 5 is now considered permanent, but that is what I would like to see, because that is the time horizon for making large investments. Three might work, but five would certainly be preferable.

Mr. WELLER. Mr. Chairman, I certainly believe from a fairness standpoint, if we are asking these employers to invest for the long-term, we should certainly ensure that the tax provision they are basing decisions on is for the long-term, as well, and that is why I hope we can work together not only for permanency but, at a minimum, for a long multiyear extension so they can make some long-term decisions.

Chairman HOUGHTON. I agree with you, Mr. Weller.

I have just one more question, The National Foreign Trade Council came out with a report on anti-deferral rules. Can you sort of spell out a few of those things—how they compare with other countries, and where we end up if we proceed with those rules?

Mr. LUBY. Well, an example is the one I used earlier in the testimony. The French exempt back these incomes from foreign taxation that comes from foreign sources, whereas, we do not. In many cases, active financing is a good example. That is active business income to our banking companies, and they have to pay current U.S. tax on that income. That puts them at a definite disadvantage vis-a-vis a French banking competitor, if they are looking at investments in Europe or elsewhere around the globe.

Other countries are very similarly situated. You hear about territorial versus our type of system, and you find that although very few have a territorial system, well, they really have a territorial system, but it is with a wink and a nod so that they can say that they followed our lead and have controlled foreign corporation rules. Great Britain has tightened their rules quite a bit, but they still allow a Bermuda headquartered company to put in low-taxed financing income and high-taxed other income and mix it all up, and guess what? You average it out, and there is no residual for you to pay for tax. We have a competitor—who I am sure you can guess—that is headquartered both there and in the Netherlands that happens to use that to their advantage when they are competing with us on projects.

So, our report shows that Subpart F needs to be reexamined; that it is a drag on the competitiveness of U.S. companies. We have now formulated recommendations that are coming out of that report, and we hope to release them in the very short term, and, as Les said a few minutes ago, echoing my earlier comment on the baskets, we have now begun the second phase of that project, which is a study of the foreign tax credit, and we will have rec-

ommendations come out of that, as well. So, we will, at least at the NFTC, heed Mr. Levin's suggestion and continue to bring attention to the area of international tax.

Chairman HOUGHTON. OK, well, thank you very much. We look forward to working with you, and, gentleman, I really appreciate your testimony. Thank you.

Mr. EZRATI. Thank you.

Chairman HOUGHTON. Now, I will call the panel composed of Mr. Cox, who is Vice President of Tax at BMC Software in Houston, Texas; Denise Strain, General Tax Counsel at Citicorp in New York; Thomas Jarrett, Director of Taxes at the Deere Company in Moline, Illinois; Gary McKenzie, Vice President of Tax for the Northrop Grumman Corporation in Los Angeles, California; and Stan Kelly, Vice President of Tax for Warner-Lambert in Morris Plains, New Jersey.

If you would come forward.

Mr. Cox, good to have you here. Would you proceed?

STATEMENT OF JOHN W. COX, VICE PRESIDENT OF TAX, BMC SOFTWARE, INC., HOUSTON, TEXAS

Mr. COX. Thank you, Mr. Chairman. Good afternoon. I am John Cox, vice president, Tax, for BMC Software. BMC is headquartered in Houston, Texas and is a worldwide developer and vendor of software solutions for automating application and database management across host-based and distributed systems environments. I thank the committee for giving me this opportunity to present my views on international tax simplification.

The U.S. software industry currently leads the international marketplace for developing new technologies used to create new products. This technology is the product of U.S.-based research and development which produces market leading patents and copyrights. The ability to efficiently use these intangible assets throughout the world is a key component in the operations of U.S. software businesses.

Currently, U.S. tax policy hinders U.S. competitiveness when compared with the tax regimes of other countries. Not only is our worldwide system of taxation more burdensome than systems of many of our trading partners, but also our incentives to encourage R&D in the United States are less beneficial than the incentives offered by many of our trading partners. In addition, U.S. rules for taxing foreign income are extraordinarily complex. As a result, an inordinate amount of resources are devoted to structuring transactions that will accomplish the business goals of U.S. companies without incurring a heavy tax burden. BMC applauds the efforts of Chairman Houghton and Congressman Levin to bring simplicity to the international tax rules of the Internal Revenue Code.

Although I favor many, if not most, of the proposals in H.R. 2018, my testimony today will highlight two provisions that I believe will particularly helpful to the software industry. In addition, my testimony will include two issues that are not addressed in the current legislation.

I support the bill's alternative minimum tax proposal. Under the current law, U.S. taxpayers subject to the AMT regime may claim a foreign tax credit against their alternative minimum tax only to

the extent of 90 percent of the actual tax paid or accrued in foreign countries. Thus, foreign tax credits can never entirely extinguish U.S. tax liability under the AMT regime.

This rule has been widely criticized on several grounds. First, foreign tax credit is not a tax preference but simply a means of reducing unfair and unavoidable double taxation that would otherwise fall on U.S. taxpayers earning income abroad. Second, the AMT limitation is fundamentally inconsistent with international tax treaty norms. U.S. treaty partners have frequently expressed dissatisfaction with this feature of U.S. law. Finally, the 90-percent limitation adds complexity to the AMT regime, which is notoriously complicated even without the provision.

I also support the effort to move towards treating the EU as one country for Subpart F purposes. Under current law, the member countries of the EU are treated as separate countries for purposes of the various "same-country exceptions" to Subpart F income. Treating the EU as a single country for these purposes would help U.S. corporations operating in the EU take full advantage in that market, and it would also help the U.S. corporations compete more effectively against EU corporations that are already able to enjoy the benefits of these initiatives.

I now turn to two international tax matters that are not covered by the bill but that deserve the Committee's attention. The first is the inconsistent characterization of cross-border transactions by the United States and its trading partners. For example, income from the sale of a disk containing a computer program might be treated as business profits by the United States but as a royalty by the customer's country of residence. Double taxation can therefore arise. These problems have in fact cropped up repeatedly in cross-border activities for software companies. Treaty mutual agreement procedures can be effective, but they are costly, time-consuming, and uncertain. We recognize that this problem is not resolvable by unilateral U.S. action; however, we do encourage Congress and the administration to pursue all available opportunities for resolving these issues, both treaty-by-treaty and multilaterally.

The last point I wish to discuss is the challenge to the Foreign Sales Corporation regime now pending before the World Trade Organization. The FSC rules are extremely important to U.S. software companies, which derive 30 percent of their revenue from exports, and the industry is grateful that Congress clarified this application of these rules to software licenses as part of the 1997 Tax Act. The FSC rules were enacted to offset a competitive disadvantage faced by U.S. exporters, because the U.S. tax system is not as generous to exports as are the tax systems of our trading partners. These concerns still exist today. As we await a final decision from the WTO panel on the FSC issue, I wanted to make you aware of the importance of this issue to the software industry.

In conclusion, Mr. Chairman, thank you again for this opportunity to present my views on these important issues. I am happy to answer any questions you might have.

[The prepared statement follows:]

**Statement of John W. Cox, Vice President of Tax, BMC Software, Inc.,
Houston, Texas**

INTRODUCTION

I am John W. Cox, Vice President of Tax for BMC Software, Inc. BMC, headquartered in Houston, is a worldwide developer and vendor of software solutions for automating application and data management across host-based and open system environments. The software industry is growing at an extremely rapid pace. Since 1994, software sales have been growing at a constant rate of 15.4% annually, which is three times the growth rate of the GDP. Much of the growth in the industry is due to expansion in overseas markets. BMC operates in approximately 30 different foreign markets. Our fiscal year 1999 revenue was \$1.3 billion, of which approximately 40% is from foreign sales.

The U.S. software industry currently leads the international marketplace in developing new technologies used to create new products. This technology is the product of U.S.-based research and development, which produces market leading patents and copyrights. The ability to efficiently use these intangible assets throughout the world is a key component in the operations of a U.S. software business.

In recent years the Congress and the Administration have made noteworthy improvements in the international tax rules affecting software companies. First, in 1997 Congress passed legislation clarifying that software exports qualify for FSC benefits. Then in 1998 the Treasury finalized regulations providing clear guidance on the proper characterization of software revenue that is generally consistent with industry business practice and will help reduce the potential for burdensome taxation by our trading partners. We thank you for these improvements. However, current U.S. tax policy still hinders U.S. competitiveness, when compared with the tax regimes of other countries. Not only is our worldwide system of taxation more burdensome than the systems of many of our trading partners, but also our incentives to encourage R&D in the United States are less beneficial than the incentives offered by many of our trading partners.

In addition, U.S. rules for taxing foreign income are extraordinarily complex. As a result, an inordinate amount of resources are devoted to structuring transactions that will accomplish the business goal of U.S. companies, without incurring a heavy tax burden. BMC applauds the efforts of Chairman Houghton and Congressman Levin to bring simplicity to the international tax rules in the Internal Revenue Code. My testimony today will highlight provisions in H.R. 2018, the "International Tax Simplification for American Competitiveness Act of 1999," that we believe will be particularly helpful to the software industry. In addition, my testimony will include two issues that are not addressed in the legislation—(1) inconsistent characterization of income by the United States and other countries, and (2) the WTO controversy between the United States and the EU over the U.S. foreign sales corporation (FSC) rules.

PROVISIONS IN H.R. 2018

A. AMT Foreign Tax Credit Rules

Under current law, taxpayers are required to pay an income tax that is the greater of their tax computed under the normal rules of the Internal Revenue Code (the "Code") or the special "alternative minimum tax" ("AMT") rules. The AMT regime is intended to ensure that high-income taxpayers making extensive use of so-called "tax preference items" pay at least a minimum level of tax. The recapture of the tax benefit afforded by the tax preference items is generally achieved by adding back to income the "excessive" portion of the deduction or exclusion granted by the preference.

The AMT regime also limits the ability of AMT taxpayers to use otherwise allowable credits against their overall U.S. tax liability. In the case of the credit allowed for income taxes paid to foreign governments (the foreign tax credit or "FTC"), the regime essentially limits the credit to 90% of the U.S. tax owed. This rule ensures that FTCs can never entirely extinguish U.S. tax liability under the AMT regime.

This rule has been widely criticized on several grounds. First, the FTC is unlike most other credits, which are essentially intended to act as incentives to modify taxpayer behavior (such as the low-income housing credit or the alcohol fuels credit). The FTC is remedial in nature in that it seeks to avoid double taxation of income. Far from being a tax preference intended to reward taxpayers that take certain affirmative action, the FTC alleviates the unfair and unavoidable double taxation that would otherwise fall on U.S. taxpayers earning income abroad. It is illogical to treat this relief provision as a "tax preference" subject to overuse or abuse.

Second, the AMT limitation is fundamentally inconsistent with international tax treaty norms. Relief from double taxation is the primary purpose of income tax treaties, and the credit provision is widely recognized as an acceptable method of complying with the treaty obligation. The majority of the over 1200 bilateral income tax treaties in force throughout the world provides for double taxation relief through a credit mechanism.

Limiting the FTC to 90% of the U.S. tax due prevents tax treaties from achieving their full objective of eliminating double taxation. While most U.S. treaties are drafted in a way that prevents the limitation from technically violating the treaty, U.S. treaty partners have frequently expressed dissatisfaction with this feature of U.S. law, which contravenes internationally accepted principles.

Finally, the FTC limitation adds complexity to the AMT regime, which is notoriously complicated even without the provision. Because the FTC is applied separately with respect to separate categories or "baskets" of income, the AMT limitation is not a single computation, but requires a series of computations that must be undertaken in addition to the normal FTC calculations.

Section 207 of the Bill would repeal the FTC limitation now found in the AMT provisions. For all of the reasons detailed above, we endorse this proposal.

B. Treatment of the European Union

The controlled foreign corporation ("CFC") provisions of the Code impose current U.S. taxation on the U.S. shareholders of foreign corporations that they control. This taxation is limited to so-called "subpart F income" earned by the CFC. Among the various categories of subpart F income is passive income such as dividends, interest, rents, and royalties. The policy underlying the current taxation of such income is that it is inherently mobile, so that a worldwide group of corporations can route the income to a low-tax jurisdiction and avoid both U.S. and foreign taxes. Similarly, income from sales, services, and insurance outside the CFC's country of incorporation is subpart F income if related party transactions are involved, on the theory that taxpayers could transfer profits from these activities to a low-tax jurisdiction.

The Code provides an exception for certain dividends, interest, rents, and royalties paid to a CFC by a related party located in the same country as the CFC's country of organization. Subpart F income also does not include sales, services, and insurance income earned in that country. The policy underlying these exceptions is that transactions occurring in the same country will rarely, if ever, result in inappropriate avoidance of local tax, and taxpayers should therefore be free to adopt in each country corporate structures and business operations that are not artificially affected by tax considerations.

Under current law, the member countries of the European Union ("EU") are treated as separate countries for purposes of the "same country" exception. Thus, payments of dividends, interest, and similar amounts from an entity organized in one EU country to a related entity in a different EU country are treated for U.S. tax purposes as subpart F income. Sales, service, and insurance income earned in another EU country may also be subpart F income.

Section 102 of the Bill would direct the Treasury Department to study the feasibility of treating the EU as a single country for purposes of the same-country exception. Under this approach, sales, service, and insurance income earned anywhere within the EU by an EU country entity, as well as passive income received from an EU affiliate by a controlled foreign corporation in an EU member state would not generally be treated as subpart F income.

We fully support the effort to move towards treating the EU as one country for subpart F purposes. This approach would help U.S. corporations operating in the EU take full advantage of the EU initiatives to create a single market with the free flow of goods, services, labor, and capital across national borders. It would also help U.S. corporations compete more effectively against EU corporations that are, by virtue of their countries of residence, already able to enjoy the benefit of these initiatives.

We understand that the Bill proposes only a study of the issue because of concerns that the EU member countries have different tax systems and rates. While we do not oppose a Treasury study, we submit that Congress should consider more immediate and direct action. The possibility of applying same-country status to the EU has been under consideration by Congress for several years.¹ We question

¹See section 601 of H.R. 5270, the Foreign Income Tax Rationalization and Simplification Act of 1992 (introduced on May 27, 1992) 102nd Cong., 2nd Sess.; H.R. 1401 (introduced on March 18, 1993), 103rd Cong., 1st Sess.; section 8 of H.R. 1690, the International Tax Simplification and Reform Act of 1995 (introduced on May 24, 1995), 104th Cong., 1st Sess.; section 206 of

whether a Treasury study, which would further delay direct Congressional consideration of this important issue, would shed a great deal of additional light on the area, particularly as the EU countries continue to move toward integrating their tax systems.

C. Expansion of subpart F de minimis rule

Under current law, a *de minimis rule* excludes all gross income of a CFC from subpart F income if what would otherwise be the CFC's gross subpart F income² is less than the lesser of (1) 5% of the CFC's gross income or (2) \$1 million. Thus, the maximum exclusion per CFC is \$1 million, which will be available only if the CFC's gross income equals or exceeds \$20 million.

The exclusion is an acknowledgement that it is difficult for corporations to avoid earning some subpart F income—interest on bank deposits, gain on the sale of unproductive assets, small royalties, and similar items. If the bulk of the CFC's income is active, however, it is administratively burdensome to keep track of relatively minor amounts of subpart F income, and there is little revenue to be gained by attempting to tax such income currently.

The Code has contained the *de minimis* rule in its current form since 1986. Before that year, the exclusion was available if 10% or less of the CFC's gross income would otherwise be subpart F income, with no dollar limitation. Section 103 of the Bill would return to this 10% limitation and increase the dollar threshold to \$2 million.

We support this proposal. The return to the percentage threshold under pre-1986 law leads to increased administrative convenience and efficiency at a low revenue cost. The increase in the dollar threshold is an appropriate adjustment to reflect inflation, and CFCs with at least 90% active income should not be burdened with the need to keep careful track of small amounts of other income.

D. Extension of foreign tax credit carryforward

Under current law, unused foreign tax credits may be carried back to the two previous taxable years and forward for five taxable years. If not usable within that time period, they expire, and the foreign taxes become a simple cost of doing business. These unused taxes may not be deducted for Federal income tax purposes, because they relate to a year in which the taxpayer elected credit treatment.

Expiring credits are a problem for many companies in our industry. Although it is often possible to control the timing and amount of foreign taxes to some extent, thereby maximizing the ability of the U.S. taxpayer to benefit from the credit, five years may not be enough time in all cases to fully enjoy this benefit. The result is that the U.S. taxpayer's overall costs rise, and its ability to compete globally decreases, even in cases where, taking a longer view, the overall worldwide tax rate is no higher than the U.S. rate.

From the taxpayer's point of view, an unlimited carryover of unused credits would of course be ideal. We recognize, however, that from the government's point of view an unlimited credit might pose an administrative and recordkeeping problem. Section 201 of the Bill would extend the current carryforward period to ten years. We believe that this period represents a reasonable—and more realistic—compromise that accommodates the concerns of both taxpayers and the government.

E. Recharacterization of overall domestic loss

U.S. taxpayers with foreign branch operations may deduct losses generated by the branch against U.S. source income in the same taxable year. This deduction reduces U.S. source income subject to U.S. tax. When in a subsequent year the branch generates income subject to foreign tax, the taxpayer may be able to claim a foreign tax credit to offset the U.S. tax on the income. This arguably creates a "double benefit" for the taxpayer arising solely from the timing of foreign income and loss.

In 1976, Congress enacted an overall foreign loss ("OFL") recapture rule to prevent this result. The Code provides that a taxpayer must create a special OFL account whenever a foreign source loss reduces U.S. source income. If positive foreign source income is generated in a later year, the income is re-sourced to the United States, effectively preventing foreign taxes on that income from being credited against the U.S. tax due.

S. 2086, the International Tax Simplification for American Competitiveness Act (introduced on September 17, 1996), 104th Cong., 2nd Sess.

²Technically, the test applies to the sum of gross foreign-based company income and gross insurance income, but for most CFCs these are the only categories of subpart F income that commonly arise.

In the reciprocal situation, however, where timing rules could operate to the taxpayer's detriment, there is no corresponding recapture rule. For example, if a taxpayer has a U.S. source loss that offsets foreign source income in the same year, the taxpayer's available foreign tax credit may be reduced because the foreign tax credit limitation is computed on the basis of net foreign source income. In a later year, U.S. source income is not re-sourced to foreign, so that the available foreign tax credit in that year is not increased.

This lack of parallelism has often been criticized as illogical, because it corrects the mismatch when favorable to the government but not when favorable to the taxpayer.³ In addition, taxpayers lose the value of their foreign tax credits as an offset against double taxation of income at a time when they are already losing money in the United States. Section 202 of the Bill would remedy this defect and provide for equitable treatment of taxpayers by applying the same rules to both foreign and domestic losses. We support this provision as a way of adding fairness and neutrality to the international provisions of the Code.

F. Ordering rules for FTC carryovers

Under current law, a taxpayer with FTC carryovers in a taxable year must first claim credits for taxes paid or accrued in that year before crediting taxes carried over from other periods. This rule suffers from the same problems as the five-year carryforward provision discussed above. The ability of taxpayers to obtain credit for taxes paid in prior years is circumscribed.

Section 206 of the Bill would reverse this rule, and give credit for taxes carried over from prior years before current year taxes were credited. The current year taxes would themselves be eligible for carryover if the taxpayer remained with excess credits after the credit computation.

We support this change. Like the extension of the carryover from five years to ten, it will smooth out year-to-year fluctuations in levels of foreign income and taxes and allow a more efficient operation of the foreign tax credit regime.

G. Application of UNICAP rules to foreign persons

The uniform capitalization ("UNICAP") rules of the Code generally require taxpayers to capitalize both direct costs and a properly allocable portion of indirect costs attributable to property produced or acquired for resale. These rules require a detailed allocation of costs to various activities and then to the products themselves. Almost 100 pages of regulations prescribe the specific accounting procedures and computations that must be made.

The UNICAP rules are not currently limited to U.S. persons. Foreign taxpayers are also subject to the rules to the extent that their income, deductions, credits, and other tax attributes are relevant to U.S. tax. For example, a CFC must use the UNICAP rules in computing its earnings and profits for purposes of determining the subpart F inclusions of its U.S. shareholders.

The application of UNICAP to foreign taxpayers is a substantial increase in complexity and administrative burden. These rules apply only for U.S. tax purposes, and a foreign corporation with no U.S. connection other than its owners would ordinarily not have to make the detailed allocations called for by the rules. Full compliance with these rules is costly for taxpayers, and often makes no revenue difference because there is usually a cushion of undistributed and untaxed CFC earnings to absorb any adjustments attributable to UNICAP allocations.

Section 302 of the Bill would provide that the UNICAP rules would apply to foreign persons only for purposes of computing the tax on income effectively connected with the conduct of a U.S. trade or business. We endorse this proposal, which will significantly simplify tax compliance for U.S. taxpayers with foreign subsidiaries. The proposal is also sound on tax policy grounds. Activities to which the rules apply are typically those of an active business, which when conducted by a CFC outside the United States are not normally subject to current U.S. tax.

INCONSISTENT CHARACTERIZATION OF INCOME FROM CROSS-BORDER TRANSACTIONS

In connection with the Committee's consideration of international tax rules, we wish to draw attention to a significant problem that is not addressed by the Bill but that has cost our industry needless time and money—and may ultimately reduce tax revenue to the U.S. Treasury. This problem is the characterization of in-

³See, for example, Isenbergh, *International Taxation: U.S. Taxation of Foreign Taxpayers and Foreign Income* (1990), at ¶21.3.3, which notes that the subsequent U.S. source income "will effectively be overtaxed."

come for a foreign country's tax purposes in a way that is inconsistent with the U.S. tax characterization of the same income.

For example, assume that a U.S. taxpayer sells a disk containing a copyrighted computer program to a foreign buyer. Under the U.S. regulations governing transactions in computer software, this transaction is characterized as the sale of a copyrighted article. Under U.S. income tax treaties, sales income is taxable under the Business Profits article. Under this interpretation, if the U.S. taxpayer does not have a permanent establishment in the country of sale, the foreign country is prohibited from imposing tax.

However, the foreign tax authorities may not agree that the transaction gives rise to business profits. Because the transaction involves copyrighted software, the payment may be viewed as a royalty, which the source country may be permitted to tax (usually at reduced rates) under the treaty. This tax may not be creditable against U.S. tax because the U.S. does not view the foreign country as having tax jurisdiction over the payment.

These problems have arisen repeatedly in the cross-border activities of software companies. Some of these companies have sought relief under the mutual agreement procedures available under tax treaties. While these avenues can be effective, they are costly, time-consuming, and uncertain. Furthermore, the problem is a recurring one, and taxpayers would prefer not to resort to the mutual agreement procedure on a regular basis.

We recognize that this problem is not resolvable by unilateral U.S. action, short of deferring in all cases to another country's characterization of income—a step that the government is understandably unwilling to take. However, we encourage the Congress and the Administration to pursue all available opportunities for resolving these issues on a bilateral or multilateral basis.

Bilaterally, the tax treaty process—in which the Senate plays a significant role—can be used to forge country-by-country agreements on specific points that have arisen with particular countries. Multilaterally, work with international organizations such as the Organizations for Economic Cooperation and Development can often lead to fruitful common understandings in key areas of international taxation. Congress should support the participation of the United States in these efforts, and be willing to participate fully in implementing points on which agreement is reached.

FOREIGN SALES CORPORATION RULES

The U.S. Foreign Sales Corporation (FSC) rules have recently been challenged by the E.U. and a decision with respect to the legality of the FSC under multilateral trade agreements is currently pending before a WTO panel. The FSC rules are extremely important to the U.S. software industry, which derive 30% of their revenue from exports, and the industry is grateful that Congress clarified the application of these rules to software licenses as part of the 1997 Tax Act. The current FSC rules, and the DISC rules that they replaced, were enacted to offset a competitive disadvantage faced by U.S. exporters because the U.S. tax system is not as generous to exports as are the tax systems of our trading partners. These concerns still exist today. As we await a final decision from the WTO panel on the FSC issue, I wanted to make you aware of the importance of this issue to the software industry.

CONCLUSION

We appreciate the opportunity to present our views on international tax simplification. We appreciate the Chairman's efforts to provide some much-needed simplification to this highly complicated area of the law. In addition, we look forward to continued Congressional attention to U.S. tax rules that hinder competition. In particular, we need a permanent R&D credit that compares favorably to the incentives offered by other countries. We also need to assure that the United States does not impose higher levels of tax on exports than do our trading partners. Finally, U.S. tax rules should not hinder efficient utilization of technology around the world. We look forward to working with the Subcommittee on these important issues.

Chairman HOUGHTON. Ms. Strain, please.

**STATEMENT OF DENISE STRAIN, GENERAL TAX COUNSEL,
CITICORP, CITIGROUP, NEW YORK, NEW YORK**

Ms. STRAIN. My name is Denise Strain, and I am the general tax counsel for Citicorp, a wholly-owned subsidiary of Citigroup. I want to thank the Chairman and the Subcommittee Members for their invitation to testify today on the topic of international tax simplification and for the Chairman's leadership in this area.

Over the last several years, the Houghton-Levin legislation has provided an approach for Congress to simplify and rationalize the U.S. tax rules that apply to the global operations of U.S.-based, multinational companies. The U.S. international tax rules are important to Citigroup because of the global reach of the company. Citigroup is a diversified financial services company which offers banking, insurance, credit cards, asset management, and investment banking to our customers throughout the world. Citigroup has 170,000 employees located in 100 countries, including 112,000 employees in the United States. This global business requires us to prepare a complicated and time-consuming tax return.

To give you some idea of the compliance burden these rules impose on Citigroup, let me describe our tax filings. In September of 1999, Citigroup will file its 1998 tax return. It will exceed 30,000 pages in length, including computations for more than 2,000 companies located in 50 States and 100 countries. More than 200 tax professionals, both here and overseas, will be involved in this process. To say the least, it is a formidable task.

My company understands first-hand that the global economy has become increasingly integrated; financial transactions have become more complex; financial decisions are made more quickly, and the tax implications, both here in the United States and in foreign jurisdictions, have become more difficult to resolve. It is not an easy task to structure a tax system that addresses both the evolving world of financial globalization in a manner that is fair and neutral while maintaining competitiveness for U.S. businesses.

H.R. 2018, the legislation introduced earlier this month by Chairman Houghton and Congressman Levin, will go a long way toward simplifying our rules and encouraging competitiveness. I would like to highlight a couple of proposals in the bill. First, the proposal to make permanent, or at least extend, the deferral from Subpart F income for the active income of financial services companies is of critical importance to the U.S. financial services industry and is one of the key provisions in your bill. The provisions that permit the active business income of U.S. banks, securities firms, insurance companies, finance companies, and other financial services firms to be subject to U.S. tax only when that income is distributed back to the United States will expire at the end of this year. Active financial services income is universally recognized as active trade or business income. Thus, if the current law provisions were permitted to expire at the end of this year, U.S. financial services companies would find themselves at a significant competitive disadvantage vis-a-vis their major foreign competitors.

Not only should the current rules be extended, but we hope very much that Congress will refrain from making another round of major changes to these rules. In order to comply with the deferral rules, over the past 2 years, U.S. companies have implemented nu-

merous systems changes to accurately follow two very different versions of the active financing law. Further changes at this time would create excruciating complexity and compliance burdens with no commensurate benefits to the U.S. Treasury.

Another proposal in your bill would greatly simplify the foreign tax credit rules. As a regulated industry in many countries, U.S.-based financial services companies operating outside the United States are often required by local laws to operate in joint ventures with local banks and other financial services companies. For this reason, it is so important for my industry that the tax rules be simplified for income from foreign joint ventures and other business operations in which U.S. companies own at least 10 percent but not more than 50 percent of the stock in a foreign company. The so-called "10/50" foreign tax credit limitation is bad tax policy and increases the cost of doing business for U.S. companies operating abroad.

The 1997 Tax Relief Act sought to correct these problems by eliminating separate foreign tax credit baskets for 10/50 companies. However, this important change will not take effect until after 2002, and it is accomplished in a rather complicated manner. Your bill, Mr. Chairman, will fix this problem. The proposal, which is also included in President Clinton's fiscal year 2000 budget, would accelerate from 2003 to 2000 the repeal of the separate foreign tax credit basket for such "10/50 companies," and would make this change for all dividends received in tax years after 1999.

My written testimony, submitted for the hearing record, details a number of other important proposals included in H.R. 2018 that we support and we believe will go a long way toward making our international tax regime less complex and more rational.

On behalf of Citigroup, I want to thank you, Mr. Chairman, and the members of the Ways and Means Committee for your interest in international tax simplification. As a representative of a U.S.-based financial services company with operations throughout the world, I believe your efforts to simplify and rationalize the U.S. international tax rules are vitally important.

Thank you.

[The prepared statement follows:]

Statement of Denise Strain, General Tax Counsel, Citicorp, Citigroup, New York, New York

INTRODUCTION

My name is Denise Strain, and I am the General Tax Counsel for Citicorp, a wholly-owned subsidiary of Citigroup. Citigroup, the product of last year's merger of Citicorp and the Travelers Group, is a diversified financial services holding company whose businesses provide a broad range of financial services to consumers and corporate customers around the world.

On behalf of Citigroup, I want to thank the Chairman and the Subcommittee for their invitation to testify today on the topic of international tax simplification. I also want to express my appreciation, and the appreciation of Citigroup, to Chairman Houghton, Chairman Archer, Congressman Levin, and other members of the House Ways and Means Committee for your efforts in this area. Over the last several years, the Houghton-Levin legislation has provided a road map for Congress in seeking to simplify and rationalize the U.S. tax rules that apply to the global operations of U.S.-based multinational companies.

Citigroup understands first hand that as the global economy has become increasingly more integrated, financial transactions have become more complex, financial decisions are being made more quickly, and the tax implications both here in the

United States and in foreign jurisdictions have become more difficult to resolve. It is not an easy task to structure a tax system that addresses this evolving world of financial globalization in a manner that is fair and neutral while maintaining the competitiveness of U.S. business. The simple fact that you are conducting this hearing today sends a strong signal that we are making progress. The legislation introduced earlier this month by Chairman Houghton and Congressman Levin, which is aimed at further simplifying key aspects of the U.S. international tax rules, includes a number of important proposals. If enacted, these proposals will go a long way towards achieving a simpler and fairer tax regime for U.S. companies operating overseas.

Mr. Chairman, in my testimony today, I would like to discuss why we believe the goal of maintaining a tax system that keeps pace with global competition and economic integration is important. Specifically, I will discuss a number of provisions in H.R. 2018, the International Tax Simplification for American Competitiveness Act of 1999, that are of significance to the financial services industry, including Citigroup.

THE IMPORTANCE OF INTERNATIONAL TAX RULES TO CITIGROUP

To understand why U.S. international tax rules are so important to Citigroup, I think it will be helpful to the Committee if I explain a little bit about my company. As I mentioned in my introduction, Citigroup is a diverse company. We offer our customers a broad range of financial services, including banking, insurance, credit cards, asset management, securities brokerage, and investment banking. The principal subsidiaries of Citigroup include Citibank, Travelers Insurance, Salomon Smith Barney, and Commercial Credit. Citigroup has 170,900 employees located in 100 countries, including 111,640 employees in the United States.

Historically, U.S. financial services companies expanded abroad to support the global expansion of U.S. commercial businesses. As companies such as Caterpillar, General Motors, Exxon, and IBM have become global powerhouses and household names outside the United States, Citicorp and Citigroup have been there to provide capital for their expansions, and to provide banking and other investment services and advice to their employees. This is still the case as a new generation of American companies, including Microsoft, Intel, and Hewlett-Packard, have launched and expanded their foreign operations.

Unfortunately, U.S.-based multinational financial services companies could soon become an endangered species. Most of the world's large financial services players are foreign-based companies. Only three U.S.-based companies—Citigroup, BankAmerica, and Chase—are among the top 25 financial services companies in the world, as measured by asset size. Citigroup's foreign-based competitors are competing with us not only on foreign soil, but also on U.S. soil. These include such companies as Deutsche Bank, which recently completed its acquisition of Bankers Trust, and HSBC Holding, which is in the process of acquiring Republic Bank. Our foreign-based competitors in insurance are also increasingly making inroads into U.S. markets. For example, just recently, German-based Allianz AG acquired Fireman's Fund Insurance and the acquisition of Transamerica Corp. by Dutch-based insurance company Aegon NV is currently pending.

It is no coincidence that, for the most part, the home-country tax systems of these companies are simpler and more neutral when it comes to taxing home-country and international investment than the U.S. system, according to a National Foreign Trade Council (NFTC) study of foreign tax regimes and subpart F released earlier this year.

This level of increased competition from non-U.S.-based financial services entities results from the fact that national economies are becoming increasingly global. Globalization is being fueled by rapid technological changes and a worldwide reduction in tax and regulatory barriers to the free international flow of goods and capital. These changes are all for the good. However, these changes are also putting tremendous pressure on our tax rules, which have become increasingly antiquated over the last 30 years.

We can not afford a tax system that fails to keep pace with fundamental changes in the global economy, or that creates barriers that place U.S. financial services companies, as well as other U.S.-based multinationals, at a competitive disadvantage. Some have questioned whether the globalization of U.S.-based companies does much for U.S. economic growth and employment. In my company, the answer is easy. As Citigroup has grown internationally, our domestic support for those international activities has grown accordingly. For example, Citibank's U.S.-based credit card manufacturing and processing facilities produce credit card statements, inserts, and actual credit cards for Citibank customers in Europe, Latin America, and the

Caribbean. Other Citigroup service centers in the United States process all the bills and payments for outside vendors the corporation utilizes around the globe, along with employee expense reports and reimbursements. We've found that consolidating many of these back-office functions in the United States achieves a maximum level of efficiency, just as the centralization of credit card manufacturing and processing takes advantage of economies of scale and R&E performed in this country.

U.S. trade policy has clearly recognized that breaking down barriers to international trade is a key factor in spurring U.S. economic growth and jobs, and this committee has played a leading role in that regard. It is ironic, therefore, that our international tax policy at times seems to go in a different direction. For example, we continue to face double taxation because our foreign tax credit rules are antiquated. In addition, the question still remains among some whether the active income of financial services companies should continue to be subject to the anti-deferral regime of subpart F. These two factors—the incidence of double taxation and the premature imposition of U.S. tax on our foreign earnings—together hinder our ability to compete against foreign-based companies that face less hostile home-country tax regimes, according to the NFTC international tax study.

THE COMPLEXITIES IN OUR SYSTEM

Moreover, our international tax regime imposes layer upon layer of needless complexity, creating an environment where taxpayers and the IRS are in a constant tug-of-war over rules that were not designed to apply in the context of many modern cross-border financial transactions.

From the standpoint of one of the largest financial services companies in the world based in the United States, we see the evidence of this first hand, every day. The labyrinth of rules and regulations we face are almost beyond comprehension. More often than not, applying these rules to increasingly complex transactions produces more questions than answers.

To give just one example of the complexities we face, at a time when American corporations are trying to concentrate on competitiveness and pare down non-essential costs, determining the earnings and profits of our foreign subsidiaries for subpart F purposes requires our staff to go through a five-step procedure. This process starts with the local books of account and then continues with a series of complicated accounting and tax adjustments. On audit, each of these steps must be explained and justified to IRS agents. Yet, equally reliable figures could be provided, at a fraction of the time and cost, by simply using GAAP to determine earnings and profits. I am glad to say that H.R. 2018 includes just such a rule, and we would recommend that this GAAP provision be extended to apply to calculations of earnings and profits of all foreign corporations for all purposes.

More generally, one of the biggest problems we face involves the coordination of U.S. rules with those of the countries in which we do business. It is a fact of life for Citigroup that our U.S. tax filing deadlines and requirements generally bear no relationship to those of other countries. This means that we generally do not have all the foreign information we need when our U.S. tax return is due, so our return contains tentative information, and we are forced to adjust our returns during the IRS audit process.

Mr. Chairman, I ask you to think about this: when you and I and tens of millions of other Americans finish our individual tax returns by April 15 every year, we breathe a long sigh of relief that an annoying, stressful, and time consuming process has been completed—until next year. For Citigroup, however, this task of filing our annual tax return is an ongoing process that often takes years to complete. This situation is ameliorated somewhat by a network of bilateral tax treaties intended to limit double taxation and coordinate information and other requirements between two countries' tax regimes. However, this network does not extend to many countries in which Citigroup does business, including such emerging market countries as Brazil and Argentina.

To give you some idea of the scope of the compliance burden for Citigroup, let me describe our tax filings. In September, Citigroup will file its 1998 tax return. It will exceed 30,000 pages in length, including computations for more than 2,000 companies located in 50 states and 100 countries. More than 200 tax professionals, both here and overseas, will be involved in this process. The end of this process is the examination of this return by IRS auditors, generally years from now. To say the least, it's a formidable process.

TAX SIMPLIFICATION PROPOSALS

Mr. Chairman, we do believe that enactment of a modest number of changes to the current system will go a long way to help simplify some rules that are unneces-

sarily complex and time consuming to deal with. Moreover, I believe these changes will help us be more competitive.

Active Financing Exception to Subpart F

The rules that permit the active business income of U.S. banks, securities firms, insurance companies, finance companies and other financial services firms to be subject to U.S. tax only when that income is distributed back to the United States, expire at the end of this year. The proposal to make permanent or, at the very least extend, the exception to the anti-deferral regime of subpart F for the active income of financial services companies is of crucial importance to the U.S. financial services industry and is one of the key provisions in your bill.

By way of background, when subpart F was first enacted in 1962, the basic intent was to require current U.S. taxation of foreign income of U.S. multinational corporations that was passive in nature. The 1962 law was careful not to subject active financial services business income to current taxation, through a series of detailed carve-outs. In particular, dividends, interest and certain gains derived in the active conduct of a banking, financing, or similar business, or derived by an insurance company on investments of unearned premiums or certain reserves received from unrelated persons, were specifically excluded from current taxation. In 1986, however, the provisions that were put in place to ensure that a controlled foreign corporation's active financial services business income would not be subject to current tax were repealed in response to concerns about the potential for taxpayers to route passive or mobile income through tax havens.

In 1997, the 1986 rules were revisited for several reasons. A key reason was the fact that many U.S. financial services companies found that the existing rules imposed a competitive barrier in comparison to home-country rules of many foreign-based financial services companies. Moreover, the logic of the subpart F regime made no sense, given that most other U.S. businesses were not subject to similar subpart F restrictions on their active trade or business income. The 1997 Tax Act created an exception to the subpart F rules for the active income of U.S.-based financial services companies, along with rules to address concerns that the provision would be available to shelter passive operations from U.S. tax. At the time, the exception was included for only one year primarily for revenue reasons, as you yourself pointed out, Mr. Chairman, in remarks in support of the provision made on the House floor.

The active financing income provision was reconsidered again in 1998, in the context of extending the provision for the 1999 tax year, and considerable changes were made in response to Congressional and Administration concerns.

Active financial services income is generally recognized as active trade or business income. Thus, if the current-law provision were permitted to expire at the end of this year, U.S. financial services companies would find themselves at a significant competitive disadvantage vis-a-vis major foreign competitors when operating outside the United States. In addition, because the U.S. active financing exception is currently temporary, it denies U.S. companies the certainty their foreign competitors have. The need for certainty in this area cannot be overstated. U.S. companies need to know the tax consequences of their business operations, which are generally evaluated on a multi-year basis.

Not only should the current rules be extended, but we hope very much that Congress will refrain from making another round of major changes to these rules. In order to comply with the deferral rules, over the last two years U.S. companies have implemented numerous system changes to accurately follow two significantly different versions of the active financing law. While some in government have indicated problems still exist, we all need to remember that many U.S. companies, including Citigroup, have yet to file their first U.S. tax returns incorporating the 1997 Tax Act rules in this area. It will be another 15 months before tax returns are filed incorporating the rules that were enacted last year to apply to the 1999 tax year. Further changes at this time would create excruciating complexity and compliance burdens with no commensurate benefits for the U.S. Treasury.

Despite any real evidence that the current rules are not working, I understand that the Treasury Department has suggested that Congress hold off extending the active financing exception until Congress has had the time to review the Treasury's suggestions. However, the international growth of American finance and credit companies, banks, securities firms, and insurance companies would be impaired by an "on-again, off-again" system of annual extensions that does not allow for certainty. Failing to extend the active financing exception this year would be the antithesis of tax simplification. In contrast, making this provision a permanent part of the law, or at least extending the provision, would greatly simplify U.S. international tax rules and enhance the global position of the U.S. financial services industry.

The 10/50 Foreign Tax Credit Basket

As a regulated industry in many countries, U.S.-based financial services companies operating outside the United States are often required by local laws to operate in joint ventures with local banks and other financial services companies. That is why it is so important for my industry that the tax rules be simplified for income from foreign joint ventures and other business operations in which U.S. companies own at least 10 percent but not more than 50 percent of the stock in the foreign company.

In particular, the so-called 10/50 foreign tax credit rules impose a separate foreign tax credit limitation for each corporate joint venture in which a U.S. company owns at least 10 percent but not more than 50 percent of the stock of the foreign entity. The 10/50 regime is bad tax policy. The current rules increase the cost of doing business for U.S. companies operating abroad by singling out income earned through a specific type of corporate business form for separate foreign tax credit "basket" treatment. Moreover, the current rules impose an unreasonable level of complexity, especially for companies with many foreign corporate joint ventures.

The 1997 Tax Relief Act sought to correct these problems by eliminating separate foreign tax credit baskets for 10/50 companies. However, this important change will not take effect until after 2002, and it is accomplished in a rather complicated manner. Under the new rules, dividends from earnings accumulated after 2002 will get so-called look-through treatment, effectively repealing the 10/50 rules, while dividends from pre-2003 earnings will all be part of a single "super" 10/50 foreign tax credit basket.

Your bill, Mr. Chairman, would fix this problem. The proposal, which is also included in President Clinton's FY 2000 budget, would accelerate from 2003 to 2000 the repeal of the separate foreign tax credit basket for such "10/50 companies." In doing so, so-called look-through treatment would apply in order to categorize income from all such ventures according to the type of earnings from which the dividends are paid. The proposal would apply the look-through rules to all dividends received in tax years after 1999, regardless of when the earnings constituting the makeup of the dividend were accumulated.

We very much support this approach and hope it can be enacted this year. In particular, the requirement of current law that we use two sets of rules on dividends beginning with the year 2003 has been a concern of taxpayers, members of Congress, and the Administration. That is why it is so important that the effective date of the 1997 Tax Act changes be accelerated and that the "super" 10/50 basket be repealed.

Application of the U.S. Aviation Ticket Tax to Foreign Frequent-Flyer Programs

Significant administrative and compliance problems have arisen due to the interpretation that the aviation ticket tax rules as modified in 1997 may apply to certain frequent-flyer "affinity" programs that operate outside the United States but involve carriers with flights to the United States. Your bill contains a modest change to the statute, giving the IRS and Treasury authority to address this issue in regulations that would adequately address this problem at very little cost to the Treasury.

This is important to my industry, Mr. Chairman, because credit card companies are among the largest providers of such affinity programs. Citibank and Diners Club, for example, compete throughout the world with locally-based banks and credit card companies. Under these affinity programs, these banks permit their customers to earn miles on air carriers when they make credit card purchases. We provide these miles to our customers by purchasing the mileage award points from the carriers.

Specifically, the problem relates to the extension of the 7.5 percent ticket tax to these purchases from air carriers of frequent-flyer miles by credit card companies, hotels, telephone companies and other consumer businesses for the benefit of their customers. The statute has been interpreted to apply this tax to the purchase of all mileage awards on a worldwide basis, including miles that could be redeemed for transportation that has no relationship to the United States. This interpretation has led to numerous diplomatic protests and has created competitive and administrative issues for the U.S. travel and tourism industry.

We also understand that the only parties actually paying the tax at this time are U.S.-based taxpayers, including U.S. purchasers of mileage awards and U.S.-based carriers. Because foreign-based carriers and purchasers of miles apparently take the position that the tax should not apply to transactions outside our borders, they are not paying the tax. This pattern of compliance is creating an unfair playing field for U.S. companies doing business in foreign markets.

The application of the aviation ticket tax to these foreign programs is a prime example of the need for simplification and rationalization in our tax rules. A simple solution to this problem would be to provide the IRS and Treasury with regulatory authority to exclude payments for mileage awards from the tax as long as the awards relate to individuals with non-U.S. addresses.

Withholding Tax Exemption for Certain Mutual Fund Distributions

We very much support the proposal included in the Houghton/Levin bill to exempt from U.S. withholding tax all distributions of interest and short-term capital gains to foreign investors by a U.S. mutual fund, including equity, balanced, and bond funds. Under the proposal, mutual fund distributions would be exempt from U.S. withholding tax if they were received by a foreign investor either directly or through a foreign fund. Similar legislation has been introduced in prior Congresses by Representatives Crane, Dunn, and McDermott.

Mr. Chairman, while the U.S. mutual fund industry is the global leader, foreign investment in U.S. funds is low. Today, less than one percent of all U.S. fund assets are held by non-U.S. investors. The current withholding tax that applies to all dividends distributed from a U.S. fund to foreign investors is a clear disincentive to foreign investment in U.S. funds. This is the case because distributions of interest income and short-term capital gains received directly, rather than from a fund investment, are not subject to withholding tax.

The proposed legislation would enhance the competitive position of U.S. fund managers and their U.S.-based workforce and simplify the administration of these funds.

OTHER SIMPLIFICATION PROPOSALS

H.R. 2018 includes a number of other international simplification proposals that we would like to highlight.

Provide an Ordinary Course Exception to the Income Re-sourcing Rule for U.S.-Owned Foreign Securities Dealers

Current law provides that income received by a U.S. parent from its CFC will be re-sourced from foreign source to U.S. source to the extent the CFC is treated as having earned U.S. source income (for example, if the CFC derives interest income from a Eurobond). Recognizing that the existing rule is inequitable when applied to securities dealers, the bill would create an exception to the existing re-sourcing rule by providing that income earned by a securities dealer from securities held in the ordinary course of conducting its customer business will not be re-sourced.

Treat a Foreign Securities Firm's Market-Making Activities in its Parent Company's Issuances Consistently with its Market-Making Activities in Other U.S. Companies' Securities

U.S.-owned foreign securities firms, as part of their ordinary course market-making activities, will hold in inventory securities of U.S. corporations. Thus, for example, a foreign securities firm may hold in inventory a Eurobond issued by General Motors. However, Citigroup's foreign securities dealers are effectively prohibited from holding Citigroup issuances in inventory over quarter-end because the holding of that security would give rise to a subpart F deemed dividend. The bill would eliminate this rule for parent and affiliate securities held by a U.S.-owned foreign securities dealer in the ordinary course of its market making activity.

CONCLUSION

On behalf of Citigroup, we want to thank you, Mr. Chairman, and Members of the Ways and Means Committee for your interest in international tax simplification and the impact of current rules on my company. As a representative of a U.S.-based financial services company with operations throughout the world, I believe your efforts to simplify and rationalize the U.S. international tax rules are vitally important. Thank you again for the opportunity to testify today.

Chairman HOUGHTON. Thanks very much, Ms. Strain.
Mr. Jarrett.

**STATEMENT OF THOMAS K. JARRETT, DIRECTOR OF TAXES,
DEERE & COMPANY, MOLINE, ILLINOIS**

Mr. JARRETT. Good afternoon, Mr. Chairman, Members of the Committee. My name is Tom Jarrett, director of Taxes for Deere & Company. In this position, I am responsible for Deere's worldwide tax and compliance measures.

Deere is the world's largest producer and distributor of agricultural equipment and a leading producer and distributor of construction and grounds care equipment. It also finances and leases equipment and has insurance and health care operations. We employ 26,000 people in the United States, 37,000 worldwide.

Mr. Chairman, we want to thank you for your efforts to make the U.S. Tax Code not only simpler and fairer but also one that helps American corporations compete abroad. In my written testimony, I have focused on the details of three specific areas of interest to Deere and other manufacturers: foreign interest expense allocation, active financing income exemption, and foreign tax credit ordering rules. The reason this Committee's attention to these issues is critical is something you understand well. Deere and other U.S. manufacturers are in a global race with our foreign competitors. Many of these foreign companies are provided tax policy advantages that support their operations around the world. The U.S. Tax Code should level the playing field for American companies so that they may compete successfully for international business.

The issue here is cost. Bad tax policy adds cost. For instance, the allocation of our U.S. credit subsidiaries' interest expense to foreign operations doubles the allocation of interest to foreign operations, yet our U.S. credit operation has basically no foreign assets. Regarding the active financing exemption, retaining this measure will permit Deere and others to compete on equal terms with U.S. banks and foreign finance competitors. It is extremely important for us to expand our markets and export our U.S. goods.

The John Deere brand is sought around the world as a result of our reputation for quality and genuine value. Our customers are willing to pay a premium for our products, innovative technology, superior engineering, and overall quality. The company's costs for research and development and quality improvement may be reflected in the price the customer pays, but there are limits to what the market will bear. The world market won't allow costs associated with outdated and disproportionate tax obligations to be passed to our customers. These costs simply slow us down in our global race.

John Deere is a global enterprise. About one-third of Deere's total equipment sales in 1998 took place outside the United States. While the U.S. farmer remains our number one customer, Deere's growth opportunities are increasingly tied to our ability to compete in the global marketplace. We have aggressive growth objectives, both in this country and abroad. Our experience is that growth here and abroad is complimentary. Our presence abroad helps our U.S. exports and helps to provide product volumes that keep U.S. products less expensive for our customers. Sometimes products produced for markets outside the United States also have a use in the United States. Our balance of payments from a U.S. perspective is clearly positive.

In summary, Deere & Company must be able to compete effectively overseas in order to continue to provide jobs to its employees, expand its business, and provide genuine value to shareholders. The three recommendations we are making today will favorably affect all U.S. equipment manufacturers. Moreover, they will strengthen our ability to compete favorably overseas and provide more jobs in and exports from this country.

Thank you.

[The prepared statement follows:]

**Statement of Thomas K. Jarrett, Director of Taxes, Deere & Company,
Moline, Illinois**

Good afternoon Mr. Chairman and Members of the Committee. I am Tom Jarrett, Director of Taxes for Deere & Company. In this position I am responsible for Deere's worldwide tax planning and compliance.

Deere & Company is the world's largest producer and distributor of agricultural equipment and a leading producer and distributor of construction and grounds care equipment. It also finances and leases equipment and has insurance and health care operations. Deere employs approximately 26,000 people in the United States and 37,000 worldwide.

The company has factories in nine states and eleven countries. Our products are distributed and serviced worldwide by a large number of independent John Deere dealers.

We have aggressive growth objectives both in this country and abroad. Our experience is that growth here and abroad is complimentary. Our presence abroad helps our U.S. exports and helps provide product volumes that keep U.S. products less expensive for our customers. Sometimes products produced for markets abroad also have a use in the U.S. Our balance of payments—from a U.S. perspective—is clearly positive.

For Deere to continue expanding our businesses at a level acceptable to our shareholders, Deere clearly must continue to expand and be competitive overseas.

One of the greatest challenges faced by Deere and other multinational companies is the complexity of U.S. international tax rules. Many provisions of the U.S. tax code not only result in a paperwork burden unmatched anywhere in the world, but also hinder the ability of American companies to compete in the international arena. Mr. Chairman, we appreciate your leadership in examining this issue. Your legislation (H.R. 2018) addresses many areas where the U.S. Code could be improved. I would like to focus on a few specific areas of interest to Deere and other manufacturers.

Three key tax issues that affect our competitiveness overseas are: the foreign interest expense allocation; the active financing income exemption; and, the foreign tax credit ordering rules. The way these issues are currently handled causes U.S. manufacturers to be less competitive with overseas manufacturers and, as a result, reduces U.S. manufacturers' ability to sell U.S. products overseas. For this reason, we have advocated for several years that U.S. international tax laws must be addressed in these areas.

(1) FOREIGN INTEREST EXPENSE ALLOCATION

The maximum foreign tax credit a U.S. company can receive is equal to the U.S. tax rate times the foreign taxable earnings less the U.S. expenses incurred to generate those earnings. In determining the U.S. expense incurred, Regulation 1.861-11T requires that the total U.S. affiliated company interest expense be allocated between domestic and foreign source income based on assets.

The Deere U.S. credit and leasing companies only finance equipment sold or leased within the U.S. The Deere U.S. credit and leasing company assets represent over 50 percent of the total asset allocation base. By comparison, foreign assets are less than 13 percent of total assets. The credit and leasing companies account for 80 percent of the U.S. consolidated income tax return interest expense. The tax regulations force a disproportionate allocation of interest expense to foreign assets. The arbitrary interest expense allocation has reduced Deere's foreign tax credit by 11 to 20 percent in recent years. The resulting double taxation of foreign earnings makes Deere and other manufacturers less competitive in foreign markets.

Currently, the interest expense allocation regulation exempts certain financial institutions, including chartered banks and thrifts, from the 861-11 allocation. How-

ever, other active domestic finance companies that are defined in Section 1.904-4(e)(3) of the Regulations are actually performing the same functions as chartered banks and thrifts (such as Deere's credit and leasing operations), but are not included in the exemption.

We recommend that the exemption to the interest allocation regulation be expanded to include all active domestic financial institutions. In this manner, our foreign income will be more accurately reflected and our eligibility for an appropriate level of foreign tax credit will be restored. This issue must be addressed to ensure that U.S. companies' international tax burden approximates that of our competitors.

(2) ACTIVE FINANCING INCOME EXEMPTION

Another important foreign tax issue to equipment manufacturers is the exemption for active financing income. In 1997 Congress adopted an exception to subpart F of the Code for foreign finance companies that comply with the significant active business tests in Section 954(h)(2)(A) of the Code. Prior to its adoption, subpart F taxed all income on foreign loans and leases as the income was earned, rather than permit such income to be deferred until foreign dividends were paid. The law viewed all finance activity as passive investment activity.

However, Section 954(h)(2)(A) established an exception to the subpart F rules for foreign finance companies where their principal business activity is to provide financing to unrelated parties located in the country in which the foreign finance company was organized. This exception strengthens the business carried on by the foreign finance companies.

Moreover, the exception was, and continues to be, extremely important to equipment manufacturers such as Deere as we expand our markets overseas and as we expand financing activities abroad to South America, Eastern Europe and Asia. All of these markets have a high demand for our products, but the customers have had difficulty in securing adequate financing for their purchases of equipment. With the expansion of our financing operations overseas during the period of the exemption, this problem has been minimized and Deere, like other equipment manufacturers, is able to compete successfully in the foreign marketplace.

The exemption for active financing income is scheduled to expire on December 30, 2000. Deere recommends that the active financing income exemption be made permanent. A permanent exemption would enable Deere and other manufacturers to continue to expand our financing operations overseas, export more equipment abroad and expand our U.S. workforce.

(3) FOREIGN TAX CREDIT ORDERING RULES

The third area of concern to Deere and other manufacturers is the manner in which corporations must use unused foreign tax credits. Currently, unused foreign tax credits that are earned in a given year must be used before any carryover credits can be used in that year. As a result, equipment manufacturers that are experiencing a downturn find it very difficult to claim any carryover foreign tax credit in years of reduced profits.

Many companies often find that in a downturn (1) lower manufacturing activity reduces foreign royalty income; (2) foreign source export sales income is greatly reduced as the demand for equipment softens overseas; (3) foreign dividends are withheld to finance the buildup of inventory and trade receivables abroad; (4) U.S. interest expense allocated to foreign source income increases as U.S. borrowings increase to finance the buildup of similar U.S. inventory and receivables; and (5) the combination of lower foreign source income and rising 861 interest expense allocations reduces a company's ability to claim a foreign tax credit. And without the benefit of a foreign tax credit, that company's foreign earnings are being double taxed.

Accordingly, we recommend that the Committee establish "ordering rules" for foreign tax credits similar to the rules governing net operating losses. These rules would permit the "earliest-to-expire" carryover credit to be used before any credit that is earned in the current year—just as currently is the case with NOL carryovers. In this manner, a company would be able to maximize its foreign tax credit carryovers without losing them during a downturn. This would enable equipment manufacturers to maximize their foreign tax credits and remain competitive in their overseas markets following a downturn.

In summary, Deere & Company must be able to compete effectively overseas in order to continue to provide jobs to its employees, expand its business and provide genuine value to its shareholders. The three recommendations that we are making today will favorably affect all U.S. equipment manufacturers. Moreover, they will strengthen our ability to compete favorably overseas and therefore provide more jobs in and exports from this country.

Thank you.

Chairman HOUGHTON. Thank you very much. You are a very efficient man. You did it well within the time limit.

Now, I would like to turn to Mr. McKenzie.

**STATEMENT OF GARY MCKENZIE, VICE PRESIDENT OF TAX,
NORTHROP GRUMMAN CORPORATION, LOS ANGELES, CALIFORNIA**

Mr. MCKENZIE. Thank you, Mr. Chairman and Members of the Subcommittee for the opportunity to appear before you today.

Northrop Grumman Corporation is a leading designer and manufacturer of defense products, and our most widely known products are the B-2 and the Joint STARS aircraft—

Chairman HOUGHTON. Do you want to bring that mike just a little closer to you? Bring the mike a little closer to you.

Mr. MCKENZIE. I am sorry. Would you like me to start over?

Chairman HOUGHTON. No, that is fine.

Mr. MCKENZIE. OK. First, I want to commend Chairman Houghton and Congressman Levin for the many constructive changes included in H.R. 2018. In my view, Subpart F of the Internal Revenue Code has become overly complex and restrictive to the point that it actually interferes with the conduct of international business. The reevaluation of the policy goals of Subpart F and the entire scheme of international taxation is overdue, and I applaud your efforts to begin that process, and I would be happy to share more of my thoughts on that once we have reached the end of this.

However, I will now focus my comments specifically on the benefits of section 303 of H.R. 2018, which repeals section 923(a)(5) of the code that severely discriminates against U.S. exporters of products on the United States munitions list. Specifically, current law reduces Foreign Sales Corporation benefits available to companies that sell military products abroad to 50 percent of the benefits available to all other exporters. The provision is essentially a penalty tax imposed only on U.S. exporters with military property and should be repealed; its time has passed. Today, military exports, like commercial exports, are subject to fierce international competition in every area from companies such as British Aerospace, Aerospacio, Daimler-Benz, and others.

Since fiscal 1985, the United States defense budget has shrunk from 27.9 percent of the Federal budget, now, to 14.8 percent in fiscal 1999; that is almost a half decrease. And in facing such dramatic cuts in U.S. defense spending, the international market has become increasingly important to U.S. defense contractors and to maintaining the defense industrial base. For example, of the three fighter aircraft programs under production in this country currently, two are largely dependent on foreign customers. The same is true for the manufacturer of the M-1A1 tank. Repeal will not only benefit the large manufacturers of military hardware, but also smaller munitions manufacturers whose products are particularly sensitive to price fluctuations.

One of Northrop Grumman's main export product lines is ground radars. In this market, we compete against companies from France,

Germany, Italy, and Great Britain, which are often government subsidized, and price is often a key factor as to who wins the foreign sale. The restoration of the full FSC benefit has the potential to strengthen the U.S. defense industry base by leveling the playing field with our international competition.

I now want to talk about Northrop Grumman's real-time FSC analysis. The FSC tax benefits have a real impact on our international sales and pricing. As an example, Northrop Grumman performs the FSC benefit analysis on a real-time basis. Under our internal procedures, the tax department is responsible for reviewing the company's foreign bids, proposals, contracts, and joint ventures. Our program managers and contracts negotiators are generally aware of the FSC benefits, and we often consult with them about it at the time the bids are prepared and the contract prices with foreign customers are being negotiated. So, my point here is that the FSC benefits are cranked into pricing and considered at the time that the prices are being negotiated with foreign customers, and if we can roll down the price, that gives us a competitive advantage against foreigners.

Now, I would like to point out that the provision is support by the Department of Defense. For example, in a letter dated August 26, 1998, Deputy Secretary of Defense, John Hamre, wrote Treasury Secretary Rubin about the FSC. And Mr. Hamre wrote—and here I am quoting: “The Department of Defense supports extending the full benefits of the FSC exemption to the defense exporters. I believe, however, that putting defense and non-defense companies on the same footing, would encourage defense exports that would promote standardization and interoperability of equipment among our allies. It could also result in a decrease in the cost of defense products to the defense products to the Department of Defense.”

Continued export license reviews: I would now like to emphasize that the repeal of section 923(a)(5) of the tax code, the discriminatory provision against defense contractors, does not alter U.S. export licensing policy. Military sales will continue to be subject to the license requirements of the Arms Export Control Act. As under current law, exporters of military property will only be able to take advantage of the FSC after the U.S. Government has determined that a sale is in the national interest. However, once a decision has been made that the military export is consistent with the national interest, our Government should encourage such sales to go to U.S. companies and workers, not to our foreign competitors.

As you probably know, Congressman Sam Johnson's bill, the Defense Jobs and Trades Promotion Act of 1999, includes language identical to section 303 of H.R. 2018. This bill enjoys broad bipartisan support. Currently, 54 Members of Congress are co-sponsors of the bill, including 9 of the 12 members of this Subcommittee and 28 of 39 members of the full Ways and Means Committee. In addition, Senators Mack and Feinstein have introduced identical legislation in the Senate, which also enjoys broad bipartisan support.

In conclusion, I urge the Congress to enact H.R. 2018. The enactment of section 303 of H.R. 2018, in particular, will provide fair and equal treatment to our defense industry and its workers and enable American defense companies to compete more successfully in the increasingly challenging international market.

Thank you for your time, and I will be pleased to answer any questions that you may have.

[The prepared statement follows:]

Statement of Gary McKenzie, Vice President of Tax, Northrop Grumman Corporation, Los Angeles, California

Mr. Chairman and Members of the Subcommittee, thank you for providing me the opportunity to appear before you today. My name is Gary McKenzie and I am Vice President of Tax for Northrop Grumman Corporation. Northrop Grumman, headquartered in Los Angeles, is a leading designer, systems integrator and manufacturer of military surveillance and combat aircraft, defense electronics and systems, airspace management systems, information systems, marine systems, precision weapons, space systems, and commercial and military aerostructures. We employ about 49,000 people based almost entirely in the United States. In 1998 we had sales of \$8.9 billion. Many of our products, including the B-2 bomber and the Joint STARS surveillance aircraft, were used extensively during the recent conflict in Kosovo.

I am pleased to provide testimony on the myriad problems facing U.S. corporations in complying with the complexity of the current U.S. international tax regime. I also want to commend Chairman Houghton and Congressman Levin for the many constructive changes included in H.R. 2018, the "International Tax Simplification for American Competitiveness Act of 1999." My specific comments on the bill will concentrate, in particular, on Section 303, the "Treatment of Military Property of Foreign Sales Corporations."

Before I discuss the Foreign Sales Corporation provision, however, I would like to say why the time has come (and, indeed, is long overdue) to reform the entire U.S. international tax system. Particularly needing reform is our system for taxing the foreign income of U.S. corporations under the so-called "subpart F" regime. The complexity of the subpart F rules and the pressing need for a fresh look at, and complete reevaluation of, subpart F was presented in a recent report prepared by the National Foreign Trade Council, "International Tax Policy for the 21st Century: A Reconsideration of Subpart F." I strongly agree with the report's recommendations, and I would like to highlight some of the issues discussed in the report.

As I am sure many of you know, subpart F was initially added to the Internal Revenue Code (IRC) almost 40 years ago, during the Kennedy Administration. Before the enactment of the subpart F rules, U.S. tax generally was imposed on earnings of a U.S.-controlled foreign corporation (a "CFC") only when the CFC's foreign earnings were actually repatriated to the U.S. owners, usually in the form of a dividend. Subpart F is referred to by many tax professionals as an "anti-deferral" regime. That is, its intended purpose, which has been achieved quite effectively during the course of numerous legislative changes since 1962, is to prevent U.S. companies from deferring the payment of U.S. tax on income earned abroad by CFCs in their foreign operations, including various categories of "active" business income. Put another way, the anti-deferral rules under subpart F frequently *accelerate* the imposition of U.S. tax on various types of income earned by CFCs, even though the income has not been repatriated to the U.S. This regime places U.S. companies at a clear disadvantage to foreign companies, which frequently do not operate under these kinds of harsh and complex taxing rules. The simple fact is that the application of subpart F to various categories of active foreign business income should be substantially narrowed as a first step to reforming the current anti-deferral regime.

A certain irony underlies this entire discussion. The subpart F rules were originally intended to achieve capital export "neutrality" when they were enacted in 1962. That is, it was intended that the subpart F rules would play no part in influencing the decision of whether to invest in the U.S. or a foreign country. Unfortunately, subpart F has developed over the last 40 years into an arcane set of rules that not only are enormously complex, but also clearly place U.S. companies at a competitive disadvantage in the global marketplace. It is my view, which I believe is shared by many others, that tax rules play a key role in America's continuing prosperity, particularly in the context of an increasingly global marketplace. A reevaluation of the policy goals of subpart F and, indeed, the entire scheme of international taxation is long overdue; and I applaud your efforts to begin that process.

I will now discuss Section 303 of H.R. 2018, which eliminates a provision of the tax code that severely discriminates against United States exporters of products on the U.S. Munitions List. Specifically, Section 303 repeals IRC Section 923(a)(5), which reduces the Foreign Sales Corporation (FSC) benefits available to companies that sell military goods abroad to 50 percent of the benefits available to other exporters.

Congressman Sam Johnson's bill, H.R. 796, the "Defense Jobs and Trade Promotion Act of 1999," includes language identical to Section 303. This bill enjoys broad bipartisan support. Currently 54 members of Congress are cosponsors of the bill, including 10 of the 13 members of this subcommittee and 28 of the 39 members of the full Ways and Means Committee, as well as a number of members from the defense oversight and appropriations committees. Senators Mack and Feinstein have introduced S. 1165, a companion bill in the Senate, which also enjoys broad bipartisan support.

Repeal of Section 923(a)(5) will help protect our defense industrial base and insure that American defense workers—who have already had to endure sharply declining defense budgets—do not see their jobs lost to foreign competitors because of detrimental U.S. tax policy.

The Internal Revenue Code allows U.S. companies to establish FSC's, under which they can exempt from U.S. taxation a portion of their earnings from foreign sales. This provision is designed to help U.S. firms compete against foreign companies relying more on value-added taxes (VAT's) than on corporate income taxes. When products are exported from such countries, the VAT is rebated, effectively lowering their prices. U.S. companies, in contrast, must charge relatively higher prices in order to obtain a reasonable net profit after taxes have been paid. By permitting a share of the profits derived from exports to be excluded from corporate income taxes, the FSC in effect allows companies to compete with foreign firms who pay less tax.

In 1976 the Congress reduced the Domestic International Sales Corporation (DISC) tax benefits for defense products to 50 percent, while retaining the full benefits for all other products. The limitation on military sales, currently IRC Section 923(a)(5), was continued when Congress enacted the FSC in 1984. The rationale for this discriminatory treatment—that U.S. defense exporters faced little competition—no longer exists. Whatever the veracity of that premise 25 years ago, today military exports are subject to fierce international competition in every area. In the mid-1970's, roughly half of all the nations purchasing defense products benefited from U.S. military assistance. Today U.S. military assistance has been sharply curtailed and is essentially limited to two countries. European and other countries are developing export promotion projects to counter the industrial impact of their own declining domestic defense budgets and are becoming more competitive internationally. In addition, a number of Western purchasers of defense equipment now view Russia and other former Soviet Union countries as acceptable suppliers, further increasing the global competition.

Circumstances have changed dramatically since the tax limitation for defense exports was enacted in 1976. Total U.S. defense exports and worldwide defense sales have both decreased significantly. Over the past fifteen years, the U.S. defense industry has experienced reductions unlike any other sector of the economy. During the Cold War defense spending averaged around 10 percent of U.S. Gross Domestic Product, hitting a peak of 14 percent with the Korean War in the early 1950's and gradually dropping to 6–7 percent in the late 1980's. That figure has now sunk to 3 percent of GDP and is planned to go even lower, to 2.8 percent by Fiscal Year (FY) 2001.

Since FY85 the defense budget has shrunk from 27.9 percent of the federal budget to 14.8 percent in FY99. As a percentage of the discretionary portion of the U.S. Government budget, defense has slid from 63.9 percent to 45.8 percent over the same time. Moreover, the share of the defense budget spent on the development and purchase of equipment—Research, Development, Test and Evaluation (RDT&E) and procurement—has contracted. Whereas procurement was 32.2 percent and RDT&E 10.7 percent of the defense budget in FY85—for a total of 42.9 percent; those proportions are now 18.5 percent and 13.9 percent, respectively—for a total of 32.4 percent.

Obviously, statistics such as these are indicative that the U.S. defense industry has lost much of its economic robustness. I know members of Congress are well aware of the massive consolidation and job loss in the defense industry. Out of the top 20 defense contractors in 1990, two-thirds of the companies have merged, been sold off or spun off; hundreds of thousands of jobs have been eliminated in the industry. To put this in perspective, consider, for instance, the fact that in 1998 WalMart had \$138 billion in revenues; in comparison, the combined revenues of the top five defense contractors totaled \$61 billion—less than half the WalMart results for the year.¹

¹"The Post-Deconstruction Defense Industry," 1999 Revised Edition, Dr. Loren B. Thompson, Lexington Institute, April 1, 1999.

Budget issues are always a concern to lawmakers. The Joint Tax Committee estimates that extending the full FSC benefit to defense exports will likely cost about \$340 million over five years. Overriding policy concerns justify this expense. With the sharp decline in the defense budget over the past fifteen years, exports of defense products have become ever more critical to maintaining a viable U.S. defense industrial base. Several key U.S. defense programs rely on international sales to keep production lines open and to reduce unit costs. For example, of the three fighter aircraft under production in this country, two are largely dependent on foreign customers. The same is true for the manufacturer of the M-1A1 tank, which must compete with several foreign tank companies. Repeal will not only benefit the large manufacturers of military hardware, but also the smaller munitions manufacturers, whose products are particularly sensitive to price fluctuations.

One of Northrop Grumman's main product lines is ground radars. In this market we compete against companies from France, Germany, Italy and Great Britain, and these companies are often government subsidized. Price is frequently a key factor as to who wins the sale. The restoration of the full FSC benefit has the potential to improve the defense industrial base and our ability to compete on a more level playing field with foreign firms.

The recent conflict in Kosovo demonstrated the importance of interoperability of equipment among NATO allies. Unfortunately, when our foreign competitors win a sale, not only does a U.S. business lose a contract, the U.S. military must then conduct operations with a military using different equipment. For example, Northrop Grumman and Lockheed Martin recently competed against a Swedish company, Ericsson, for a contract to supply an Airborne Early Warning System (AEW) to the Greek Government. Despite the fact that both U.S. companies were offering proven, state-of-the-art technology at a fair price, the Greek Government selected the Ericsson proposal, which had never been tested and will lack commonality with the NATO AEW system when built.

This is one reason why the Department of Defense supports repeal of Section 923(a)(5). In an August 26, 1998, letter, to Treasury Secretary Rubin, Deputy Secretary of Defense John Hamre wrote:

The Department of Defense (DoD) supports extending the full benefits of the FSC exemption to defense exporters. I believe, however, that putting defense and non-defense companies on the same footing would encourage defense exports that would promote standardization and interoperability of equipment among our allies. It also could result in a decrease in the cost of defense products to the Department of Defense.

Section 303 implements the DoD recommendation and calls for the repeal of this outdated tax provision.

The recent decision to transfer jurisdiction of commercial satellites from the Commerce Department to the State Department illustrates the fickleness of Section 923(a)(5). When the Commerce Department regulated the export of commercial satellites, the satellite manufacturers received the full FSC benefit. When the Congress transferred export control jurisdiction to the State Department, the identical satellites, manufactured in the same facility, by the same hard working employees, no longer receive the same tax benefit. Why? Since these satellites are now classified as munitions, they receive 50 percent less of a FSC benefit than before. This result demonstrates the inequity of singling out one class of products for different tax treatment than every other product manufactured in America.

The Cox Committee, recognizing the absurdity of the situation, recommended that the Congress take action to correct this inequity as it applies to satellites. The administration has agreed with this recommendation. Section 303 would not only correct the satellite problem, but would also change the law so that all U.S. exports are treated in the same manner under the FSC. The Department of Defense and the Cox Committee are not the only entities that have commented publicly about this provision. Several major trade associations including the National Association of Manufacturers, the U.S. Chamber of Commerce, and the Electronics Industry Alliance, to name just a few, have stated that Section 923(a)(5) is bad tax policy and should be repealed.

A joint project of the Lexington Institute and the Institute for Policy Innovation, entitled "Out of Control: Ten Case Studies in Regulatory Abuse," highlighted the FSC. The December 1998 article, fittingly titled "26 U.S.C. 923(a)(5): Bad for Trade, Bad for Security, and Fundamentally Unfair," because it reveals the many problems with this provision. In the paper, Dr. Thompson argues that Congress' decision to limit the FSC benefit for military exports was not based on sound analysis of tax law, but on the general anti-military climate that pervaded this country in the mid-1970's. Congress enacted Section 923(a)(5), and I quote: "to punish weapons makers.

Section 923(a)(5) was simply one of many manifestations of congressional anti-militarism during that period.”

I want to emphasize that the repeal of Section 923(a)(5) of the tax code does not alter U.S. export licensing policy. Military sales will continue to be subject to the license requirements of the Arms Export Control Act. Exporters will only be able to take advantage of the FSC after the U.S. Government has determined that a sale is in the national interest.

Decisions on whether or not to allow a defense export should continue to be made on foreign policy grounds. However, once a decision has been made that an export is consistent with those interests, surely our government should encourage such sales to go to U.S. companies and workers, not to our foreign competitors. Discriminating against these sales in the tax code puts our defense industry at great disadvantage and makes no sense in today’s environment. Removing this provision of the tax code will further our foreign policy objectives by making defense products more competitive in the international market.

I urge the Congress to repeal this provision in order to provide fair and equal treatment to our defense industry and its workers and to enable American defense companies to compete more successfully in the increasingly challenging international market.

I thank you for your time and will be pleased to answer any questions that you have.

Chairman HOUGHTON. Thank you, Mr. McKenzie.
Now, Mr. Kelly.

STATEMENT OF STAN KELLY, VICE PRESIDENT-TAX, WARNER-LAMBERT COMPANY, MORRIS PLAINS, NEW JERSEY

Mr. KELLY. Good afternoon. I am honored to appear before the Ways and Means Committee. I am Stan Kelly, Vice President of Tax for Warner-Lambert Company, a \$10 billion U.S. multinational headquartered in Morris Plains, New Jersey.

Warner-Lambert employs 41,000 people in 150 countries and operates 78 manufacturing facilities worldwide. Warner-Lambert has three principal product lines: confections, consumer health products, and pharmaceuticals. Well known Warner-Lambert brands include Listerine, Benadryl, Sinutab, Trident gums, and Halls lozenges. Warner-Lambert’s pharmaceutical line includes Lipitor, the world’s leading cholesterol reducing agent, and Viracept, the world’s leading AIDS treatment.

The pharmaceutical industry is on the brink of a scientific revolution that will be sparked by the decoding of the human genome during the next few years. This revolution will be global. Drug targets will jump from 500 to 15,000, triggering a tidal wave of competition. Warner-Lambert’s competition will come primarily from Japan and Europe whose tax policies support their multinationals better than U.S. policies support our multinationals. U.S. international tax policy must change in order to improve the competitive position of U.S. companies.

Mr. Chairman, your bill and this hearing are important steps that can help to move U.S. international tax policy in the right direction. Warner-Lambert strongly supports H.R. 2018 because it promotes three sound, international tax policies that would help to improve American competitiveness. First, your bill would begin to reverse the anti-deferral rules in our tax system. I refer to section 107 of the bill, which provides for look-through treatment for sales with partnership interest. In addition, although it does not affect

Warner-Lambert, I refer to section 101 of the bill, which provides for permanent Subpart F exemption for active financing income.

Second, your bill would improve the operation of the foreign tax credit system by reducing double taxation that is inherent in the system today. Eliminating double taxation is a fundamental objective of U.S. international tax policy. I refer to section 207 of the bill, which provides for the repeal of the 90 percent foreign tax credit limitation under the alternative minimum tax.

Third, your bill would simplify the administration of our international tax rules. I refer to section 306 of the bill instructing the Treasury to issue regulations stating that agreements which are not legally enforceable are not intangible property for various purposes. Warner-Lambert supports this provision, which mandates a bright-line test in an area where Treasury has not exercised the regulatory authority given to it more than 15 years ago.

I would now like to direct your attention to two provisions of the bill that may need further clarification. First, section 102 of the bill authorizes Treasury to conduct a study of the feasibility of treating the European Union as one country for purposes of the same-country exceptions under Subpart F. Warner-Lambert supports this concept, but section 102(a) also provides,

Such studies shall include consideration of methods of ensuring that taxpayers are subject to a substantial effective rate of foreign tax in such countries if such treatment is adopted.

The policy goals represented by this sentence are unclear. Does the United States have a tax or trade policy requiring U.S. multinationals to pay substantial amounts of foreign tax on profits made outside the U.S.? Wouldn't such a policy make it easier for other developed countries to fund the support of their own multinationals? Mr. Chairman, I strongly urge you to reconsider the language in section 102 of your bill.

The second provision that may need clarification is section 310 of your bill, which would amend the earning stripping rule in section 163(j) of the code. I believe that this provision could actually facilitate stripping of U.S. earnings by our foreign competitors, and Warner-Lambert could not identify any benefit to U.S. multinationals in section 310. I am concerned that section 310 may inadvertently impose a competitive tax disadvantage on U.S. multinational corporations.

Overall, H.R. 2018 is a good step in the right direction for U.S. international tax policy, but more can be done to improve the competitiveness of U.S. multinationals. I encourage this committee to continue its efforts. Warner-Lambert is ready to offer its assistance.

I want to thank you all for your time today and commend and thank you, Mr. Chairman, for introducing H.R. 2018 and for holding this hearing.

[The prepared statement follows:]

**Statement of Stan Kelly, Vice President-Tax, Warner-Lambert Company,
Morris Plains, New Jersey**

Good afternoon, Chairman Houghton and members of the Committee, I am pleased to testify today about the impact of the current U.S. tax system on the competitiveness of U.S. multinationals. I will also comment on your effort to improve

and simplify the U.S. tax system, specifically H.R. 2018, the "International Tax Simplification for American Competitiveness Act of 1999."

WARNER-LAMBERT: A GLOBAL LEADER BUILDING GLOBAL BRANDS

I am Stan Kelly, Vice President of Tax for Warner-Lambert Company. Warner-Lambert is a U.S. multinational company headquartered in Morris Plains, New Jersey, which employs approximately 41,000 people devoted to developing, manufacturing and marketing quality health care and consumer products worldwide. The members of the Subcommittee may be familiar with some of Warner-Lambert's brand name products, such as Listerine, Sudafed, Benadryl, Schick and Wilkinson Sword shaving products, Tetra, Roloids, Halls, Trident, Dentyne and Certs. Our Pharmaceutical sector is comprised of three parts: Parke-Davis, which has been engaged in the pharmaceutical business for 127 years; Agouron, a wholly-owned subsidiary of Warner-Lambert, an integrated pharmaceutical company engaged in the discovery, development and commercialization of drugs for treatment of cancer, viral diseases, and diseases of the eye; and Capsugel, the world leader in manufacturing empty, hard gelatin capsules. Warner-Lambert's leading pharmaceutical products, Lipitor, Rezulin, Neurotin, Accupril, and Agouron's Viracept were developed to treat patients suffering from high cholesterol, diabetes, epilepsy, heart failure, and AIDS.

It is an honor to appear before the Ways and Means Committee and to continue our company's participation in the trade and tax policy-making process. Our Chairman and CEO, Lodewijk de Vink, testified two years ago before the Subcommittee on Trade. Warner-Lambert is proud to be a leader in promoting free trade policies and my remarks today regarding the U.S.'s international tax regime are closely intertwined with those same policies.

In 1998, Warner-Lambert had total revenues of approximately \$10.2 billion (\$4.3 billion, or 40% from international sales) and sold product in over 150 countries. Warner-Lambert has approximately 78 production plants in its six lines of business worldwide.

THE BIOMEDICAL CENTURY

Senator Daniel Patrick Moynihan (D-NY) recently said that the 21st century would be the "Biomedical Century." At the heart of this statement are the significant potential biomedical advances that Warner-Lambert and other companies in the pharmaceutical industry will make in the next decade. Scientists will soon complete a project started in 1990, to map the code of life itself, the Human Genome. Within five years, the number of targets for drug therapy will increase from 500 today, to more than 15,000, as scientists apply the findings of this project. That is a thirty-fold increase at a time when even 500 drug targets keeps the global pharmaceutical industry going at full bore. So, for this reason and others, we agree with Senator Moynihan's statement. We are on the brink of a revolution in research and development that will lead to new forms of prevention, new cures, and new treatments. This revolution is global and U.S. companies need to compete aggressively in product discovery, development, manufacturing, marketing, and delivery with equally talented and driven foreign competitors primarily from Europe and Japan. U.S. trade policy and U.S. international tax policy must keep pace with these changes in order to mitigate competitive disadvantages facing U.S.-based companies.

Let me emphasize this last part: the global pharmaceutical industry is highly competitive, with many of the world's largest pharmaceutical corporations headquartered outside the United States. These competitors such as Glaxo-Wellcome, Novartis, Astra Zeneca, Roche, Hoechst Marion Roussel, and SmithKline Beecham are not subject to the worldwide tax system similar to that used by the United States.

The U.S. has long recognized the importance of open global markets in the continued growth of the U.S. economy. The U.S. trade policy is evolving to ensure that U.S. companies are able to remain competitive in a global economy. Conversely, U.S. tax policy, particularly as it relates to the taxation of international activities, has not kept pace with changes in the global market place in helping to promote U.S. competitiveness. Simply stated, U.S. tax policy is out of step with the broader objectives of our country's evolving trade policy. Mr. Chairman, your bill and this hearing are important steps towards harmonizing these two important and related policy areas.

Before I turn to my specific comments on your bill, let me give you an example of how well the system can work when U.S. businesses and the Government work together toward a common objective. Last year Warner-Lambert and others had the opportunity to work with the U.S. Treasury Department and foreign revenue officials in coordinating the tax consequences of the conversion to the Euro. The policy

asserted by U.S. business was tax neutrality, i.e., the U.S. tax cost of converting to the Euro should be the same to a U.S. multinational corporation operating in Europe as the foreign tax cost to a foreign multinational corporation operating in Europe. By maintaining tax neutrality, the competitiveness of U.S. multinational corporations operating in Europe was maintained. The U.S. Treasury should be complimented for quickly developing a practical policy that enabled a smooth transition to the Euro.

Turning now to your bill.

WARNER-LAMBERT STRONGLY SUPPORTS H.R. 2018

Warner-Lambert strongly supports H.R. 2018 because it promotes three sound overall international tax policies: (i) reversing the growth of anti-deferral rules in our tax system by narrowing the scope of subpart F; (ii) improving the operation of the foreign tax credit system by reducing double taxation; and (iii) simplifying tax compliance.

- *Reversing Anti-Deferral rules:* The proposed changes would restore aspects of deferral that have been eliminated since the enactment of subpart F in 1962. This is an important contribution to the continued effort to improve the competitiveness of American industry. I refer to Sections 103 (expansion of the de minimis rule under subpart F) and 107 (look-through treatment for sales of partnership interests) of the bill as examples of this policy. In addition, even though not of direct interest to Warner-Lambert, I also refer to Section 101 of the bill (permanent subpart F exemption for active financing income) as an example of this policy.

- *Improving the Operation of the Foreign Tax Credit System By Reducing Double Taxation:* The foreign tax credit system is the United States' attempt at fairness to U.S. multinationals (as compared to the exemption system used by many countries), with the intention of eliminating double taxation of income earned outside the United States. Eliminating double taxation through the foreign tax credit system is a fundamental objective of U.S. international tax policy. Accomplishing this objective is critical to the competitiveness of American industry. I refer to Sections 201 (extension of period to which excess foreign taxes may be carried) and 207 (repeal of limitation of foreign tax credit under alternative minimum tax) of the bill as examples of this policy.¹

- *Simplifying Tax Compliance:* Simplifying the administration of tax compliance is another important element in improving the competitiveness of American industry. U.S. tax compliance is generally considered much more burdensome than tax compliance under the laws of many of our principal trading partners. I refer to Section 306 of the bill (instructing the Treasury to issue regulations to the effect that agreements which are not legally enforceable are not intangible property for various purposes) as an example of this policy. Warner-Lambert supports this provision, which mandates a bright-line test in an area where Treasury has not exercised regulatory authority given to it more than 15 years ago.

I would like to direct your attention to one section of H.R. 2018 that is of particular interest to Warner-Lambert. Section 107(a) would amend Section 954(c) of the Internal Revenue Code (the "Code") to provide a look-through rule for the sale of a partnership interest by a controlled foreign corporation ("CFC"). If a CFC disposes of an interest in a partnership, the CFC would be deemed to have sold its pro rata share of the underlying assets of the partnership. This look-through rule only applies if the CFC has a 10% or greater interest in the partnership. This rule makes sense for three reasons. First, with the proliferation of international joint ventures there are instances where a transfer of a partnership interest is deemed to be a sale and gain recognized for U.S. tax purposes. Thus, the U.S. tax treatment of gain from the sale of a partnership interest by a CFC is becoming a more common issue.

Second, under the present law the gain on the sale of a partnership interest is treated as passive subpart F income. That is the case even if 100% of the income generated by the partnership in its business is otherwise treated as active non-subpart F income. Thus, under this amendment gain from a partnership interest is treated in a manner similar to the income earned from the partnership, which is a rational tax policy.

Third, under current law the transfer of a partnership interest is frequently treated as a deemed transfer of a pro rata share of the partnership's underlying assets,

¹Section 207 of H.R. 2018 is identical to H.R. 1633 (introduced on April 29, 1999 by Chairman Houghton and 25 other members of the Ways and Means Committee) and S. 216 (introduced on January 19, 1999 by Sens. Moynihan and Jeffords (R-VT)).

such as under Code Section 367(a)(4). Thus, this change enhances consistency in the treatment of a sale of a partnership interest in the international tax area.

Overall H.R. 2018 is clearly a step in the right direction. It should be noted, however, that there are confusing signals from Congress. For example, Section 201 of H.R. 2018 expands the carryover period for foreign tax credits, but, in contrast, the Senate Finance Committee earlier this year once again approved a proposal to reduce the carryback period.²

REQUEST FOR CLARIFICATION

There are two provisions of your bill, Mr. Chairman, that need further clarification. Section 102(a) of the bill authorizes the Secretary of the Treasury to conduct a study on the feasibility of treating all countries included in the European Union as one country for purposes of applying the same country exceptions under subpart F. That aspect of Section 102 represents a positive step, which Warner-Lambert strongly supports. That provision is attractive to us because it would lessen the gap between ourselves and our European based pharmaceutical competitors in that market. But then Section 102(a) provides as follows:

Such study shall include consideration of methods of ensuring that taxpayers are subject to a substantial effective rate of foreign tax in such countries if such treatment is adopted.

The policy represented by this sentence is unclear. Should the policy of the United States be that non-U.S. business activities of a U.S. multinational corporation must be subject to “substantial” foreign tax? If so, how did we reach this point? Mr. Chairman, I strongly urge you to reconsider the language in Section 102(a) of your bill and in particular ask that you do so in light of the recent National Foreign Trade Council’s (the “NFTC”) report on international tax policy for the 21st century.

Also Section 310 in H.R. 2018 appears to be inconsistent with the notion of “International Tax Simplification for American Competitiveness.” Section 310 would amend the so-called “earnings stripping” rule in Section 163(j) of the Code. The earnings stripping rule imposes a limitation on the amount of interest expense that may be deducted by a foreign-owned domestic corporation. This subsection was enacted to stop the practice by foreign multinationals of “stripping” the earnings out of their domestic subsidiaries through related-party loans. Many other developed countries have similar restrictions, frequently in the form of debt/equity ratio requirements.

I believe that this provision might potentially facilitate earnings stripping by our foreign competitors. Warner-Lambert could not identify a benefit to U.S. multinationals of Section 310. Let us make certain that Section 310 is not an instance where by unilateral action the United States indirectly imposes a competitive tax disadvantage on its own multinational corporations.

Although this amendment to Code Section 163(j) may have merit, I ask this Committee to take into account the treatment accorded U.S. multinationals in the reverse situation before proceeding with this subsection. I would also point out that Section 310 incorporates what may be considered a subjective test, i.e., satisfying the Secretary that a loan would have been made without a parent guarantee. A number of years ago the subjective test in the high-tax exception of Code Section 954(b)(4) (no tax avoidance intention) was repealed because of alleged administrative difficulties in applying the test.

THE NFTC REPORT

Before I conclude, I would like to comment on a recent report issued by the NFTC, an organization of which I am pleased to be a member of the Board of Directors. This report, *The NFTC Foreign Income Project: International Tax Policy for the 21st Century* (the “Report”), is the first of a series of studies commissioned by the NFTC to evaluate our international tax policies in light of the globalization of the world’s economy. The first report focused on the subpart F rules of the Code, which provide a number of exceptions to the principal U.S. international tax policy of deferral of U.S. taxation on foreign earnings until distributed. The Report highlights the slow breakdown of deferral. Your bill focuses on and addresses this trend.

The Report concludes that (1) the economic policy justification for the current structure of subpart F has been substantially eroded by the growth of a global economy; (2) the breadth of subpart F exceeds the international norms for such rules,

²A reduction in the carryback period from two years to one year was most recently approved by the Senate Finance Committee on May 19, 1999 as Section 401 of S. 1134, the Affordable Education Act of 1999.

adversely affecting the competitiveness of U.S.-based companies; and (3) the application of subpart F to various categories of income that arise in the course of active foreign business operations should be substantially narrowed.

When subpart F was enacted in 1962, 18 of the 20 largest corporations in the world (ranked by sales) were headquartered in the U.S. Now there are eight. In 1962 over 50% of worldwide cross-border direct investment was made by U.S. businesses. Now that number is 25%. U.S. gross domestic product as a percentage of the world total has gone from 40% to 26%. As these figures suggest, the competitive environment in 1962 and the competitive environment today are completely different. Thus, international tax policy should reflect this change to a global economy.

In 1962 subpart F included a *de minimis* test where a CFC was deemed to have *no* subpart F income if certain designated categories of income constituted 30% or less of total gross income. That test over time has been reduced to the lesser of 5% of gross income or \$1,000,000. As a result, we have reached the point where incidental interest income earned on normal levels of working capital used in an active business constitutes subpart F income. In 1962, the “high-tax exception” referred to the alternative of a specified effective tax rate or establishment of no tax avoidance intent. Now a mechanical effective tax rate test creates anomalous situations in which, for example, a CFC organized in Italy (with a statutory tax rate in excess of the U.S. rate) may fail the high-tax exception because U.S. and Italian capital recovery rules are not identical. Also, the U.K. now constitutes a low-tax jurisdiction under our subpart F rules and, therefore, a CFC doing business in the U.K. may no longer qualify for the high-tax exception of Code Section 954(b)(4).

A subsequent NFTC report will focus on the functioning of the second principal U.S. international tax policy—avoidance of double taxation through the foreign tax credit system.

CONCLUSION

In conclusion, I commend and thank you Mr. Chairman for introducing H.R. 2018 and holding a hearing on what is a highly technical but extremely important area of our tax laws. Warner-Lambert supports the bill but more can be done in the international tax area to improve the competitiveness of U.S. multinationals. I encourage this Committee to continue its efforts in this regard. Warner-Lambert is ready to offer its assistance in your efforts. Finally, I urge you to include the important provisions in H.R. 2018 in the tax bill the Committee will be marking up early next month.

Mr. Chairman, I am pleased to answer any questions.

Chairman HOUGHTON. Well, thank you very much.

I am going to ask one question, and then I am going to pass it over to Mr. Coyne.

Tell me, gentlemen, how do we treat the European Union as one tax entity when there are so many different tax laws in the various countries? Help us on that.

That is a question, and I hear no answers.

Mr. KELLY. Maybe I will try.

Chairman HOUGHTON. Well, yes, because—I mean, it is very easy to say that there are too many baskets and a lot of bows being thrown the way of U.S. corporations that make us uncompetitive with other parts of the world and other European countries, but to move from the principle to the practical, how does it get done?

Mr. KELLY. Mr. Chairman, just to make sure I understand the question, are we talking about the provision related to the European Union?

Chairman HOUGHTON. Yes.

Mr. KELLY. OK. The way I understand that provision is that it is really addressing the treatment of Subpart F income in the European Union so that it is dealing with movements of funds across borders. It is not trying to say that all of the rules and all of those

countries should be treated the same. It is only saying that if you move cash back and forth with royalty payments or interest payments, et cetera, that we not treat those movements of cash as taxable in the United States.

Mr. COX. I think that is right, Mr. Chairman, and I think also, to give you an example in our industry, Germany is our biggest market; Switzerland is a small market, so I actually had a discussion with our German country manager one time that said he wanted to service the Swiss market by having men and women sales representatives just either fly in or drive into the Swiss market. I told him he couldn't do that. He looked at me like I was cross-eyed, and I said, "Well, you can't do it because of U.S. Subpart F," and then he really went cross-eyed on me. But the importance of that—and the gentleman is exactly correct—the issue is not how much tax we would pay in Switzerland or how much tax we would pay in Germany, the issue is, absent setting up—and I believe Mr. Jarrett pointed it out correctly—adding additional costs, administrative costs, setting up a new subsidiary in Switzerland, all that cost, why do I have to do that as a corporation? Why do I need to make that decision? I am going to pay tax, and the foreign taxes I pay and I credit will simply be determined based on whichever country I do business in, irrespective of and knowing full well that all those countries will have different rates. So, I think we are maybe trying to make that a little more complicated than it should be.

Chairman HOUGHTON. Well, we will get back to this in a minute. I want to call on Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

One would hope that our international tax policies would lend themselves to domestic firms having incentives to retain operations and workers here in the United States. Which provisions of the proposed bill, 2018, would do that? They would lend themselves to retain jobs in the United States. Anyone can answer.

Mr. MCKENZIE. I think, if I could speak, that section 303 of the bill clearly would aid in doing that by making us more competitive on international bids and for selling military property overseas. That would tend to strengthen the industrial base for defense companies, keep workers employed here to the extent that we could win those contracts, and, as a byproduct, even though we get somewhat of a tax break on the FSC rules, overall, we pay more U.S. tax if we are able to generate additional U.S. profits overseas. So, as I see it, it is a win-win situation for everybody.

Mr. COYNE. Anyone else care to comment?

Ms. STRAIN. I would agree with that. If one assumes that, for example, the active financing provision helps us U.S. companies be more competitive in the overseas marketplace and therefore be able to expand our businesses there. We see, today, in my company that we have a number of locations in the United States which originally started out servicing just a domestic customer base which now service our global customers. It is the credit card business, our payables, some of our cash management functions—all are done in the United States for overseas markets. Similarly, our R&D, is developed primarily first for the American market, and then we ex-

port. It, therefore, becomes cheaper for us to develop if we have a larger customer base.

Mr. COYNE. Can you cite what types of industries, however, would be more likely to move operations overseas and why that would be an advantage to them? Just by type of industry.

Mr. COX. Congressman, specifically related to provisions in this bill?

Mr. COYNE. Right.

Mr. COX. I cannot.

Mr. COYNE. All right, thank you.

Chairman HOUGHTON. All right. Mr. Watkins.

Mr. WATKINS. Let me ask the question a little differently in something that might be in the real practical phase of it. By the way, I have used a lot of that green and yellow.

Each of you see some of these provisions were enacted to take place. How many more jobs—let me say it right now—what percentage of exports do you do now, so to speak, from this country? What additional increases and exports would you think your company would achieve by these provisions? And then we were talking about, probably, economic growth here, jobs over here in this country, too, and you tried to give us a little bit of insight on that. A lot of companies do not do a very good job educating their employees that their job depends on export trade. Now, I have talked to some of my businesses, because we can't pass Fast Track, we can't do other things, and people are voting actually against their jobs, in many cases, with some of these industries. Now, what kind of increase do you think you would have with jobs in this country if some of these provisions would be passed?

Mr. MCKENZIE. Well, Congressman, if I may answer that the way I understand your question, I think it cuts two ways. If a company forms a "maquiladora" in Mexico to attain cheaper wages in Mexico, that may, in fact, have some effect of transferring jobs overseas to obtain the cheaper labor. However, the case that we are after—if I could just point out a couple of statistics. In 1998, for example, Northrop Grumman had export sales qualifying for the FSC treatment of approximately \$1 billion. That is up 128 percent over 1997, and it is up 278 percent over 1994. So, that created U.S. jobs, OK? Because the manufacturing that took place on those qualifying sales took place in the United States by definition, in order to meet the requirements to qualify for a foreign export sale. That is what we mean by strengthening the U.S. defense base in the workplace.

Mr. WATKINS. Right. You see where I am coming from. I think this is going to be the compelling argument on how this is going to be helping over here and sharing with us.

How about you, Mr. Jarrett and John Deere?

Mr. JARRETT. As I mentioned in my statement, I think about one-third of Deere's sales today are export sales. Deere serves an agricultural market for half of its income, basically. It is a very mature market in the United States. The growth in our agricultural products, many of our construction products is going to be overseas. The markets in South America, the markets in Asia are growing, and that is where the farmers, the customers need equipment. Much of that equipment comes from the United States. It is going to be our

ability to not only produce equipment in the United States but also to produce equipment in the countries that need it. The technology, the competitiveness, the research and development all comes from the United States, and that is what we want to retain from our perspective or from a manufacturers perspective. I need to control that technology; I need to control that patent and the ability to make that equipment worldwide. That is where we will gain from having an even playing field from a tax structure.

Mr. WATKINS. Well, I know your company has done a good job. I am product of using the old Pop and Johnny, what we called it years ago, the old Pop and Johnny, and it has changed a whole lot since that day when I used to crank them a little bit. I am not that old, but, you know, just back where you couldn't get them to me. Any other comment on some of the other companies?

I think we have done a poor job of educating the American people—if I can just say this—and part of it—I am challenging the companies that I know of and I have worked with to get off their duffs and help, because they expect a lot of things from us, and I am a believer. I am willing to get into the trenches and try to make sure we don't have certain barriers out there that make it difficult to burst into those markets overseas and be able to do business. But I know the chairman of Boeing is leading an effort and realizes that—a go trade effort and hope that your companies are involved in that, because we have got to do a lot in those areas, including, as I said, not only the taxation policy but the regulatory and litigation policies that you are confronted with and many companies are, and what little work I have done outside the Congress in the international field, I found it very complicated.

Mr. Chairman, thank you very, very much, and I appreciate the insight in your companies; something is happening there.

Chairman HOUGHTON. Is that it? OK. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Ms. Strain, the Treasury Department has urged Congress to delay any extension of the active financing exception to the Subpart F rules until after it completes a thorough study of the Subpart F regime later this year. Do you believe that we should agree to that proposal from Treasury?

Ms. STRAIN. I would urge you to continue with the provision that you have. I think that the Treasury study that is being undertaken is very worthwhile. I think it needs to be done. We need simplification and reform, and perhaps, answers, to Mr. Levin's question earlier of what more needs to be done. We probably need to have that discussion, but I think that we also need to get on with business and continue to maintain a competitive posture. The Treasury study, I believe, will spark a lot of conversation, a lot of study, and a lot of analysis, and that is not going to be a short-term effort. It will be a longer-term effort. But in the shorter-term, now, we need to have the provision renewed and extended.

Mr. NEAL. Thank you. Mr. McKenzie, thank you for your statement on the Foreign Sales Corporation rules for military property. From a tax perspective, can you think of any legitimate policy reason why defense projects should be singled out from receiving the full FSC benefit?

Mr. MCKENZIE. No, sir. As a matter of fact, we view in the industry as a penalty tax against U.S. defense contractors. In other words, we are the only ones who are not permitted to claim the full FSC benefit, and we were singled out and discriminated against and allowed only half the benefit that was allowed to everyone else. Now, in my view—and I am speaking strictly for myself here—this provision came into law back in 1975 at the height of the global arms race between the United States and Russia, at a time when Vietnam was the hot issue, and there were those on both sides of the aisle who, on the one hand, wanted to disallow all benefits for FSC for military contractors and those on the other side that wanted to allow full benefits, seeing no difference whatsoever between exporting military sales approved by DOD and all other products. And I think what happened in the end was the baby was cut in half as a compromise, and that is where we have been so far. I see no logic, really, to allowing half if there are sound arguments for repeal. It seems to me, it should either come out one way or the other, and now that the environment has totally changed, it seems to me that we should allow and treat military product exports that are approved by DOD as being in the national interest as no different from any other export product.

Mr. NEAL. Fair enough.

Thank you, Mr. Chairman.

Chairman HOUGHTON. Thanks very much.

Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman, and I want to commend Mr. Levin and the Chairman, Mr. Houghton, for doggedly pursuing this issue over the years since I have been on the Ways and Means Committee. It is a simplification issue and a competitiveness issue, the two being related, and I think it is great that we are rolling up our sleeves and getting into some of these issues, and I hope on this tax bill we will be able at least to make the downpayment.

I have an interest in the territorial tax system. I am told that this didn't come up today—and I apologize that I am late—but if we could talk a little about the territorial tax system and its impact on your companies as compared to some of your competitors. Maybe if I could just ask a couple of questions, Mr. Chairman, the first being, do you have any competitors in developed countries, industrialized countries like the United States, that use other than a territorial tax system for their employees, their foreign employees? Are there any other competitors of yours that are based in a foreign country that have a tax situation that is similar to the one you face being a U.S. company? Are you aware of any?

Mr. COX. With few exceptions, Congressman. In the software industry, most of the companies are U.S.-based multinationals. There are some exceptions, but most of them are similar to us.

Mr. PORTMAN. Ms. Strain.

Ms. STRAIN. In the financial services industry, I would say that most of our foreign competitors are not U.S.-based multinationals. Deutsche Bank, HSBC, Standard Charter, are our major competitors in a number of different jurisdictions. If you look at their published effective tax rates compared to the effective tax rates of U.S. financial institutions, they are generally lower.

Mr. PORTMAN. And that is because they have territorial tax system, correct?

Ms. STRAIN. You are crossing a number of different jurisdictions, but that is a factor, also probably, more liberal controlled foreign corporation rules. Integration systems, as well. So there will be a number of different factors, but the data shows that they are generally facing lower effective tax rates.

Mr. PORTMAN. Mr. Jarrett.

Mr. JARRETT. That is very true with manufacturing. We face local competitors in those countries, and U.S. tax law today for international operations forces us at a significant disadvantage. As I mentioned earlier, in just looking at my interest allocation rules, over half of the interest expense that Deere incurs this year relates to our credit operation. Our credit operation has no foreign assets; it basically operates within the United States to provide credit to the Deere customers here, but we have to allocate almost 60 percent of that interest expense overseas. That causes us to lose about 20 percent of our foreign tax credit, raising our price to our customers.

Mr. PORTMAN. The interest allocation issue is one that is near and dear to my heart, and I understand it is not a subject of this hearing, particularly. We are addressing it during a competitiveness hearing that is coming up, but getting back to the territorial issue, the territorial system versus a worldwide system, does that put you at a competitive disadvantage?

Mr. JARRETT. Yes, it does.

Mr. PORTMAN. Mr. McKenzie.

Mr. MCKENZIE. Yes, I couldn't agree more. One of the biggest problems I see is being able to move excess cash in one country to another country where it's needed to enhance the overall conduct of the business. That gets very difficult under current subpart F rules. Of course there's tremendous U.S. taxes. If you simply loan excess capital from a subsidiary in Germany to a subsidiary in Switzerland, that is considered to be a deemed dividend back to the United States, taxable in the United States, and then back to Switzerland. That seems to me totally unfair. That is why I say it interferes with the conduct of good U.S. business practices. That is just one example.

All of the other examples come under section 367(d). When you want to transfer products overseas, section 482 for inter-company pricing allocations. Foreign tax credits when you do want to bring income back to the United States. You have to be extremely careful about what you invest or U.S. foreign earnings in. When you liquidate a company, it gets very complicated, but when you want to reorganize foreign subsidiaries, that also gets extremely complicated to avoid U.S. taxes.

Mr. PORTMAN. And many of these are not problems that a foreign competitor of Northrop Grumman would experience?

Mr. MCKENZIE. In my experience, the foreign competition we face have much more lax rules in that area. It is much easier for them to move working capital around to where they need it. As a matter of fact, I would be in favor actually of going back to the 1962 proposals that the Kennedy Administration came up with to tax U.S. companies currently on their U.S. worldwide operations, and in ex-

change for that, allow foreign tax credits for foreign taxes actually paid overseas. If that is too much to put through all at once, perhaps establish some arbitrary limit on the foreign tax credit of 80 to 85 percent. That would dramatically simplify the rules in this area, it seems to me, and do away with a lot of the bells and whistles that we have hung onto the system. I would not—however, support a change in current law that would lead to a higher tax burden for U.S. taxpayers.

I don't mean to castigate the system. I think that the principles and fundamentals that we have in the Internal Revenue Code are sound. It is just a matter that we tried to hand too many bells and whistles on it that we need to scale it back.

Mr. PORTMAN. Mr. Kelly, do you have anything to add?

Mr. KELLY. Yes. In the case of the pharmaceutical industry, we have obviously some U.S. competitors and some foreign competitors. With respect to the foreign competitors, some are located in countries which use territorial systems. For example, the German pharmaceutical companies, Hoechst Marion Roussel and Scherig AG operate under a territorial system.

With respect to the other competitors, foreign competitors who are not located in territorial systems, if you were to look at the NFTC study I think you would see that although they appear to be systems like ours, in fact there is substantially less taxing of off-shore operations by countries such as Japan, the UK, France, et cetera.

Mr. PORTMAN. Thank you, Mr. Kelly.

Thank you, Mr. Chairman.

Chairman HOUGHTON. Thanks very much.

Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman. This is becoming an increasingly interesting hearing. There are some policy bases or maybe irrational policy bases for all these provisions. I appreciate the questions of our colleagues, Mr. Chairman; Mr. Coyne, and Mr. Neal's questions I think helped to bring out issues like the impact on jobs in this country. I appreciate Mr. Portman's kind words.

His question raises the most basic issue about our system. I think we should always be ready to look at the assumptions in our system, always though careful to avoid the conclusion that there is an easy alternative. Radical reform is often more easily said than done. We have essentially proceeded I hope importantly, but somewhat incrementally. That has been the assumption. We hope it has made a difference and there is more ground to cover.

In that regard, Mr. Kelly, we will take another look at the language about the study. I think actually one of your colleagues, panelists, kind of answered it. The question relates not to—it doesn't really I think reflect the fact that there are different tax rates and structures in the country, in the various European countries, but the notion that we could for the purposes of this provision, treat all those systems, the countries the same. Whether that is really an appropriate assumption, I don't know. We will take another look at it.

Mr. KELLY. Thank you.

Mr. LEVIN. It was to look at tax havens within the European Community and the impact of them on these provisions.

Let me say, Mr. McKenzie, I asked some of the staff who have been around here I think longer than I have, but who are younger than I, whether they remembered the rationale for the 50 percent. Their explanation was the same as yours, if you can call it a rationale.

Mr. MCKENZIE. Yes.

Mr. LEVIN. I think that may have been a case where you split the baby in half and it clearly doesn't make any sense.

Mr. MCKENZIE. I believe so, yes.

Mr. LEVIN. But we need to take a look at that as we're doing in this provision. I hope we can have some rational discussions.

Just quickly, the question about active financing and the Treasury. Were we talking about two different things? I think maybe we were. The Treasury study about the entire structure and the Treasury response to extension of this provision. I am not sure they are one in the same, maybe they are. I would hope Treasury could give us their suggestions about extending the active financing provision in time for us to act, even if they are looking at the broader picture.

Let me close, Mr. Chairman, and just ask Mr. Cox, because I think you stated correctly that it is hard for us I think to adopt a policy that simply says that we'll accept the characterization of other countries in your field. So I think you need to help us come up with how we resolve that riddle, because I am not sure what we do about it. It seems to me if we allowed the characterization of other countries to determine our tax treatment, it would be subject to manipulation on their part. Correct?

Mr. COX. I agree, Congressman Levin. One of the things that Congress can do is play an active role in treaty negotiations. Obviously that is usually done on the Senate side, but in following recognized bodies like OECD, OECD has now come with models that they are coming to a position that has agreed upon with regard to characterization of a lot of things, one of which is software income. So I think by supporting those types of efforts, that is one thing that Congress can do.

Mr. LEVIN. OK. But let's talk further about it because I would believe—and this relates to Mr. Coyne's good question about the impact on businesses and jobs here. I think your answer was a very responsive one. The jobs are basically here, not entirely, but substantially, which we want to be able to continue. I think we would like to find ways to be helpful without adopting a statutory provision that really would not be workable. So let us know. Give us some further ideas.

Mr. COX. That is correct. I mean whether it's changes in subpart F, which allow us, as Mr. Jarrett said, those are cost issues. Cost issues means do I spend money on tax issues or do I spend money hiring people to do jobs which can create a new product in my particular industry. In my particular company, the average wage of the U.S.-based workforce exceeds \$75,000 per annum. So these are extremely good jobs that we would like to keep in the United States. So whether it's issues like extending the research credit on a more permanent basis, you had a discussion about that earlier, all of these things are important as we look at where do we place

jobs. We would like to place them here, whether it's in the United States.

Mr. LEVIN. We surely agree with that.

Mr. COX. I didn't think you would have any objection.

Mr. LEVIN. No.

Mr. COX. We're on the same page there.

Mr. LEVIN. Absolutely.

Mr. COX. But realize as we make business decisions, those are factors, maybe not the only factor, maybe not even the most important factor, but those are factors that business men and women look at every day in terms of where to—

Mr. LEVIN. Right. That is the gist of this legislation. Thanks.

Thanks, Mr. Chairman.

Chairman HOUGHTON. Thanks. I just have a few questions.

Mr. Jarrett, you talk about controlling technology, it's important that you control technology. Tell me how the treatment of international tax laws affects the control of technology.

Mr. JARRETT. The treatment of international tax policy will affect that because if your U.S. tax policy forces me or other companies overseas, we get into regimes that we have to develop technology in those countries. Those countries will own that technology from the standpoint of the sub that's there. The United States loses some of its effectiveness to control where that technology goes from there. All countries don't have the same laws to protect trademarks, patents. If we have some of those in our overseas subsidiaries, we have to follow their country rules. I like to keep that technology at home where it is controlled, where we can dole it out as it needs to be, make the investment in it in U.S. property and export the product.

Chairman HOUGHTON. Still—you have to help me. I am a little slow on this. What you are saying is that if you move basic weight of industry abroad—jobs, investment, and, technology will be there. The reason that's its moved abroad is because of the tax laws. Therefore, less of our technology can be produced in this country. Is that right?

Mr. JARRETT. If that technology is developed overseas, that belongs to that overseas subsidiary. It doesn't belong to our U.S. subsidiary. There is a cost to bring that back home. We are trying to keep that technology home where I believe we should keep that technology at home.

Chairman HOUGHTON. Yes. But as you look way out, I mean, you can take a look at the past 30 years of your company and you take it and look at another 30 years, won't you be doing a great deal more sort of spot manufacturing and spot development in the areas where you have got to serve that market? So, you still will have that problem in terms of controlling technology. It doesn't have anything to do with the tax laws.

Mr. JARRETT. We would have that problem, except we license that technology overseas rather than develop it overseas. We want our U.S. parent to own that technology.

Chairman HOUGHTON. OK. Thank you.

I would like to ask Ms. Strain the question about the active financing exception to subpart F. Tell me a little bit about this. How does this help you?

Ms. STRAIN. In a couple of different ways. From my perspective, I worry about the computation of our ultimate U.S. tax liability. It is a complicated procedure. We have had two different tax laws that we have had to deal with in the last 2 years. In terms of gathering information, calculating it for our tax return, I am sending requests out to personnel in 100 different countries. English is not necessarily their first language. I am asking them to interpret U.S. tax law and give information back. So in that regard, I would hope that we don't have a change for a third year in a row in terms of the law, considering the compliance aspect to it.

Without active financing we are required to provide for U.S. taxes whether we distribute income or not. In terms of our acquisition activity, which as you might guess, has been increasing over the last couple of years of the financial services industry worldwide consolidates, when we are bidding for a company overseas, we are using a U.S. tax rate rather than the local tax rate. We find that many of our competitors obviously are operating in lower tax jurisdictions or have lower effective rates. Again, not 100 percent of the time is the tax reason why we may not win a bid, but it is certainly an important factor in terms of our ability to expand overseas.

Last, it helps in normal planning. The subpart F requirements in terms of recognizing income on a current basis require us to calculate income as if it was distributed back to the United States. It does not obviously reflect a reality. It is more complicated. It affects our foreign tax credit computations. It makes the whole management of our overseas operations more difficult.

Chairman HOUGHTON. OK. That is very helpful. Thanks a lot.

Now let me just come back to the basic question which I had posed earlier. I have a report here from the Joint Committee on Taxation. Again, I have got to go back to the concept of the European Union as being considered one tax entity. Our bill, as you probably have read, will direct the Secretary of the Treasury to study this feasibility, and I know the European Union has taken great steps to integrate their economies and so on and so forth, but they do have different tax rules. I just wondered how you feel about whether these tax rules are sufficiently harmonized to allow sort of a single treatment. Anyone?

Ms. STRAIN. I think the answer is that the tax rules are probably not harmonized at this point in time, but I believe that the answer to that question was that it relates to the treatment of subpart F income and how it should be calculated.

One of the factors though I think we should point out is that if we are looking at the European Union, the OECD is also concerned about this issue in terms of tax haven activity. They are trying to exclude from the definition of the European Union so-called "tax havens," which I think they are working to develop. So I think in one sense there is a certain amount of pressure off the notion that the European Union contains within it, tax havens that will draw more and more business activity to that location. But the answer I think was that the subpart F rules have to be reviewed in the context of whether they still make sense.

Chairman HOUGHTON. Does anybody have any other comments on that?

Mr. KELLY. I hope this is helpful. If a member of the E.U. makes a dividend distribution back to its U.S. parent, we are going to look at the tax structure in that country to determine the U.S. tax consequences. So that actual distributions and actual payments back to the United States, as far as I understand the provision, wouldn't be affected by our using the single country exception for all the E.U. That is just for Subpart F. So in effect, you kind of split the system. The advantage of doing that is really to facilitate our handling of cash off shore and to simplify our compliance here in the United States.

Mr. COX. I think Mr. Kelly is exactly correct on that. It eliminates that need to worry about common everyday business issues, movement of funds. You know, one subsidiary needs money, one does not, irrespective of the differing rules which is when you actually do have a distribution from one of those foreign corporations.

Chairman HOUGHTON. OK. That is very helpful. Any other questions? All right. Well, ladies and gentlemen, thank you very much for being with us. I look forward to working with you.

The hearing is adjourned.

[Whereupon, at 2:49 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of William W. Chip, Chairman, Tax Committee, European-American Business Council

My name is Bill Chip. I have been engaged in international tax practice for 20 years and am a principal in Deloitte & Touche LLP. I am testifying today as Chairman of the Tax Committee of the European-American Business Council (EABC). The EABC is an alliance of 85 multinational enterprises with headquarters in the United States and Europe. A list of EABC's members is attached. Because the EABC membership includes US companies with European operations and European companies with US operations, the EABC brings a unique but practical perspective to how the complexity of the US international tax regime may impede US companies from competing in the European Union (EU)—the world's largest marketplace.

The EABC welcomes the efforts underway in this Subcommittee and elsewhere in Congress to reconsider the international tax rules that have accumulated in the Internal Revenue Code. The current regime imposes tax burdens on US-owned foreign enterprises that are not borne by the same foreign enterprises when owned by non-US companies. If US ownership of a foreign enterprise is not tax-efficient, that enterprise will not relocate to the US but will instead become foreign-owned. The foreign-owned enterprise may continue to ship its output to the US, but its profits will be forever exempt from US taxation.

Nowhere is the anti-competitive burden imposed by US tax rules more evident and damaging than in the application of the US "subpart F" rules to US-owned enterprises in the EU. The subpart F rules were intended to prevent US companies from avoiding US taxes by sheltering mobile income in "tax havens." The impact of these rules is exacerbated by the fact that since 1986 any country with an effective tax rate not more than 90% of the US rate is effectively treated as a tax haven. Even the United Kingdom, an industrialized welfare state with a modern tax system, is treated as a tax haven by subpart F because its 30% corporate rate is only 86% of the US corporate rate. If the US corporate tax rate when subpart F was enacted were the benchmark, the US today would itself be considered a tax haven.

Subpart F focuses on economic activity that Congress perceived as "mobile" and therefore readily located in a tax haven. Manufacturing income was generally exempted from subpart F because manufacturing was perceived as geographically tied to transportation facilities and to sources of energy and materials and therefore unlikely to be artificially located in a tax haven. Because Congress perceived that selling and services were relatively mobile activities that could be separated from manufacturing and located in tax havens, the "foreign-base company" rules of subpart F immediately tax income earned by US-controlled foreign corporations from sales or services to related companies in other jurisdictions.

How do these rules impede the competitiveness of a US company seeking to do business in the EU? Consider a US company that already has operations in several

EU countries but wishes to rationalize those operations in order to take advantage of the single market. Such a company may find it most efficient to locate personnel or facilities used in certain sales and service activities in a single location or at least to manage them from a single location. While a number of factors will affect the choice of location, all enterprises, whether US-owned or EU-owned, will favor those locations that impose the lowest EU tax burden on the activities in question. However, if the enterprise is US-owned, the subpart F rules may eliminate any locational tax efficiency by immediately imposing an income tax effectively equal to the excess of the US tax rate over the local tax rate. Thus, US companies are penalized for setting up their EU operations in the manner that minimizes their EU tax burden (even though reduction of EU income taxes will increase the US taxes collected when the earnings are repatriated). It makes as little sense for the US to penalize its companies in this way as it would for the EU to impose a special tax on European companies that based their US sales and service activities in the US states that imposed the least taxes on those activities.

The original rationale for the foreign-base company rules was twofold. The first was that companies with operations in low-tax jurisdictions might abuse transfer pricing to allocate unwarranted amounts of income to those operations. This concern is obsolete in light of the powerful tools acquired by the IRS in the past decade to enforce arm's length transfer pricing. The second was that, if a mobile sales or service activity did not need to be located in any particular location, there was generally no valid business purpose served by incorporating that activity in a tax haven company rather than a US company. This rationale has no application to US companies that locate their EU-wide sales and service functions in a single EU location, from which other EU subsidiaries are then served. The current subpart F rules would not tax the income of a UK subsidiary from serving another UK subsidiary, but they would tax such income if the UK company's personnel went to France to serve a French subsidiary. It should be self-evident that there are valid business reasons for not establishing a separate company in France, let alone a US company, to perform the latter services. Moreover, there is little likelihood of US companies achieving "tax haven" results through EU locational decisions, since the EU member states have ample reason themselves not to permit the formation of tax shelters within the EU, as evidenced by the emerging EU Code of Conduct against harmful tax competition.

For the foregoing reasons, the EABC was pleased to see that section 102 of H.R. 2018 acknowledges the importance of this issue by requiring a Treasury study to be concluded within six months of enactment. However, the EABC believes that further study is unwarranted. The EU is unique—nowhere else in the world have so many important trading nations established a truly integrated market. Success in this fiercely competitive market is critical to success in the world at large. Almost since the inception of subpart F, US companies attempting to exploit the opportunities of the common European marketplace have pleaded for relief from the application of subpart F rules that treat the location of EU-wide activity in one EU member rather than in another as a form of tax avoidance that must be penalized. We respectfully observe that the time for correcting this most blatant of the unwarranted consequences of the US subpart F regime is long overdue.

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Statement of the Financial Executives Institutes, Detroit, MI

Chairman Amo Houghton and Members of the Subcommittee on Oversight of the House Ways and Means Committee:

The Financial Executives Institute (“FEI”) Committee on Taxation appreciates this opportunity to present its views on the current U.S. international tax regime.

FEI is a professional association comprising 14,000 senior financial executives for over 8,000 major companies throughout the United States. The Tax Committee represents the views of the senior tax officers from over 30 of the nation’s largest corporations.

At the outset, FEI would like to thank Chairman Houghton and Mr. Levin for introducing H.R. 2018, the International Tax Simplification for American Competitiveness Act of 1999. This legislation builds on your previous successful efforts to keep step with the rapid globalization of the economy by simplifying and rationalizing the international provisions of the Internal Revenue Code (the “Code”).

TAXATION IN A GLOBAL ECONOMY

The U.S. international tax regime reflects a balance between two important, but sometimes conflicting, goals: neutrality and competitiveness. The U.S. generally tries to raise revenue in a neutral manner that does not discriminate in favor of one investment over another. At the same time, the U.S. seeks to raise revenue in a way that does not hinder, and where possible helps, the competitiveness of the American economy, its firms and its workers.

The current balance between neutrality and competitiveness was struck almost four decades ago during the Kennedy Administration. At the time, the rest of the world was still in large measure trying to rebuild from the social, physical and political devastation of World War II. The United States was a comparative economic giant, accounting for 50 percent of worldwide foreign direct investment and 40 percent of worldwide GDP. Under these circumstances, policymakers were more concerned with the impact of tax law on the location decisions of U.S. firms—i.e., neutrality—than on the effect of tax law on the competitiveness of those firms.

Accordingly, the Code taxes U.S. taxpayers on their worldwide income, with a tax credit for taxes paid to foreign jurisdictions. In theory, this approach ensures that a given investment by a U.S. firm will experience roughly the same level of taxation regardless of location. The Code takes competitiveness concerns into account by deferring tax on the active income of foreign subsidiaries of U.S. firms until the income is repatriated. This ensures that active subsidiaries are not more heavily taxed currently than their non-U.S. competitors down the street. Over the years, this deferral has been increasingly limited as competitiveness has taken a back seat to concerns about tax avoidance by U.S. taxpayers.

Today, the global economic landscape looks very different than it did during the Kennedy Administration. Europe, Japan and a host of other nations have emerged as tough competitors. Revolutions in transportation, telecommunications and information technology mean that firms increasingly compete head-to-head on a global basis. As a result, the U.S. is fighting harder than ever to maintain its share, now down to about 25 percent, of the world’s foreign direct investment and GDP, and many U.S. firms now focus as much or more on fast-growing overseas markets as on the mature U.S. market.

The U.S. needs to adapt its international tax regime to this new reality. It is no longer acceptable merely to strive to treat U.S. taxpayers or their investments in a neutral manner. We must also consider how their competitors from other nations are taxed by their host governments. For example, while the United States continues to tax its taxpayers on a worldwide basis, many of our trading partners tend to tax their businesses on a “territorial” basis in which only income earned (“sourced”) in the home jurisdiction is subject to taxation. Even countries which tax on a worldwide basis do so with far fewer limitations and less complex rules on deferral, the foreign tax credit and the allocation and apportionment of income, deductions and expenses between domestic and foreign sources.

MAKING AMERICA MORE COMPETITIVE

With your leadership, Mr. Chairman, Congress in recent years has taken some positive steps to reform the international tax rules and make America more competitive. Among the important changes: eliminating the PFIC/CFC overlap, simpli-

fyng the 10/50 basket, applying the FSC regime to software, repealing section 956A, and extending deferral to active financing income.

H.R. 2018 includes many of the necessary next steps for reform. FEI strongly endorses this legislation and associates itself with the oral testimony of the National Foreign Trade Council with respect to specific provisions of the bill.

For example, FEI strongly supports the provision in H.R. 2018 that seeks to treat the European Union as a single country. The European Union created a single market in 1992 and a single currency, the euro, in 1999. Yet U.S. international tax rules still treat the EU as 15 separate countries. This has made it difficult for U.S. companies to consolidate their EU operations and take advantage of the new economies of scale. Over time, our European competitors, who do not face such obstacles to consolidation, will gain a competitive advantage.

Another example is the provision that would accelerate the effective date for “look-through” treatment in applying the foreign tax credit baskets to dividends from 10/50 companies. The 1997 tax law allows such look-through treatment for dividends paid out of earnings and profits accumulated in taxable years beginning after December 31, 2002. This means U.S. corporate taxpayers face an unnecessary tax cost until 2003.

THREATS TO COMPETITIVENESS

Notwithstanding these positive developments, there have been some ominous clouds on the international tax horizon. The Treasury Department early last year issued guidance on so-called “hybrid entities” that would have substantially hindered the ability of U.S. companies to compete abroad (Notice 98–11). Although the original “hybrid” rules were withdrawn and we understand that the subsequent notice (Notice 98–35) is being reconsidered, Treasury has given every indication that it will continue to push neutrality concerns over competitiveness. (e.g. seeking limits on deferral and promoting the OECD effort on “harmful tax competition”). These and other proposals to amend the Code in ways that threaten U.S. competitiveness take us in precisely the opposite direction from where we need to go in the global economy. Consider the effort by some to further limit deferral.

Under current law, ten percent or greater U.S. shareholders of a controlled foreign corporation (“CFC”) generally are not taxed on their proportionate share of the CFC’s operating earnings until those earnings are actually paid in the form of a dividend. Thus, U.S. tax on the CFC’s earnings generally is “deferred” until an actual dividend payment to the parent company, just as tax is “deferred” when an individual holds shares in a company until such time as the company actually pays a dividend to the individual. However, under Subpart F of the Code, deferral is denied—so that tax is accelerated—on certain types of income produced by CFCs.

Subpart F was originally enacted in 1962 to curb the ability of U.S. companies to allocate income and/or assets to low-tax jurisdictions for tax avoidance purposes. Today, it is virtually impossible under the Section 482 transfer pricing and other rules to allocate income in this manner. Indeed, the acceleration of tax on shareholders of CFC operations has no counterpart in the tax laws of our foreign trading partners.¹ Nevertheless, Subpart F remains in the Code, putting U.S. companies at a disadvantage. In many instances, Subpart F results in the taxation of income that may never be realized—perhaps because of the existence in a foreign country of exchange or other restrictions on profit distributions, reinvestment requirements of the business, devaluation of foreign currencies, subsequent operating losses, expropriation, and the like—by the U.S. shareholder.

Other problems posed by the acceleration of tax under Subpart F and similar proposals include:

- Acceleration of tax may lessen the likelihood or totally prevent U.S. companies from investing in developing countries by vitiating tax incentives offered by such countries to attract investment. This result would be counter to U.S. foreign policy objectives by opening the door to foreign competitors who would likely order components and other products from their own suppliers rather than from U.S. suppliers. Moreover, any reduced tax costs procured by these foreign competitors would likely be protected under tax sparing-type provisions of tax treaties that are typically agreed to by other nations, although not by the U.S. Treasury.

¹ For example, according to a 1990 “White Paper” submitted by the International Competition Subcommittee of the American Bar Association Section of Taxation to congressional tax writing committees, countries such as France, Germany, Japan, and The Netherlands do not tax domestic parents on the earnings of their foreign marketing subsidiaries until such earnings are repatriated.

- It may result in double taxation in those countries which permit more rapid recovery of investment than the U.S., because the U.S. tax would precede the foreign creditable income tax by several years and the carryback period may be inadequate. Moreover, even if a longer carryback period were enacted, the acceleration of the U.S. tax would be a serious competitive disadvantage vis-a-vis foreign-owned competition.

- It would discriminate against shareholders of U.S. companies with foreign operations, as contrasted with domestic companies doing business only in the U.S., by accelerating the tax on unrealized income. This is poor policy because U.S. multinational companies have been and continue to be responsible for significant employment in the U.S. economy, much of which is generated by their foreign investments.

- It could harm the U.S. balance of payments. Earnings remitted to the U.S. have exceeded U.S. foreign direct investment and have been the most important single positive contribution to the U.S. balance of payments. The ability to freely reinvest earnings in foreign operations results in strengthening those operations and assuring the future repatriation of earnings. Accelerating tax on CFCs would greatly erode this advantage.

Acceleration of tax on CFCs is often justified by the belief that U.S. jobs will somehow be preserved if foreign subsidiaries are taxed currently. However, in reality, foreign operations of U.S. multinationals create rather than displace U.S. jobs, while also supporting our balance of payments and increasing U.S. exports. Foreign subsidiaries of U.S. companies play a critical role in boosting U.S. exports by marketing, distributing, and finishing American-made products in foreign markets. In 1996, U.S. multinational companies were involved in an astounding 65 percent of all U.S. merchandise export sales. And studies have shown that these exports support higher wage jobs in the United States.

U.S. firms establish operations abroad because of market requirements or marketing opportunities. For example, it is self-evident that those who seek natural resources must develop them in the geographical locations where they are found, or that those who provide time-sensitive information technology products and services must have a local presence. In addition, as a practical matter, local conditions normally dictate that U.S. corporations manufacture in the foreign country in order to enjoy foreign business opportunities. This process works in reverse: it has now become commonplace for foreign companies like BMW, Honda, Mercedes, and Toyota to set up manufacturing operations in the U.S. to serve the U.S. market. It is not just multinationals that benefit from trade. Many small- and medium-sized businesses in the U.S. either export themselves or supply goods and services to other export companies.

Moreover, CFCs generally are not in competition with U.S. manufacturing operations but rather with foreign-owned and foreign-based manufacturers. A very small percentage (less than 10% in 1994) of the total sales of American-owned foreign manufacturing subsidiaries are made to the U.S. Most imports come from sources other than foreign affiliates of U.S. firms. In addition, a decrease in foreign investment by U.S. companies would not result in an increase in U.S. investment, primarily because foreign investments are undertaken not as an alternative to domestic investment, but to supplement such investment.

There is a positive relationship between investment abroad and domestic expansion. Leading U.S. corporations operating both in the U.S. and abroad have expanded their U.S. employment, their domestic sales, their investments in the U.S., and their exports from the U.S. at substantially faster rates than industry generally. In a 1998 study entitled "Mainstay III: A Report on the Domestic Contributions of American Companies with Global Operations," and an earlier study from 1993 entitled "Mainstay II: A New Account of the Critical Role of U.S. Multinational Companies in the U.S. Economy," the Emergency Committee for American Trade ("ECAT") documented the importance to the U.S. economy of U.S. based multinational companies. The studies found that investments abroad by U.S. multinational companies provide a platform for the growth of exports and create jobs in the United States. (The full studies are available from The Emergency Committee for American Trade, 1211 Connecticut Avenue, Washington, DC 20036, phone (202) 659-5147).

Proposals to accelerate tax through the repeal of "deferral" are in marked contrast and conflict with over 50 years of bipartisan trade policy. The U.S. has long been committed to the removal of trade barriers and the promotion of international investment, most recently through the NAFTA and WTO agreements. Moreover, because of their political and strategic importance, foreign investments by U.S. companies have often been supported by the U.S. government. For example, participation by U.S. oil companies in the development of the Tengiz oil field in Kazakhstan has been praised as fostering the political independence of that newly formed nation, as

well as securing new sources of oil to Western nations, which are still heavily dependent on Middle Eastern imports.

CONCLUSION

Current U.S. international tax rules create many impediments that cause severe competitive disadvantages for U.S.-based multinationals. By contrast, the tax systems of other countries actually encourage our foreign-based competitors to be more competitive. It is time for Congress to improve our system to allow U.S. companies to compete more effectively, and to reject proposals that would create new impediments making it even more difficult and in some cases impossible to succeed in today's global business environment.

We thank you for the opportunity to provide our comments on this extremely important issue.

Statement of General Motors Corporation

General Motors is pleased to submit comments on simplification of the international tax system of the United States and how the system could be changed to make U.S. business more competitive in the global market place. We commend Chairman Houghton, Representative Levin and the other members who joined in the recent introduction of H.R. 2018, the International Simplification for American Competitiveness Act of 1999.

We believe the U.S. rules for taxing international income are unduly complex and, in many cases, inequitable. We believe that legislation is required to rationalize and simplify the international provisions of the U.S. tax law. Thus, we are pleased with the recent introduction of H.R. 2018 and this hearing by the Subcommittee which focuses attention on this important area of U.S. tax law.

The International Simplification Bill (H.R. 2018) contains important provisions which are a good start to making the tax rules more rational and workable and to remove some of the tax barriers currently faced by U.S.-based multinational companies. We would like to highlight three issues addressed in the bill that we at General Motors believe are particularly important.

ALLOCATION OF INTEREST EXPENSE (§ 309 OF H.R. 2018)

First, the bill includes a requirement that the Secretary of Treasury conduct a study of the rules for allocating U.S. interest expense of an affiliated group of companies between domestic and foreign-source income. We would like to see the bill go farther and actually include provisions that substantively fix the onerous interest allocation rules. In fact, GM strongly supports the Interest Allocation Reform Act, H.R. 2270, introduced recently by Congressmen Portman and Matsui which we believe is the right approach toward fixing the problem and should be included in any international tax reform legislation.

By way of background, the U.S. tax system currently requires U.S. interest expense of U.S. multinational companies to be apportioned to foreign-source income for purposes of determining the amount of foreign tax credits that may be claimed. This apportionment of interest expense reduces the taxpayer's foreign-source income and thereby restricts its capacity to utilize foreign tax credits. This effectively results in an amount of income equal to the apportioned interest expense being taxed in the United States with no offsetting credit for foreign taxes. Another way of looking at it is that, in this circumstance, there is effectively no U.S. tax deduction for this apportioned interest expense. And, of course, there is no deduction for this amount in any foreign country. The result is double taxation.

The interest allocation rules put U.S. companies at a competitive disadvantage in both foreign markets and in the United States. An investment by a U.S. company in a foreign market results in an additional allocation of U.S. interest expense with the consequent double taxation. However, foreign-based companies competing in that foreign market are not faced with losing any part of related interest expense deductions in their home country. We are not aware of any foreign competitor being subjected to as harsh a tax regime on its interest expense as a U.S.-based company.

The interest allocation rules also discourage investments by U.S. businesses to enhance their domestic competitiveness vis-a-vis foreign competition in the United States. An expansion by a U.S.-based multinational of operations in the U.S. through the use of debt results in the apportioning of additional interest expense against foreign-source income and an increased U.S. tax liability. GM itself experi-

enced this in its creation of Saturn Corporation, (which, in a twist of irony, was conceived as an import-fighting line of small cars). GM incurred debt in the U.S. to finance the construction of Saturn facilities in Spring Hill, Tennessee. A portion of the interest on that debt was allocated to foreign-source income, and in effect a current deduction for some of that interest was lost. By contrast, foreign-owned competitors who were constructing new U.S. plants at about the same time could finance them with U.S. borrowings and get the full U.S. tax benefit from this interest expense, as they were unlikely to have any foreign-source income or foreign assets. Thus, under current interest allocation rules, U.S. companies can't even compete on a level playing field when they're the home team!

Another problem with the interest allocation rules arises in the case of "subgroups" of U.S.-affiliated companies. By way of example, GM has a wholly-owned domestic subsidiary, GMAC, whose principal business is to provide financing to GM dealers and customers who buy or lease GM motor vehicles in the United States. GMAC borrows on the basis of its own credit and uses the proceeds in its own operations. Yet under current tax rules, GMAC's interest expense must be lumped together with all GM's U.S. affiliates in making the allocation. This has the effect of over-allocating U.S. interest expense to foreign-source income.

The Portman-Matsui bill (H.R. 2270) would substantially correct the adverse effect of these rules by taking into account as an offset the interest expense incurred by foreign affiliates, thus reducing the amount of U.S. interest expense allocated to foreign-source income. Also, it would allow an election to make a separate allocation computation in certain circumstances for subgroups of U.S. affiliates, including financial services subgroups, such as GMAC.

RECHARACTERIZATION OF OVERALL DOMESTIC LOSS (§202 OF H.R. 2018)

The second provision in H.R. 2018 which we would like to mention is the one which would recharacterize an overall domestic loss in a year as foreign-source income in subsequent years to prevent permanent double taxation.

Under current tax law, a U.S. taxpayer experiencing an overall loss on its domestic operations must offset that loss against its foreign-source income. Today, this *permanently* reduces the capacity of the taxpayer to claim foreign tax credits and can result in double taxation. The proposal would in effect convert this to a *timing difference* by recharacterizing certain future domestic income as "foreign-source," and thus, restore the taxpayer's capacity to claim foreign tax credits in later years.

The tax law already requires that when *foreign loss* exceeds domestic income the overall foreign loss amount is recaptured in subsequent years by recharacterizing similar amounts of foreign income as "domestic income." Thus, the current proposal appropriately adds important and needed symmetry and fairness to present law. This would eliminate a "trap" in the current foreign tax credit rules for the unfortunate company that incurs domestic losses.

With our current robust economy, people do not want to think these days about such problems as economic downturns or tax losses. But, for a company such as GM which is in an economically cyclical industry, and which in the past has been adversely impacted by such things as work stoppages and oil embargoes, the possibility of tax losses can never be totally dismissed. And with the economy now "running on full," there couldn't be a better time to fix tax problems related to tax losses, i.e., when the revenue cost would be minimized.

PERMANENT SUBPART F EXEMPTION FOR ACTIVE FINANCING INCOME (§101 OF H.R. 2018)

Prior to 1998, the earnings of foreign subsidiaries which carried on an active financial services business in a foreign country were subject to U.S. tax even though the earnings were not distributed to the U.S. parent. That problem was alleviated temporarily through legislation which excludes such active business income from current U.S. taxation. However, that temporary relief expires at the end of this year and needs to be made permanent. This important provision allows U.S.-owned foreign finance companies, including foreign subsidiaries of GMAC, to compete on an equal footing with their foreign-based financing competitors. GM strongly supports making this rule permanent.

In closing, General Motors again commends the Subcommittee for its consideration of the U.S. international tax provisions. We urge the Subcommittee in its review to give particular attention to remedying the interest allocation rules along the lines proposed in H.R. 2270. This is the single most important reform that's needed in the international area. In addition, permitting domestic loss recharacterization and extending the subpart F exception for active financing income are very badly needed provisions.

Statement of Howard P. Goldberg, Assistant Director, Taxation, Mileage Award Tax Committee, International Air Transport Association, Montreal, Quebec, Canada

Mr. Chairman, Members of the Committee, on behalf of the IATA Mileage Award Tax Committee, the International Air Transport Association (IATA) appreciates the opportunity to submit these written comments on the complexity of the current U.S. international tax regime.¹ As part of the 1997 amendments, section 4261(e)(3) imposed an excise tax on an airline's sale of frequent flyer miles to third party vendors like hotels, car rental agencies and credit card companies (the "mileage credit excise tax"). The tax is imposed on purchasers but is required to be collected by the selling airline.

Amendments made in 1997 to the aviation ticket tax rules of the Internal Revenue Code have increased both the complexity and the uncertainty regarding the application of excise taxes to international aviation. For example, it has been argued that the mileage credit tax might apply to a sale of miles from a foreign airline to a foreign hotel which provides those miles to its foreign hotel guests. Application of the tax in that situation, however, would be an infringement of the tax prerogatives of other sovereign nations. Such an infringement could lead to reciprocating tax regimes in foreign countries seeking to tax a U.S. carrier's sale of frequent flyer miles to U.S. hotels, credit card companies and car rental agencies.

Diplomatic Notes. Some twenty foreign countries have submitted diplomatic notes to the Department of State and to Congress protesting any interpretation that would impose the mileage credit on an extraterritorial basis. The United States has been requested to confirm that such tax would not be imposed on non-U.S. commerce or in contravention of the U.S.'s obligations under its treaties, international agreements or international law.

An Unfair User Fee. Section 4261(e)(3) cannot fairly be read to apply on an extraterritorial basis to sales of frequent flyer miles by foreign airlines. The aviation ticket taxes, including the mileage credit tax, are user fees which are dedicated to support the operation of the U.S. aviation infrastructure and are imposed based on a fair approximation of the use of U.S. aviation infrastructure. See, H.R. Rep. No. 91-601, at 41 (1970); and S. Rep. No. 91-706, at 11 (1970) (both directing the Department of Transportation to prepare a report on the aviation user fees "in order to insure an equitable distribution of future tax burdens among the various categories of airport and airway users as well as other persons deriving benefits from the aviation system"). The 1997 amendments to the aviation ticket tax, including section 4261(e)(3), were intended to improve the fairness of the aviation ticket taxes by expanding the taxation of currently untaxed payments to the extent that such payments benefit from the U.S. aviation infrastructure. H.R. Rep. No. 105-148, at 482-483.² Payments by foreign vendors, for example, to participate in a foreign airline's frequent flyer program do not have an immediate or ascertainable impact on or derive a quantifiable benefit from the U.S. aviation infrastructure. Imposing the mileage credit tax on such payments would be an unfair application of the aviation ticket taxes and would not be based on or correlate to any benefit derived from the U.S. aviation infrastructure.

Extraterritorial Application Would Violate U.S. Obligations. In addition, any extraterritorial application of the mileage credit excise tax would violate inter-

¹The International Air Transport Association (IATA) is a worldwide association comprised of 263 member airlines. The members of IATA carry the bulk of the world's scheduled international and domestic air transportation under the flags of some 150 nations. The stated purposes of IATA include the promotion of safe, regular and economical air transport for the benefit of the peoples of the world and the fostering of international air commerce. All non-U.S. IATA member airlines have been established under the laws of their respective countries and many are duly designated and licensed to provide international transportation of passengers, cargo and mail to and from points in the United States. The IATA members who comprise the IATA Mileage Award Tax Committee are Aer Lingus, Aerolineas Argentina, Air Canada, Air France, Air New Zealand, Alitalia, British Airways, CSA Czech Airlines, Finnair, Iberia Airlines, Japan Airlines, KLM Royal Dutch Airlines, Lufthansa German Airlines, Qantas Airways, Sabena World Airlines, Swissair, Thai Airways, Turkish Airways, and Varig.

²The House Report states: "the Committee determined that the perceived fairness of the passenger air transportation excise taxes will be improved if certain currently untaxed payments and passengers were required to contribute to the financing of the FAA programs from which they benefit. In furtherance of this goal, the bill extends the tax to internationally arriving passengers and clarifies that the tax applies to payments to airlines (and related parties) from credit card and other companies in exchange for the right to award frequent flyer or other reduced air travel rights."

national agreements to which the United States is a party and would be inconsistent with principles of international law. The relationship of payments by vendors to foreign airlines for miles that ultimately might or might not be used for U.S. air transportation does not satisfy the just and reasonable requirements for user fees under international agreements to which the United States is party, or the norms of international law for excise taxation.

The United States is party to numerous bilateral aviation agreements under which it has agreed that neither state may impose user fees on transactions that do not reasonably relate to a state's expenditures for the provision of aviation facilities. The United States has agreed under its bilateral aviation agreements that each state's airlines shall have fair and equal rights to compete in providing international air transportation. *E.g.*, Air Transport Agreement of Jan. 17, 1966, as amended Feb. 24, 1995, U.S.-Can., arts. 4, 8.³ In order to respect the bilateral aviation agreements, the mileage credit excise ticket tax cannot apply on an extraterritorial basis to payments made by a vendor to participate in a foreign airline's frequent flyer program.

Under U.S. law, U.S. statutes are presumed and interpreted not to violate international law. *Murray v. The Schooner Charming Betsy*, 6 U.S. (2 Cranch) 64, 118 (1804). International law prohibits excise taxes on transactions that do not occur, originate or terminate in or have substantial relation to the state imposing the tax. *Restatement (Third) of Foreign Relations Law of the United States*, §412(4). Payments by a foreign vendor, for example, to participate in a foreign airline's frequent-flyer program do not have a substantial relationship to the United States and do not occur, originate or terminate in the United States. Application of the mileage credit tax on an extraterritorial basis to a foreign airline's sale of frequent flyer miles would be inconsistent with international law.

As a matter of tax policy and international law, U.S. tax laws should not be applied on an extraterritorial basis to non-U.S. commerce.

Thank you very much for your consideration of this matter.

Statement of the Investment Company Institute

The Investment Company Institute (the "Institute")¹ urges the Committee to enhance the international competitiveness of U.S. mutual funds, treated for federal tax purposes as "regulated investment companies" or "RICs," by enacting legislation that would treat certain interest income and short-term capital gains as exempt from U.S. withholding tax when distributed by U.S. funds to foreign investors.² The proposed change merely would provide foreign investors in U.S. funds with the same treatment available today when comparable investments are made either directly or through foreign funds.

I. The U.S. Fund Industry is the Global Leader. Individuals around the world increasingly are turning to mutual funds to meet their diverse investment needs. Worldwide mutual fund assets have increased from \$2.4 trillion at the end of 1990 to \$7.6 trillion as of September 30, 1998. This growth in mutual fund assets is expected to continue as the middle class continues to expand around the world and baby boomers enter their peak savings years.

U.S. mutual funds offer numerous advantages. Foreign investors may buy U.S. funds for professional portfolio management, diversification and liquidity. Investor confidence in our funds is strong because of the significant shareholder safeguards provided by the U.S. securities laws. Investors also value the convenient shareholder services provided by U.S. funds.

Nevertheless, while the U.S. fund industry is the global leader, foreign investment in U.S. funds is low. Today, less than one percent of all U.S. fund assets are held by non-U.S. investors.

³Article 4(1) of the U.S.-Canada Air Transport Agreement states: "[e]ach Party shall allow a fair and equal opportunity for the designated airlines of both Parties to compete in providing the international air transportation governed by this Agreement." Articles 8(A) and 8(B) require user charges to be "just and reasonable" and "just, reasonable, not unjustly discriminatory, and equitably apportioned among categories of users."

¹The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,576 open-end investment companies ("mutual funds"), 479 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about \$5.860 trillion, accounting for approximately 95% of total industry assets, and have over 73 million individual shareholders.

²The U.S. statutory withholding tax rate imposed on non-exempt income paid to foreign investors is 30 percent. U.S. income tax treaties typically reduce the withholding tax rate to 15 percent.

II. U.S. Tax Policy Encourages Foreign Investment in the U.S. Capital Markets. Pursuant to U.S. tax policy designed to encourage foreign portfolio investment³ in the U.S. capital markets, U.S. tax law provides foreign investors with several U.S. withholding tax exemptions. U.S. withholding tax generally does not apply, for example, to capital gains realized by foreign investors on their portfolio investments in U.S. debt and equity securities. Likewise, U.S. withholding tax generally does not apply to U.S. source interest paid to foreign investors with respect to “portfolio interest obligations” and certain other debt instruments. Consequently, foreign portfolio investment in U.S. debt instruments generally is exempt from U.S. withholding tax; with respect to portfolio investment in U.S. equity securities, U.S. withholding tax generally is imposed only on dividends.

III. U.S. Tax Law, However, Inadvertently Encourages Foreigners to Prefer Foreign Funds Over U.S. Funds. Regrettably, the incentives to encourage foreign portfolio investment are of only limited applicability when investments in U.S. securities are made through a U.S. fund. Under U.S. tax law, a U.S. fund’s distributions are treated as “dividends” subject to U.S. withholding tax unless a special “designation” provision allows the fund to “flow through” the character of its income to investors. Of importance to foreign investors, a U.S. fund may designate a distribution of long-term gain to its shareholders as a “capital gain dividend” exempt from U.S. withholding tax.

For certain other types of distributions, however, foreign investors are placed at a U.S. tax disadvantage. In particular, interest income and short-term capital gains, which otherwise would be exempt from U.S. withholding tax when received by foreign investors either directly or through a foreign fund, are subject to U.S. withholding tax when distributed by a U.S. fund to these investors.

IV. Congress Should Enact Legislation Eliminating U.S. Tax Barriers to Foreign Investment In U.S. Funds. The Institute urges the Committee to support the enactment of H.R. 2430,⁴ which generally would permit all U.S. funds to preserve, for withholding tax purposes, the character of short-term gains and interest income distributed to foreign investors.⁵ For these purposes, U.S.-source interest and foreign-source interest that is free from foreign withholding tax under the domestic tax laws of the source country (such as interest from “Eurobonds”)⁶ would be eligible for flow-through treatment. The legislation, however, would deny flow-through treatment for interest from any foreign bond on which the source-country tax rate is reduced pursuant to a tax treaty with the United States.

The Institute fully supports H.R. 2430 because it would eliminate the U.S. withholding tax barrier to foreign investment in U.S. funds, while containing appropriate safeguards to ensure that (1) flow-through treatment applies only to interest income and gains that would be exempt from U.S. withholding tax if received by a foreign investor directly or through a foreign fund and (2) foreign investors cannot avoid otherwise-applicable foreign tax by investing in U.S. funds that qualify for treaty benefits under the U.S. income tax treaty network.

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The Institute urges the enactment of legislation to make the full panoply of U.S. funds—equity, balanced and bond funds—available to foreign investors without adverse U.S. withholding tax treatment. Absent this change, foreign investors seeking to enter the U.S. capital markets or obtain access to U.S. professional portfolio management will continue to have a significant U.S. tax incentive *not* to invest in U.S. funds.

**Statement of Richard G. Palaschak, Director of Operations, Munitions
Industrial Base Task Force, Arlington, VA**

Mr. Chairman and Members of the Subcommittee, thank you for providing this opportunity to submit a statement for consideration by the Committee. This statement is offered on behalf of the fourteen companies in the munitions business that

³“Portfolio investment” typically refers to a less than 10 percent interest in the debt or equity securities of an issuer, which interest is not “effectively” connected to a U.S. trade or business of the investor.

⁴Introduced by Representatives Crane, Dunn and McDermott as the “Investment Competitive-ness Act of 1999.”

⁵The taxation of U.S. investors in U.S. funds would not be affected by these proposals.

⁶“Eurobonds” are corporate or government bonds denominated in a currency other than the national currency of the issuer, including U.S. dollars. Eurobonds are an important source of capital for multinational companies.

are members of the Munitions Industrial Base Task Force (MIBTF). The member companies are: Aerojet General Corp.; Alliant Techsystems, Inc.; Armtec Defense Products Co.; Bulova Technologies, Inc.; Chamberlain Manufacturing; Day & Zimmermann, Inc.; General Dynamics Ordnance Systems, Inc.; KDI Precision Products, Inc.; Mason & Hanger Co., Inc.; Primex; Talley Defense Systems, Inc.; Textron Systems; Thiokol Corp.; Valentec International Corp.

In May and June 1993, executives from a cross section of the nation's private munitions companies and its arsenal operators met and concluded that they were in the middle of an unplanned free-fall in munitions funding which would, if not reversed, cause the destruction of the United States munitions industrial base. This conclusion led to the formation of the Munitions Industrial Base Task Force, a non-profit organization representing the nation's munitions developers and producers, and to an intense effort to quantify the crisis and communicate its dimensions to decision-makers in the administration and the Congress. Task Force membership represents many of the major munitions prime contractors, as well as a cross section of subcontractors and suppliers. We manage both government-owned facilities as well as those owned solely by the private sector. The Task Force does not advocate specific programs on behalf of any of its members. Its sole purpose is to pursue a common goal:

Adequate funding and policies to sustain a responsive, capable U.S. munitions industrial base to develop, produce, and support superior munitions for the U.S. and its allies.

Throughout its existence our member companies have worked in cooperation with the DOD's Single Manager for Conventional Ammunition (SMCA) and other DOD and service ammunition oriented organizations to preserve threatened portions of the munitions production and design base. Let me emphasize that our purpose is not to ensure the survival of individual companies, but to ensure the survival of those threatened research, development, and production capabilities, and the associated skilled workforce, somewhere within the U.S. domestic industrial base. Mr. Chairman, our organization was formed because the munitions portion of the Department of Defense (DOD) budget declined by nearly 80% between fiscal year 1985 and fiscal year 1994. This precipitous funding decline seriously damaged the U.S. munitions industrial base and compromised its viability as well as its ability to support the national security strategy. The U.S. munitions base lost nearly 70% of its major munitions companies during this period. It is estimated that the base also lost thousands of second/third tier subcontractors. Thanks to actions taken by the DOD and the Congress, this decline has been stopped, but even the most recent assessment of the munitions industrial base by the Army Materiel Command (AMC) still characterizes the base as "weak."

This situation is exacerbated by the unfair and discriminatory provision contained in Section 923(a)(5) of the Internal Revenue Code which reduces the Foreign Sales Corporation (FSC) benefits available to companies that sell defense materiel to foreign countries to 50 percent of that available to other exports. As the surviving companies struggle to remain viable, the international marketplace affords them an opportunity to supplement the U.S. domestic production needs and, thereby, sustain their workforce and maintain an available industrial capability to sustain our armed forces with ammunition or replenish expenditures of ammunition by our forces after a conflict. However, the sale of munitions overseas is one of this nation's most tightly regulated areas. In several instances, U.S. weapons have been provided or sold to friendly countries but the sale of the associated U.S. munitions has been disapproved. Even when regulators approve the sale of an item, U.S. munitions manufacturers are faced with a growing array of foreign competitors, many of whom are not only financially supported by their government, but also supported by their government's tax and procurement policies. Rare is the country that has no capability for munitions manufacturing, and many developed countries market, produce, and sell very competitive products. In fact, the U.S. itself has procured numerous foreign designed munitions that are in today's service inventories. These countries have sustained their indigenous munitions manufacturing capability, in the face of declining domestic defense budgets, by emphasizing exports. Many of them subsidize their munitions companies, restrict their own munitions procurements to domestic sources, help indigenous munitions companies market their products, and forgive Value Added Taxes for munitions exports. The current FSC provision places U.S. munitions companies at a serious disadvantage when they compete in this environment.

In addition, the current FSC provision is a significant handicap to U.S. companies because of today's budget reality. In the past U.S. munitions companies could often overcome the FSC penalty imposed on munitions exports because of the large pro-

duction requirements of the U.S. military. Economies of scale could sometimes offset that penalty as well as the advantages that foreign governments provided to their domestic manufacturers. That situation no longer exists.

While the size of the U.S. military has been reduced by about a third, the munitions war reserve requirements of the U.S. military have plummeted by over 80% (in terms of tonnage) during the past decade. Concurrently, the requirements for training ammunition have been dramatically reduced by the innovative use of simulators and other changes instituted by the services. The net result has been smaller production runs or no production at all. Consequently, U.S. munitions companies lost one of the few offsets to the fierce foreign government supported competition that exists today for the international sale of munitions to countries approved by the U.S. government. Removal of the FSC tax penalty against the export of defense materiel will help level the international playing field and, in the process, help preserve a U.S. industrial capability that is absolutely essential to the conduct of successful warfare in support of the nation's national security strategy.

We, the members of the Munitions Industrial Base Task Force, urge the Congress to repeal the FSC penalty on the export of defense products in order to provide a fair and equivalent treatment to our nation's defense industry and its workers, and to improve our industry's competitiveness in the international marketplace. The repeal of this provision is particularly vital to the U.S. munitions industrial base because of its unique circumstances as detailed above. This action is not only in the best interests of the U.S. defense industry and its workforce, but also in the best interests of the nation in ensuring a capable, viable, and enduring U.S. industrial base to support American armed forces in the future.

Statement of Lawrence F. Skibbie, President, National Defense Industrial Association, Arlington, VA

Mr. Chairman, Members of the Subcommittee, I am Larry Skibbie, president of the National Defense Industrial Association (NDIA). On behalf of NDIA, I want to compliment you for holding this important hearing and to express our appreciation for the opportunity to provide this statement.

NDIA is the largest defense-related association dedicated to the viability of the technology and industrial base. Our 24,000 individual Members and nearly 900 Member companies, which employ the preponderance of the two million men and women in the defense sector and represent the full spectrum of the base, are vitally interested in maintaining a strong, responsive national security infrastructure.

A little background is in order so that the Subcommittee has the full appreciation of both NDIA'S position and the current U.S. International Tax Regime's adverse impact on the defense sector.

Currently, the Internal Revenue Code allows U.S. exporters to establish Foreign Sales Corporations (FSC) under which they can exempt from U.S. taxation a portion of their earnings from foreign sales. Enacted in 1976, this provision was intended to help U.S. firms compete against companies in other countries which rely more on value-added taxes (VATS) than on corporate income taxes. Generally, VATS on products are rebated as they are exported.

For U.S. exporters of defense products, however, the FSC tax incentive is reduced by 50 percent. Specifically, section 923(A)(5) of the Internal Revenue Code reduces the tax exemption available to companies which export defense products to 50 percent of the benefits available to other exporters. Initially, the limitation of section 923 was based on the premise that military products are not sold in competitive market environments, therefore the FSC incentive is unnecessary for defense exporters.

However, examination of today's market environment argues heavily against the original premise. Competition among defense exporting countries is intense and likely to intensify as budgets continue to be reduced. The United States faces increased European export promotion incentives, and Russia has become a major exporter in world markets. In addition, the U.S. Government prohibits the sale of defense products to certain countries and requires advanced approval of all sales.

There is no valid economic or policy basis for continuing the discriminatory treatment that U.S. defense exporters face. NDIA is strongly opposed to such treatment and supports the repeal of section 923(A)(5), of the Internal Revenue Code. Moreover, repeal of section 923 will not impact foreign policy objectives of the United States. The same checks and balances will remain in place and sales of defense exports will continue to be subject to existing policy dictates and review processes.

Therefore, NDIA strongly supports restoring Foreign Sales Corporation (FSC) tax benefits for defense products to full comparability with other U.S. exports. The FSC limitation for defense exports hampers the ability of U.S. companies to compete effectively abroad with many of their products. The FSC program was enacted to promote trade, which is fundamental to our economic health. Discriminating against the defense industry only contributes to our trade imbalance, reduces employment stability in the defense sector and allows competitors to capture business that would likely go to U.S. firms.

Recently, Chairman Houghton and Representative Sander Levin introduced H.R. 2018, the international tax simplification for American competitiveness act of 1999. Section 303 of the bill represents a step toward rectifying a major tax inequity for U.S. defense exports. This Omnibus bill seeks to simplify certain international taxation rules for U.S. businesses operating abroad. Specifically, Section 303 repeals IRC Section 923(a)(5), which reduces the FSC benefits available to companies that sell military goods abroad to 50 percent of the benefits available to other exporters.

NDIA supports a strong, viable and competitive U.S. defense industrial base that contributes to our overall national and economic security. Unfortunately, the defense industry is hindered by the enactment and maintenance of tax laws based on outdated premises which represent serious barriers to our international competitiveness. These impediments, such as section 923(A)(5), should be dismantled as quickly as possible. Therefore, prompt repeal of section 923(A)(5) is in order.

Mr. Chairman, Members of the Subcommittee, thank you again for permitting NDIA this opportunity to submit this statement.

TROPICAL SHIPPING
RIVIERA BEACH, FL,
July 6, 1999.

The Honorable A.L. Singleton
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C.

Re: June 22, 1999 Oversight Subcommittee Hearing on Current U.S. International Tax Regime

Dear Mr. Singleton:

The U.S. international tax regime is forcing the U.S.-owned fleet to expatriate to remain competitive. An unintended result of the 1986 and 1975 tax law changes has been the near complete removal of U.S. investment from the Ocean Shipping industry leaving the cargo trades of the United States almost entirely in the hands of foreign-owned and foreign-controlled shipping companies. Overall, U.S. ownership of the world fleet has declined from 25% of world tonnage in 1975 when Congress enacted the first tax code change affecting shipping, to less than 5% today!

This unintended consequence has profound implications for the United States, as international trade and commerce of goods have historically been influenced by the national interests of the country of ultimate ship ownership.

Tropical Shipping is a U.S.-owned container shipping company (CFC) with a business focus on serving the Caribbean, the only region in the world in which the United States has a balance of trade surplus. The exports to this region create numerous jobs throughout the U.S. agricultural and manufacturing sectors as well as our own company's employment of over 500 people in the U.S.

The existence of the U.S. balance of trade surplus with the Caribbean is no coincidence. This region is the last area in the world where U.S.-owned shipping companies dominate the carriage of general cargo and this contributes to the success and promotion of U.S. exports. Our company, and our U.S.-owned competitors, are active every day, putting Caribbean buyers in touch with U.S. exporters as this is beneficial for Tropical Shipping's long term interests.

Our tax laws force U.S. companies to become acquired by foreigners because these countries have adopted tax policies to ensure that their international shipping is competitive in world markets. The U.S. international tax system puts U.S. corporations and their employees at a competitive disadvantage. Our foreign-owned competitors have a great advantage in their accumulation of capital, as they are not taxed on a current basis and generally only pay tax when the dividends are repatriated. It is inevitable that sales of U.S. companies to foreigners or mergers of U.S.

companies with foreign companies will leave the resulting entity headquartered overseas. Because of the adverse consequences resulting under the current foreign tax system, U.S. shipping companies are being forced out of the growing world market.

Buying and operating ships is capital intensive. U.S. owners in this capital intensive and very competitive shipping industry, have sold out, gone out of business, and not invested in shipping because they just cannot compete due to the unintended consequences of the overly complex U.S. international tax regime. It is simply this regime that places U.S. owners at a distinct disadvantage in the global commerce of ocean transportation. U.S. owners can compete in all other respects.

This tax system is contributing to the de-Americanization of U.S. industry because the U.S.-owned fleet is forced to expatriate to remain competitive. In the containerized shipping industry, U.S.-owned participation in the carriage of U.S. trade has steadily declined to an all time low of 14.2% of the container trade in 1988. The decline is not in the economic interest of the United States and weakens U.S. exports contributing to fewer U.S.-based jobs. It will be a sad day indeed if all the ocean commerce created in the growing market of the Americas as a result of NAFTA and the FTAA ends up benefiting foreign owners with no chance for U.S. investors to participate.

Please correct the tax code, by reinstating the deferral of foreign-based company shipping income, so that the U.S. shipping industry is placed in a position of global competitiveness, rather than a competitive disadvantage. H.R. 265, introduced by Congressman Shaw and co-sponsored by Congressman Jefferson, is an important response to this problem.

Sincerely yours,

RICHARD MURRELL
President and CEO

Statement of LaBrenda Garrett-Nelson, and Robert J. Leonard, Washington Counsel, P.C.

Washington Counsel, P.C. is a law firm based in the District of Columbia that represents a variety of clients on tax legislative and policy issues.

INTRODUCTION

The provisions that make up the U.S. international tax regime rank among the most complex provisions in the Code. This statement discusses section 308 of the International Tax Simplification for American Competitiveness Act of 1999 (H.R. 2018), a proposal to reduce complexity in this area by repealing the little used regime for export trade corporations ("ETCs"). The ETC rules were enacted in 1962 to provide a special export incentive in the form of deferral of U.S. tax on export trade income. The rationale for the proposed repeal is that the special regime for ETCs was, effectively, repealed by the 1986 enactment of the passive foreign investment company ("PFIC") rules. At the same time, the proposal would provide appropriate (and prospective) transition relief for ETCs that were caught in a bind created by enactment of the PFIC regime.

I. The Overlap Between the ETC Regime and the PFIC Rules Effectively Nullified the ETC Rules For Many Corporations

Although the PFIC rules were originally targeted at foreign mutual funds, the Congress has recognized that the scope of the PFIC statute was too broad. Thus, for example, the Taxpayer Relief Act of 1997 eliminated the overlap between the PFIC rules and the subpart F regime for controlled foreign corporations. Similarly, in the 1996 Small Business Jobs Protection Act, the Congress enacted a technical correction to clarify that an ETC is excluded from the definition of a PFIC.

The 1996 technical correction came too late, however, for ETCs that took the reasonable step of making "protective" distributions during the ten-year period between the creation of the uncertainty caused by enactment of the PFIC regime and the passage of the 1996 technical correction. Although U.S. tax on distributed earnings would have been deferred but for the ETC/PFIC overlap, these ETCs made distributions out of necessity to protect against the accumulation of large potential tax liabilities under the PFIC rules. Thus, the PFIC rules, in effect, repealed the ETC regime.

II. Congressional Precedents for Providing Transition Relief for ETCs

The proposal would simplify the foreign provisions of the tax code by repealing the ETC regime. When the Congress enacted the Domestic International Sales Company (“DISC”) rules in 1971, and again when those rules were replaced with the Foreign Sales Corporation (“FSC”) rules in 1984, existing ETCs were authorized to remain in operation. Moreover, ETCs that chose to terminate pursuant to the 1984 enactment of the FSC regime were permitted to repatriate their undistributed export trade income as nontaxable previously taxed income (or “PTI”).

The Proposal also provides a mechanism for providing prospective relief to ETCs that were caught in the bind created by the PFIC rules. Consistent with the transition rule made available in the 1984 FSC legislation, the proposal would grant prospective relief to ETCs that made protective distributions after the 1986 enactment of the PFIC rules. Essentially, future (actual or deemed) distributions would be treated as derived from PTI, to the extent that pre-enactment distributions of export trade income were included in a U.S. shareholder’s gross income as a dividend. Note that the proposed transition relief would provide only “rough justice,” because taxes have already been paid but the proposed relief will occur over time.

CONCLUSION

Repeal of the ETC provisions would greatly simplify the international tax provisions of the Code, but such a repeal should be accompanied by relief for ETCs that were caught in the bind created by the PFIC rules.

Statement of LaBrenda Garrett-Nelson, Washington Counsel, P.C., on behalf of the Ad Hoc Coalition of Finance and Credit Companies

Section 101 of the International Tax Simplification for American Competitiveness Act of 1999 (H.R. 2018) highlights the need to extend the provision that grants active financial services companies an exception from subpart F. In light of the growing interdependence and integration of world financial markets, coupled with the international expansion of U.S.-based financial services entities, the foreign activities of the financial services industry should be eligible for deferral on terms comparable to that of manufacturing and other non-financial businesses. This statement was prepared on behalf of an ad hoc coalition of leading finance and credit companies whose activities fall within the catch-all concept of a “financing or similar business.”

The ad hoc coalition of finance and credit companies includes entities providing a full range of financing, leasing, and credit services to consumers and other unrelated businesses, including the financing of third-party purchases of products manufactured by affiliates (collectively referred to as “Finance and Credit Companies”). This statement describes (1) the ordinary business transactions conducted by Finance and Credit Companies, including information regarding the unique role these companies play in expanding U.S. international trade, and (2) the importance of the active financing exception to subpart F to the international competitiveness of these companies.

I. THE INTERNATIONAL OPERATIONS OF U.S.-BASED FINANCE AND CREDIT COMPANIES

A. Finance and Credit Companies Conduct Active Financial Services Businesses

Finance and Credit Companies are financial intermediaries that borrow to engage in all the activities in which banks customarily engage when issuing and servicing a loan or entering into other financial transactions. Indeed, many countries (e.g., Germany, Austria, and France) actually require that such a company be chartered as a regulated bank. For example, one member of the ad hoc group has a European Finance and Credit Company that is regulated by the Bank of England and, under the European Union (“EU”) Second Banking Coordination Directive, operates in branch form in Austria, France, and a number of other EU jurisdictions. The principal difference between a typical bank and a Finance and Credit Company is that banks normally borrow through retail or other forms of regulated deposits, while Finance and Credit Companies borrow from the public market through commercial paper or other publicly issued debt instruments. In some cases, Finance and Credit Companies operating as regulated banks are required to take deposits, although they may not rely on such deposits as a primary source of funding. In every important respect, Finance and Credit Companies compete directly with banks to provide loan and lease financing to retail and wholesale consumers.

B. A Finance and Credit Company's Activities Include A Full Range Of Financial Services.

The active financial services income derived by a Finance and Credit Company includes income from financing purchases from third parties; making personal, mortgage, industrial or other loans; factoring; providing credit card services; and hedging interest rate and currency risks with respect to active financial services income. As an alternative to traditional lending, leasing has developed into a common means of financing acquisitions of fixed assets, and is growing at double digit rates in international markets. These activities include a full range of financial services across a broad customer base and can be summarized as follows:

- **Specialized Financing:** Loans and leases for major capital assets, including aircraft, industrial facilities and equipment and energy-related facilities; commercial and residential real estate loans and investments; loans to and investments in management buyouts and corporate recapitalizations.
- **Consumer Services:** Private label and bank credit card loans; merchant acquisition, card issuance, and financing of card receivables; time sales and revolving credit and inventory financing for retail merchants; auto leasing and lending and inventory financing; and mortgage servicing.
- **Equipment Management:** Leases, loans and asset management services for portfolios of commercial and transportation equipment, including aircraft, trailers, auto fleets, modular space units, railroad rolling stock, data processing equipment, telecommunications equipment, ocean-going containers, and satellites.
- **Mid-Market Financing:** Loans and financing and operating leases for middle-market customers, including manufacturers, vendors, distributors, and end-users, for a variety of equipment, such as computers, data processing equipment, medical and diagnostic equipment, and equipment used in construction, manufacturing, office applications, and telecommunications activities.

Each of the financial services described above is widely and routinely offered by foreign-owned finance companies in direct competition with Finance and Credit Companies.

C. Finance and Credit Companies Are Located In The Major Markets In Which They Conduct Business And Compete Head-on Against "Name Brand" Local Competitors.

Finance and Credit Companies provide services to foreign customers or U.S. customers conducting business in foreign markets. The customer base for Finance and Credit Companies is widely dispersed; indeed, a large Finance and Credit Company may have a single customer that itself operates in numerous jurisdictions. As explained more fully below, rather than operating out of regional, financial centers (such as London or Hong Kong), Finance and Credit Companies must operate in a large number of countries to compete effectively for international business and provide local financing support for foreign offices of U.S. multinational vendors. One Finance and Credit Company affiliated with a U.S. auto maker, for example, provide services to customers in Australia, India, Korea, Germany, the U.K., France, Italy, Belgium, China, Japan, Indonesia, Mexico, and Brazil, among other countries. Another member of the ad hoc coalition conducts business through Finance and Credit Companies in virtually all the major European countries, in addition to maintaining headquarters in Hong Kong, Europe, India, Japan, and Mexico. Yet another member of the ad hoc coalition currently has offices that provide local leasing and financing products in 22 countries.

Finance and Credit Companies are legally established, capitalized, operated, and managed locally, as either branches or separate entities, for the business, regulatory, and legal reasons outlined below:

1. *Marketing and supervising loans and leases generally require a local presence.* The provision of financial services to foreign consumers requires a Finance and Credit Company to have a substantial local presence—to establish and maintain a “brand name,” develop a marketing network, and provide pre-market and after-market services to customers. A Finance and Credit Company must be close to its customers to keep abreast of local business conditions and competitive practices. Finance and Credit Companies analyze the creditworthiness of potential customers, administer and collect loans, process payments, and borrow money to fund loans. Inevitably, some customers have trouble meeting obligations. Such cases demand a local presence to work with customers to ensure payment and, where necessary, to terminate the contract and repossess the asset securing the obligation. These active functions require local employees to insure the proper execution of the Finance and Credit Company's core business activities—indeed, a single member of the ad hoc group has approximately 15,000 employees in Europe. From a business perspective, it would be almost impossible to perform these functions outside a country of oper-

ation and still generate a reasonable return on the investment. “Paper companies” acting through computer networks would not serve these local business requirements.

In certain cases, a business operation and the employees whose efforts support that operation may be in separate, same-country affiliates for local business or regulatory reasons. For example, in some Latin American jurisdictions where profit sharing is mandatory, servicing operations and financing operations may be conducted through separate entities. Even in these situations, the active businesses of the Finance and Credit Companies are conducted by local employees.

2. *Like other financial services entities, a Finance and Credit Company requires access to the debt markets to finance its lending activities, and borrowing in local markets often affords a lower cost of funds.* Small Finance and Credit Companies, in particular, may borrow a substantial percentage of their funding requirements from local banks. Funding in a local currency reduces the risk of economic loss due to exchange rate fluctuations, and often mitigates the imposition of foreign withholding taxes on interest paid across borders. Alternatively, a Finance and Credit Company may access a capital market in a third foreign country, because of limited available capital in the local market—Australian dollar borrowings are often done outside Australia for this reason. The latter mode of borrowing might also be used in a country whose government is running a large deficit, thus “soaking up” available local investment. A Finance and Credit Company may also rely for funding on its U.S. parent company, which issues debt and on-lends to affiliates (with hedging to address foreign exchange risks).

3. *In many cases, consumer protection laws require a local presence.* Finance and Credit Companies must have access to credit records that are maintained locally. Many countries, however, prohibit the transmission of consumer lending information across national borders. Additionally, under “door-step selling directives,” other countries preclude direct marketing of loans unless the lender has a legal presence.

4. *Banking or currency regulations may also dictate a local presence.* Finance and Credit Companies must have the ability to process local payments and—where necessary—take appropriate action to collect a loan or repossess collateral. Foreign regulation or laws regarding secured transactions often require U.S. companies to conduct business through local companies with an active presence. For example, as noted above, French law generally compels entities extending credit to conduct their operations through a regulated “banque” approved by the French central bank. Other jurisdictions, such as Spain and Portugal, require retail lending to be performed by a regulated entity that need not be a full-fledged bank. In addition, various central banks preclude movements of their local currencies across borders. In such cases, a Finance and Credit Company’s local presence (in the form of either a branch or a separate entity) is necessary for the execution of its core activities of lending, collecting, and funding.

EU directives allow a regulated bank headquartered in one EU jurisdiction to have branch offices in another EU jurisdiction, with the “home” country exercising the majority of the bank regulation. Thus, for example, one Finance and Credit Company in Europe operates in branch form, engaging in cross-jurisdictional business in the economically integrated countries that comprise the EU. The purpose of this branch structure is to consolidate European assets into one corporation to achieve increased borrowing power within the EU, as well as limit the number of governmental agencies with primary regulatory authority over the business.

D. Finance and Credit Companies Play A Critical Role In Supporting International Trade Opportunities

As U.S. manufacturers and distributors expand their sales activities and operations around the world, it is critical that U.S. tax policy be coordinated with U.S. trade objectives, to allow U.S. companies to operate on a level playing field with their foreign competitors. One of the important tools available to U.S. manufacturers and distributors in seeking to expand foreign sales is the support of Finance and Credit Companies providing international leasing and financing services. U.S. tax policy should not hamper efforts to provide financing support for product sales.

U.S. manufacturers, in particular, include the availability of financing services offered by Finance and Credit Companies as an integral component of the manufacturer’s sales promotion in foreign markets. For related manufacturing or other businesses to compete effectively, Finance and Credit Companies establish local country financial operations to support the business. As an example, the Finance and Credit Company affiliate of a U.S. auto maker establishes its operations where the parent company’s sales operations are located, in order to provide marketing support.

In supporting the international sales growth of U.S. manufacturers and distributors in developed markets, Finance and Credit Companies are themselves forced

into competition with foreign-owned companies offering the same or similar leasing and financing services. To the extent Finance and Credit Companies are competitively disadvantaged by U.S. tax policy, U.S. manufacturers and distributors either are prevented from competing with their counterparts or must seek leasing and financing support from foreign-owned companies operating outside the United States.

II. THE NEED TO CONTINUE THE SUBPART F EXCEPTION FOR ACTIVE FINANCING INCOME

A. Legislative Background

When deferral for active financial services income was repealed in 1986, the Congress was concerned about the potential for abuse by taxpayers routing passive or mobile income through tax havens. At that time, the U.S. financial services industry was almost entirely domestic, and so little thought was given to the appropriateness of applying the 1986 Act provisions to income earned by the conduct of an active business. The subsequent international expansion of the U.S. financial services industry created a need to modernize Subpart F by enacting corrective legislation.

The Taxpayer Relief Act of 1997 introduced a temporary (one-year) Subpart F exception for active financing income, and 1998 legislation revised and extended this provision for an additional year. The financial services industry continues to seek a more permanent Subpart F exception for active financing income.

But for the Active financing exception, current law would discriminate against the U.S. financial services industry by imposing a current U.S. tax on interest, rentals, dividends etc., derived in the conduct of an active trade or business through a controlled foreign corporation. From a tax policy perspective, a financial services business should be eligible for the same U.S. tax treatment of worldwide income as that of manufacturing and other non-financial businesses.

B. The Active Financing Exception is Necessary To Allow U.S. Financial Services Companies To Compete Effectively In Foreign Markets

U.S. financial services entities engaged in business in a foreign country would be disadvantaged if the active financing exception were allowed to expire (and the United States thereby accelerated the taxation of their active financing income).

To take a simplified example, consider a case where a Finance and Credit Company establishes a U.K. subsidiary to compete for business in London. London is a major financial center, and U.S.-based companies compete not only against U.K. companies but also against financial services entities from other countries. For example, Deutsche Bank is a German financial institution that competes against U.S. Finance and Credit Companies. Like many other countries in which the parent companies of major financial institutions are organized, Germany generally refrains from taxing the active financing income earned by its foreign subsidiaries. Thus, a Deutsche Bank subsidiary established in London defers the German tax on its U.K. earnings, paying tax on a current basis only to the U.K.

The application of Subpart F to the facts of the above example would place the U.S. company at a significant competitive disadvantage in any third country having a lower effective tax rate (or a narrower current tax base) than the United States (because the U.S. company would pay a residual U.S. tax in addition to the foreign income tax). The acceleration of U.S. tax under Subpart F would run counter to that of many other industrialized countries, including France, Germany, the United Kingdom, and Japan.¹ All four of these countries, for example, impose current taxation on foreign-source financial services income only when that income is earned in tax haven countries with unusually low rates of tax.

In view of the relatively low profit margins in the international financing markets, tax costs might have to be passed on to customers in the form of higher financing rates. Obviously, foreign customers could avoid higher financing costs by obtaining financing from a foreign-controlled finance company that is not burdened by current home-country taxation, or—in the case of Finance and Credit Companies financing third-party purchases of an affiliate's product—purchasing the product from a foreign manufacturer offering a lower all-in cost. The active financing exception advances international competitiveness by insuring that financial services companies are taxed in a manner that is consistent with their foreign competitors—consistent with the legislative history of Subpart F and the long-standing tax policy goal of striking a reasonable balance that preserves the ability of U.S. businesses to compete abroad.

¹For detailed analyses of other countries' approaches to anti-deferral policy with respect to active financing income, see "The NFTC Foreign Income Project: International Tax Policy for the 21st Century," Chapter 4 (March 25, 1999).

III. THE DEFINITION OF A FINANCE COMPANY UNDER THE ACTIVE FINANCING EXCEPTION TO SUBPART F WAS CAREFULLY CRAFTED TO LIMIT APPLICATION OF THE EXCEPTION TO BONA FIDE BUSINESSES

The 1998 legislation introduced a statutory definition of a “lending or finance business” for purposes of the active financing exception to subpart F. A lending or finance business is defined to include very specific activities:

- (i) making loans;
- (ii) purchasing or discounting accounts receivable, notes, or installment obligations;
- (iii) engaging in leasing;
- (iv) issuing letters of credit or providing guarantees;
- (v) providing charge or credit services; or
- (vi) rendering related services to an affiliated corporation that is so engaged.

A. *A Finance Company Must Satisfy a Two-pronged Test to be Eligible to Qualify any Income for the Active Financing Exception.*

1. *Predominantly Engaged Test.* Under a rule that applies to all financial services companies, a finance company must first satisfy the requirement that it be “predominantly engaged” in a banking, financing, or similar business. To satisfy the “predominantly engaged” test, a finance company must derive more than 70 percent of its gross income from the active and regular conduct of a lending or finance business (as defined above) from transactions with unrelated “customers.”

2. *Substantial Activity Test.* Even if a finance company is “predominantly engaged,” as in the case of all financial services companies, it will flunk the test of eligibility unless it conducts “substantial activity with respect to its business. The “substantial activity” test, as fleshed out in the committee report, is a facts-and-circumstances test (e.g., overall size, the amount of revenues and expense, the number of employees, and the amount of property owned). In any event, however, the legislative history prescribes a “substantially all” test that requires a finance company to “conduct substantially all of the activities necessary for the generation of income”—a test that cannot be met by the performance of back-office activities.

B. *Once Eligibility is Established, Additional Requirements Must be Satisfied Before Income From Particular Transactions Can be Qualified Under the Active Financing Exception.*

As listed in the relevant committee report, there are only 21 types of activities that generate income eligible for the active financing exception. In addition, an eligible Finance and Credit Company cannot qualify any income under the exception unless the income meets four, additional statutory requirements that apply to all financial services businesses:

1. *The Exception Is Limited to Active Business Income.* First, the income must be “derived by” the finance company in the active conduct of a banking, financing or similar business. This test, alone, would preclude application of the active financing exception to the incorporated pocketbook of a high net worth individual or a pool of offshore passive assets.

2. *Prohibition on Transactions With U.S. Customers.* Secondly, the income must be derived from one or more transactions with customers located in a country other than the United States.

3. *Substantial Activities.* Substantially all of the activities” in connection with a particular transaction must be conducted directly by the finance company in its home country.

4. *Activities Sufficient For a Foreign Country To Assert Taxing Jurisdiction.* The income must be “treated as earned” by the Finance and Credit Company—i.e., subject to tax—for purposes of the tax laws of its home country.

C. *In any Event, a Finance Company Cannot Qualify any Income Under the Active Financing Exception Unless it meets an Additional 30-Percent Home Country Test.*

Under a “nexus” test applicable to Finance and Credit Companies (but not banks or securities firms with respect to which government regulation satisfies the nexus requirement), a company must derive more than 30 percent of its separate gross income from transactions with unrelated customers in its home country. This rule makes it highly unlikely that taxpayers could locate a finance company in a tax haven and qualify for the active financing exception, because tax havens are unlikely to provide a customer base that would support the transactions required to meet the 30-percent home country test. Even if such a well-populated tax haven could be found, the ability to qualify income would be self-limiting (in terms of abso-

lute dollars) by the dollar-value of transactions that could be derived from unrelated, home-country customers

CONCLUSION

We urge the Congress to extend the provision that grants active financial services companies an exception from subpart F. Without this legislation, the current law provision that keeps the U.S. financial services industry on an equal footing with foreign-based competitors will expire at the end of this year. Moreover, this legislation will afford America's financial services industry parity with other segments of the U.S. economy.

