IMPACT OF U.S. TAX RULES ON INTERNATIONAL COMPETITIVENESS

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

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IMPACT OF U.S. TAX RULES ON INTERNATIONAL COMPETITIVENESS

WEDNESDAY, JUNE 30, 1999

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

The Committee met, pursuant to notice, at 10:02 p.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
June 15, 1999
No. FC–12

CONTACT: (202) 225–1721

Archer Announces Hearing on Impact of U.S. Tax Rules on International Competitiveness

Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on the impact of U.S. tax rules on the international competitiveness of U.S. workers and businesses. The hearing will take place on Wednesday, June 30, 1999, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

Oral testimony at this hearing will be from both invited and public witnesses. Also, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee or for inclusion in the printed record of the hearing.

BACKGROUND:

The tax rules that apply to individuals and businesses with international operations are among the most complex in the Internal Revenue Code. These international tax rules often cause U.S. taxpayers to structure their domestic and international activities in particular ways. For instance, the current rules may effectively prevent a taxpayer from undertaking a particular activity in a specific location, business entity, or manner otherwise consistent with the taxpayer's business interests. Similarly, the current rules may create incentives to structure business activities in a particular location, entity, or manner. Some of the consequences of these U.S. international tax rules are intended; many, however, are either unintended or result from competing tax, economic, or social policies in the international tax rules.

In announcing the hearing, Chairman Archer stated: "I have long been interested in reform of our international tax rules. I strongly believe that our tax rules must help, rather than hinder, the competitiveness of American workers and businesses. People in too many businesses, large and small, have described to me how our tax law has affected their decisions regarding place of incorporation, choice of business entity, and location of business assets and operations. Having the tax system-rather than business, economic, or family considerations-drive these decisions is troubling.

I am truly concerned by what I see happening to our economy. Are the current rules arbitrary or unfair? Is the U.S. tax system contributing to the de-Americanization of U.S. industry? Do our tax laws force U.S. companies to be domiciled in foreign countries? Are we making it a foregone conclusion that mergers of U.S. companies with foreign companies will always leave the resulting new company headquartered overseas? I want the Committee to examine (1) the effect that our current international tax rules have on U.S. workers and businesses, and (2) the policies (tax or otherwise) our international tax rules ought to reflect and implement."

FOCUS OF THE HEARING:

The hearing will focus on the impact of current U.S. tax rules on international competitiveness including that on cross-border transactions, international operations

of U.S.-based companies, and the treatment of U.S. citizens working in foreign countries. The hearing will examine some of the problems caused by the current rules and proposed solutions to these problems.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Pete Davila at (202) 225–1721 no later than the close of business, Tuesday, June 22, 1999. The telephone request should be followed by a formal written request 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. The staff of the Committee will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff at (202) 225–1721.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE-MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record, in accordance with House Rules.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, of their prepared statement for review by Members prior to the hearing. **Testimony should arrive at the Committee office, room 1102 Longworth House Office Building, no later than, Monday, June 28, 1999.** Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

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, Wednesday, July 7, 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 Committee office, room 1102 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 submitted 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 hearing record.**

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

3. 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/".

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 ARCHER. Good morning. Today, the Committee is holding what the Chair believes to be one of the most important hearings that we will conduct for the entire year and that is the effect of U.S. tax rules on our country's global competitiveness.

As you all know, I have been a long-time advocate of fundamental tax reform. In short, I do not believe we will ever fix the income tax. That is perhaps an issue for another day. I will continue to push to completely eliminate income as the base of taxation because rather than this negative way to tax, we could adopt a border adjustable consumption tax and one that gets the IRS completely out of our everyday lives. In my view, the notion of taxing the foreign earnings of American corporations and not having a border adjustable Tax Code are absurd in a competitive global economy. We force our businesses to enter this arena with one hand tied behind their backs relative to the Tax Codes of the countries where corporations are competing against us.

However, those of you who still need convincing that we should throw out our current income tax, I suggest you look closely at the rules that apply to international transactions. These rules are unbelievably complex and often at odds with our economic goals. Professionals spend a lifetime trying to understand the complexities of how we tax foreign source income and, yet, there is massive disagreement among the experts because of the complexities.

Our current tax rules are grossly outdated. The basic Subpart F rules, for example, were enacted in 1962. These rules reflect the economic climate of that time. In 1962, the United States was a net exporter of capital and ran a trade surplus. Imports and exports were only one-half of the percentage of GDP that they are today. U.S. companies focused on the domestic market and international trade had relatively little effect on our economy. My how things have changed since 1962.

To put things in perspective, in 1962, the cost of college was described by President Kennedy has skyrocketing to astronomical levels of $1,600 a year. In 1962, a Japanese motorcycle company

called Honda decided to start making cars for the first time. In 1962, Bill Gates was probably more concerned about his second grade teacher than computer software. The world has changed and our tax laws need to change to.

In particular, I have been troubled by some aspects of the recent acquisitions of U.S. companies. I do not have anything against foreign investment in the United States. It is part of a healthy, open economic system. I am very concerned that our tax law increasingly puts American companies at a disadvantage in the world marketplace. How we tax foreign source income will influence what kind of economy we have in the long-run, specifically, whether we have a strong and vibrant economy with competitive workers and companies, whether we can create more jobs for export which pay on average 17 percent more to the workers of this country.

As a growing consensus develops behind the need to re-examine and modify our international tax rules, there have been some significant studies and reports in this area, and we will hear about them from several witnesses today.

The Treasury Department is also undertaking a study of the Subpart F rules. I do not know whether I will agree with anything in the Treasury's study, but I do know that we need to have an open-minded debate. I urge us all, Congress, the administration, and the private sector, to get involved in this debate. Our long-term economic well-being is at stake.

If there is anyone here on the minority, I would be happy to recognize them for a statement. Mr. Levin, would you like to make a statement on behalf of the minority or do you want to wait until you make your statement from the witness stand?

Mr. LEVIN. I think I will wait for the latter. I think once will be enough.

Chairman ARCHER. All right.

Mr. LEVIN. Thank you.

Chairman ARCHER. Well, we are fortunate to start off today with two respected Members of the Ways and Means Committee. I hope that this augurs that there is bipartisanship on this entire issue. We are happy to recognize first Mr. Levin of Michigan?

STATEMENT OF HON. SANDER M. LEVIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. LEVIN. Thank you, Mr. Chairman, and my colleagues on the Ways and Means Committee and especially hello to the gentleman next to me. We have been working together in the international tax area for a number of years. And I fully concur with your discussion, with your suggestion, Mr. Chairman, that we very much need to debate the international tax field. Wherever one comes from, I think it is vital that we continue to do that. And Mr. Houghton and I are pleased to report to you on our further package of proposals.

This is the fourth bill that we have put together and the third on a bipartisan basis with Senators Hatch and Baucus.

This bill contains a long list of proposals unified by a common theme. The way we tax the income of U.S. companies doing business abroad should reflect the economic realities of doing business abroad and should facilitate the efficient allocation of resources. Guided by that principle, our bill seeks to further amend the U.S.

international tax regime in a way that will simplify the reporting burden, enhance the competitiveness of U.S. businesses and their workers, and promote exports.

This bill seeks to further update the U.S. international tax regime by bringing it into further sync with the realities and demands of the modern business environment. We made substantial progress though there are no doubt continuing problems in the 1997 legislation, and let me just review them very quickly so we have that background.

As you know, one of the changes related to active financing. Our Tax Code generally defers taxation of manufacturing income of U.S. controlled foreign corporations, CFCs, until that income is repatriated. In enacting the 1997 legislation, we recognized that the time has come to apply the same common sense policy to financial services companies, banks, brokers, insurance companies, auto financing companies, that we apply to manufacturers.

Second, reporting by so-called 10/50 companies. A number of American companies engage in business abroad through joint ventures in which they hold more than 10 percent but less than 50 percent of the equity. Prior to 1997, each so-called 10/50 venture was treated separately for purposes of determining foreign tax credit limitations. This rule resulted in tremendous reporting burdens for U.S. companies doing business through multiple 10/50 ventures with little impact, little impact on their ultimate tax liability. Thanks to reforms enacted in the 1997 act, a look-through rule will kick in beginning in the year 2003 that will allow U.S. companies to group income from 10/50 ventures, greatly reducing their reporting burden. Another change related to the overlap between P-FIC and CFC rules.

So there has been some progress, but much work remains to be done. And let me highlight, if I might, just a few of the key provisions in H.R. 2018. And my colleague and friend, Mr. Houghton, will give a more general overview.

One of the changes is to make the deferral of active financing income permanent. The last change, the change I mentioned, is due to expire at the end of the year.

Mr. Chairman and my colleagues, I hope as we look at expiring provisions, we will take a hard look at this provision because, as with other expiring provisions of the Tax Code, such as the R&D credit, expiration of this provision and uncertainty as to whether it will be extended impairs businesses' ability to plan ahead, and I don't think I need to elaborate on that view, Mr. Chairman and my colleagues.

The second proposed change, and I referred earlier to the treatment of 10/50 companies, that would not go into effect until the year 2003 and this bill proposes would make it effective at the beginning of next year.

Let me just spend a little more time on a provision relating to section 202 to make domestic loss recapture rules mirror foreign loss recapture rules. Currently, if a U.S. company experiences a loss in its foreign operations in a given year, it may deduct that loss against U.S. source income. If the foreign operations turn a profit in a subsequent year, the loss is recaptured, i.e., the U.S. company is required to characterize a portion of that profit as U.S.

source income, thus, effectively reducing its ability to use foreign tax credit. This ensures that the company will not receive a double benefit. But a similar rule does not apply when a U.S. company experiences a loss in U.S. operations in 1 year and a profit in a second subsequent year.

Our bill proposes to correct this asymmetry and I elaborate on this on my statement to Mr. Chairman, which I know you will place in the record.

Let me finish by referring to two issues that will be discussed by further panels where——

Chairman ARCHER. Mr. Levin, let me make a general observation that without objection, all written statements of every witness will be inserted in full into the record.

Mr. LEVIN. Thank you. And I shall finish, Mr. Chairman, by reference to two studies that this bill of Mr. Houghton and others of our colleagues and mine proposes. A study, first of all, of treating the European Union as a single country for tax purposes. And perhaps we will want to go into this further. Mr. Houghton had an oversight hearing where this issue was discussed at great length. It is not a simple issue. We clearly need to study it to prepare to be able to act on it. The second study, our bill would direct Treasury to study current rules for allocating interest expense between domestic and foreign operations and the effect that those rules have on different industries.

We have made some progress but we need to continue this effort. We can help bring our Tax Code further up-to-date in a way that will make U.S. companies and U.S. goods produced by American workers more competitive. These are goals on which I am sure we can all agree, and I am committed to continue to work with Members of this Committee and with Mr. Houghton and the Senate to advance those goals.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of Hon. Sander M. Levin, a Representative in Congress from the State of Michigan

Thank you Mr. Chairman for giving me the opportunity to testify before this Committee. I am pleased to report to you on the package of international tax simplification proposals that Mr. Houghton and I, along with a number of our colleagues, have put together in this session.

This is the fourth such bill on which I have had the privilege to work with Mr. Houghton, and our third with Senators Hatch and Baucus.

The bill, H.R. 2018, contains a long list of proposals unified by a common theme: The way we tax the income of U.S. companies doing business abroad should reflect the economic realities of doing business abroad and should facilitate the efficient allocation of resources. Guided by that principle, our bill seeks to amend the U.S. international tax regime in a way that will simplify the reporting burden, enhance the competitiveness of U.S. businesses and their workers, and promote exports.

There has not been a major review of our international tax regime since 1986. The commercial landscape has changed significantly since then. Increasingly, as international business transactions have become the norm, it has been necessary to re-assess when rules designed to rein in tax avoidance have the effect of deterring or severely burdening transactions undertaken for legitimate and, from the point of view of American competitiveness, desirable, economic reasons.

Today, companies regularly take advantage of the gains in efficiency that come from locating strategically in multiple points around the globe. It is not uncommon for a U.S. company to rely on a support network based in several different countries. This is how companies operate in today's business environment. Not only does strategic location around the globe make U.S. companies more competitive, it also can

increase demand for U.S. exports, since U.S. companies operating overseas are very likely to purchase U.S. goods and services.

Our International Tax Simplification bill seeks to update the U.S. international tax regime by bringing it in to sync with the realities and demands of the modern business environment.

We made substantial progress towards that end in the Taxpayer Relief Act of 1997 and in international tax simplification measures enacted last year. Some of our changes were in the following areas:

Active Financing: Our Tax Code generally defers taxation of manufacturing income of U.S. controlled foreign corporations (CFCs) until that income is repatriated. This rule ensures that a German subsidiary of a U.S. company will be taxed in the same way as other German-based companies with which it competes. It will not be handicapped by current U.S. taxation of its income in addition to German taxation of the same income. In enacting the Taxpayer Relief Act of 1997, we recognized that the time has come to apply the same commonsense policy to financial services companies—banks, brokers, insurance companies, auto financing companies—that we apply to manufacturers.

Reporting by 10/50 Companies: A number of U.S. companies engage in business abroad through joint ventures in which they hold more than 10% but less than 50% of the equity. Prior to 1997, each so-called 10/50 venture was treated separately for purposes of determining foreign tax credit limitations. This rule resulted in tremendous reporting burdens for U.S. companies doing business through multiple 10/50 ventures with little impact on their ultimate tax liability. Thanks to reforms enacted in the Taxpayer Relief Act, a "look-through" rule will kick in beginning in 2003 that will allow U.S. companies to group income from 10/50 ventures, greatly reducing their reporting burden.

Overlap Between P-FIC and CFC Rules: Prior to 1997, confusing and sometimes conflicting regimes applied when a controlled foreign corporation (CFC) engaged in active business accumulated enough income from passive investments to trigger rules regarding passive foreign investment companies (P-FIC). The 1997 Act eliminated this problem by providing that under most circumstances the P-FIC rules will not apply to CFCs engaged primarily in active business.

I am pleased by the progress we made in the last Congress. But much work remains to be done. Our goal in this Congress is to build on the accomplishments of the last Congress. Let me highlight a few of the key provisions in H.R. 2018:

Make Deferral of Active Financing Income Permanent (Sec. 101): The rule that makes active financing income exempt from current taxation (like manufacturing income) is due to expire at the end of this year. As with other expiring provisions of the Tax Code (such as the R&D credit), expiration of this provision and uncertainty as to whether it will be extended impairs businesses' ability to plan ahead. The lack of predictability is an unnecessary cost that reduces competitiveness.

Accelerate Look-Through Treatment for 10/50 Companies (Sec. 204): As I mentioned earlier, the "look-through" rule that will simplify reporting for U.S. companies engaged in 10/50 joint ventures will not kick in until January 1, 2003. Our bill proposes acceleration of this much-needed element of simplification to January 1, 2000.

Make Domestic Loss Recapture Rule Mirror Foreign Loss Recapture Rule (Sec. 202): Currently, if a U.S. company experiences a loss in its foreign operations in a given year, it may deduct that loss against U.S.-source income. If the foreign operations turn a profit in a subsequent year, the loss is "recaptured"—*i.e.,* the U.S. company is required to characterize a portion of that profit as U.S.-source income (thus, effectively reducing its ability to use foreign tax credits). This ensures that the company will not receive a double benefit—first, the benefit of applying a foreign loss against U.S. income, and second, the benefit of a foreign tax credit on the subsequent foreign-source income. A similar rule does not currently apply when a U.S. company experiences a loss in U.S. operations in one year and a profit in a subsequent year. Thus, a loss attributable to domestic operations in a given year must be spread over worldwide income. This reduces the loss carryover the company would have but for its foreign income, and it reduces the limit against which the company may apply foreign tax credits.

Our bill proposes to correct this asymmetry by allowing a U.S. company in the latter situation to characterize U.S. income in a subsequent year as foreign-source income. Instead of suffering a double detriment as a result of a loss attributable to U.S. operations, the detriment would be offset by an increase in

the company's foreign tax limitation in a subsequent year when U.S. operations are profitable.

In addition to the foregoing examples, and a list of other proposals, our bill calls for the study of issues that are becoming increasingly important as the commercial environment in which U.S. companies operate evolves. These include:

Treating the European Union as a Single Country for Tax Purposes (Sec. 102): The anti-deferral regime in Subpart F is subject to certain exceptions for transactions that take place within a single country. Our bill would require the Department of Treasury to study whether the European Union should be treated as a single country for such purposes.

Interest Allocation (Sec. 309): Our bill would direct Treasury to study current rules for allocating interest expense between domestic and foreign operations and the effect that those rules have on different industries.

I am very encouraged by the progress we have made to date in the area of international tax simplification. By continuing this effort, we can bring our Tax Code up to date in a way that will make U.S. companies and U.S. goods produced by American workers more competitive. Those are goals on which I am sure we can all agree, and I am committed to working with the Members of this Committee to advance those goals.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Houghton, we are pleased to have you as a witness before the Committee and welcome. You may proceed.

STATEMENT OF HON. AMO HOUGHTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. HOUGHTON. Thank you very much. Thank you, Mr. Chairman. Well, Mr. Chairman, I appreciate the opportunity to be here, not only to testify here with people who I am sure have the feelings about our tax system, but also with Mr. Levin, who I have got tremendous respect for. Mr. Levin has spelled out a lot of the things. I am not going to go into the details. The testimony will be submitted for the record. I just want to hit some of the high spots.

Really because of your concerns, a number of the provisions in our prior bills have been enacted. For example, simplifying the translation of foreign taxes using average exchange rates, an extension of tiers for the indirect foreign tax credit. Those things were all a result of what you did and reaction to some of the pieces of legislation that Mr. Levin and I have put forward.

As Mr. Levin has said, we had a hearing of the Oversight Committee last week on the bill and other international tax simplification issues. In our bill, 2018, it contains about 26 provisions to change the tax law affecting multinational corporations. And I am not going to go into the details at this time. They are all spelled out. Be glad to talk about them whenever you would like.

But I do want to mention a concern I expressed last week and that is the disconnect between our tax laws and our trade laws. On the one hand, we pass trade laws to encourage exports by U.S. companies, then we retain or impose restrictive tax laws relating to the multinationals themselves. So many times these tax laws place U.S. companies at a disadvantage vis-a-vis their competitors overseas.

Since I have been on this Committee, we have passed a variety of trade laws: NAFTA, GATT, African Growth, CBI, NTR for China each year. Why? The reason being to break down, obviously, the

trade barriers to increase opportunities for American workers and American companies to trade overseas.

Now are markets are open. I don't think there is a more open economic system in this world. So we need to continue to push for markets to be open abroad and it is a constant, constant push. It is important we update U.S. international tax laws now, and we need to re-work the system so that it helps U.S. businesses become more competitive. Today, the tax laws I believe stand in the way, and I think that Mr. Levin would agree with that.

And our bill, we hope, will help. But beyond that, we need to take a hard look at Subpart F, as well as the foreign tax credit provisions of the Code.

So, Mr. Chairman, I appreciate being here. I applaud your efforts of holding this hearing and the goals and objectives you spelled out and it is important that we address these now.

If I could really sort of sum up, I think that there are three or four big things. Every so often, you need to open the file and take a look at what you have got and judge is this what we intended in the first place? And as far as our tax laws now, I have got to believe there is a lot of correction to be made. Second, tax laws should be compatible with our trade laws. Third, there should be no double taxation, that was the whole concept initially. And the fourth thing is to simplify it, to simplify because as these things go and corrode and get more complicated, they obliterate the real reason for the law in the first place.

Thank you very much.

[The prepared statement follows:]

Statement of Hon. Amo Houghton, a Representative in Congress from the State of New York

I wish to thank Chairman Archer and Representative Rangel for the opportunity to appear before the Committee to discuss the issue of the U.S. international tax laws and how that affects the competitiveness of our multinational companies vis-a-vis their foreign counterparts. I am appearing here today with my colleague, Sander Levin from Michigan, a Member of this Committee.

Mr. Levin and I have introduced a bill, H.R. 2018, "International Tax Simplification for American Competitiveness Act of 1999." The bill contains twenty-six (26) provisions to change tax law affecting multinational companies. Most are simplification proposals. Some are included in separate tax bills before this Committee. This is the third international tax simplification bill we have introduced in as many Congresses. Because of your concerns regarding the negative effect of the international tax system on U.S. multinationals, a number of our proposals in the earlier bills have been enacted, and I thank you for that.

I do not intend to dwell on the detailed provisions in our bill. The Oversight Subcommittee had a hearing last week. There was a good discussion of the various provisions in the bill, as well as other international tax issues. We will hear more on those from today's witnesses.

I would to like to take a minute to emphasize a concern which I mentioned the other day at the Oversight hearing. This is the disconnect between our tax laws and trade laws. On the one hand we pass trade laws to encourage exports by U.S. companies, then we retain or impose restrictive tax laws relating to multinationals which not only are complex, but in many cases place our companies at a disadvantage vis-a-vis their foreign competitors. As a result, we hear horror stories about complexity, mountains of paperwork, legions of talented people gathering tax information, "name" companies moving abroad, etc.

Since I have been on this Committee, Congress has passed a variety of trade laws, including implementation of NAFTA, Uruguay Round of GATT, normal trade relations for China on an annual basis, and recently 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 and expand export opportunities for U.S.

firms and workers. Our markets are open. It is important that we push for open markets abroad.

It is important that we update U.S. international tax laws now. I believe it is time to rework the system so that it helps U.S. businesses become more competitive. A strong economy in the U.S. is driven by how competitive our companies are around the globe. Today the international tax laws stand in the way. Our bill will help. Beyond that we need to take a hard look at Subpart F as well as the foreign tax credit provisions of the Code.. Many of the complexities of the Code spring from these provisions. The provisions can lead to double taxation. They can throw up roadblocks to capital formation.

In the 1960s, the U.S. accounted for more than 50% of cross-border direct investment. By the mid–1990s, that had dropped to 25%. In the 1960s, 18 of the world's largest corporations, ranked by sales, were headquartered in the U.S. By the mid–1990s that number had dropped to 8. Despite the decline of U.S. dominance of world markets, the U.S. economy is far more dependent on foreign direct investment than ever before. 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% of all U.S. corporate net income. The same story is true regarding exports. They have gone from 3.2% of national income to 7.5% in a comparable period.

Mr. Chairman, I applaud you for holding this hearing. It is a most important subject. The law as now constituted frustrates the legitimate goals and objectives of American business and erects artificial and unnecessary barriers to U.S. competitiveness. Neither the large U.S. multinationals nor the Internal Revenue Service are in position to administer and interpret the web of complexity that makes up the foreign tax provisions in our Code. It is important that we address these issues as we are doing today. It is also important that we take action. Thank you, Mr. Chairman.

Chairman ARCHER. The Chair is grateful to both of you because I do not think there is enough interest on the part of either members or the general public in this issue, which is going to loom as more vital to the welfare of every working American in the next century. That is why I said I think this may be one of the most important hearings that we will have this year. I wish it could be beamed into the homes of every single American so that Americans would have an understanding of how they are not really insulated from this, but they ultimately are directly connected with it. I, of course, agree with everything that both of you have said, and I thank you for your work on your legislation.

Does any other member wish to inquire?

[No response.]

If not, thank you very much.

Mr. LEVIN. Thank you.

Mr. HOUGHTON. Thank you.

Chairman ARCHER. We will be pleased to welcome our next panel: Mr. Green, Mr. Loffredo, Mr. Lipner, Ms. Stiles, and Mr. Finnerty. If you will come to the witness table, please?

Good morning and welcome. Mr. Green, if you would lead off, the Chair would be pleased to hear your testimony. If you will identify yourself first for the record and that would be true for each of you. You may proceed. Under the rules of the Committee, we would ask you to try to stay within the 5 minute on your oral testimony and your entire written statement will be inserted in the record.

Mr. Green, you may proceed.

STATEMENT OF RICHARD C. GREEN, JR., CHAIRMAN AND CHIEF EXECUTIVE OFFICER, UTILICORP UNITED, KANSAS CITY, MISSOURI

Mr. GREEN. Thank you, Mr. Chairman. I have submitted a written statement and these oral comments are a summary of that. My name is Rick Green. I am chief executive officer of UtiliCorp United, an international energy company headquartered in Kansas City, Missouri.

Let me first acknowledge that much of the business community is grateful for the efforts of this Committee to improve our Nation's ability to compete in the global economy. And I do welcome this opportunity to address what I think is a very serious problem that unfairly constrains international growth aspirations of American companies. The inequity that I am talking about is that of the interest allocation rules of the U.S. Tax Code. This problem looms large over many American companies doing business abroad. And we at UtiliCorp support an economy-wide solution.

However, I can best describe the inequity that poses the problem to our competitiveness by looking at the industry I know best: regulated utilities. This industry offers an especially poignant example of the problem. The global needs of energy are poised for explosive growth. To meet the growing needs, companies, markets, governments need to dramatically alter the way we do business. The vigorous demands of this marketplace are pointing to the fault lines in our tax rules. This impairs what otherwise would be a strong competitive instinct of our American companies. Huge amounts of capital are going to be required to take advantage of these emerging opportunities. Unfortunately, outdated interest allocation rules act as a strong disincentive, literally trapping American corporate funds in foreign countries where they cannot be efficiently utilized.

When U.S. companies doing business overseas prepare their returns under present law, tax on foreign income is paid in the foreign country and again in the United States, but without full credit. That is double taxation, pure and simple. Many of the foreign competitors have no such burden. Their profits from the United States are free to go home, strengthen their operations on their own turf and fund other international ventures, possibly even including additional U.S. acquisitions. As an American chief executive officer, I would love to have that choice. But as it is, I only have one choice, that is to leave such funds overseas or take a double tax hit.

In some respects, the concerns I have raised would apply to many U.S. corporations doing business internationally. But my operating arena, the utility industry, is especially hurt by existing interest allocation rules. The current interest apportionment formula harms an industry such as mine because a disproportionate amount of U.S. interest is allocated to foreign source income thereby reducing and sometimes eliminating the foreign tax credit and creating a double tax. Some of the contributing factors to this are the facts that utilities are capital intensive businesses, holding long-lived assets that are among the more highly leveraged U.S. companies. The greater the leverage, the greater the interest expense, the greater the interest to be allocated, therefore decreasing the foreign tax credit.

Also, because of our inability to transport electricity or gas over long distances, particularly over an ocean, U.S. utilities must establish a taxable presence where the utility customer resides. This means the U.S. utilities generally do not have the ability to generate low tax foreign income to offset the disadvantage caused by the interest allocation rules.

Foreign utility companies generally are not subject to the same regulatory restrictions as U.S. utility companies in making foreign investments. This is a serious competitive disadvantage. U.S. tax law should not further compound this problem.

The proposed solution we would like you to consider eliminates double taxation, changing the allocation rules to take into account foreign interest in the interest allocation formula. As I have stated, we believe the solution should be available to all U.S. companies eligible for foreign tax credit. However, Mr. Chairman, we understand there may be revenue constraints and if it is not possible to enact this with an immediate effective date, we hope you will consider a phased in approach, phased in across all American industry with an initial focus on those most negatively impacted.

Mr. Chairman, American know-how, muscle, capital have built an energy system that is the envy of the world. In fact, it is clear to foreign corporations that they cannot be successful in the emerging global energy market unless they are a player in our U.S. markets. U.S. tax policy should not unduly disadvantage U.S. companies in their efforts to expand internationally. We, therefore, respectfully request relief from double taxation we presently face under the existing interest allocation rules.

Thank you, Mr. Chairman, for the opportunity to appear here.

[The prepared statement follows:]

Statement of Richard C. Green, Jr., Chairman and Chief Executive Officer, UtiliCorp United

Mr. Chairman . . . Members of the Committee, my name is Rick Green and I am the Chief Executive Officer of UtiliCorp United, an international energy company based in Kansas City, Missouri. Much of the business community is already grateful for the efforts of this Committee to resolve some of the more critical issues facing our country in dealing with increasingly sophisticated and vigorous international competition.

Therefore, I welcome this opportunity to address a very serious problem that unfairly constrains the international growth aspirations of American companies—the inequity of interest allocation rules in the U.S. Tax Code that limit the ability of American businesses to compete.

Let me emphasize that this problem looms large over many American companies doing business abroad. I can best describe the nature and extent of this threat to our competitiveness by reference to the industry that I know best—regulated energy suppliers. And as will become evident, this industry offers an especially poignant example of the problem.

Although my comments have a utility industry focus, at UtiliCorp we've identified a possible remedy to this inequity for your consideration which we think would apply to all U.S. businesses. I'll discuss that more later, but I must emphasize that the problem is particularly onerous for the U.S. regulated utility industry.

The current tax law does not give companies the ability to efficiently bring cash generated from foreign investments back to the U.S.—therefore, when UtiliCorp makes a foreign investment, it is evaluated as a "cash invested offshore" strategy. This obviously does not provide the best answer to the U.S. economy, or to our shareholders.

I thought it also might be helpful if I could provide some context by offering a closer look at how one U.S. utility company views the emerging reality of the global energy marketplace. For it is the rigorous demands of this marketplace that are

pointing to the fault lines in our tax rules which impair the otherwise strong competitive instincts of American companies.

UtiliCorp has been pursuing investments overseas since 1987 first in Canada, and later in Great Britain, New Zealand and Australia. To date we have invested $1.4 billion in international projects and plan to seek additional opportunities. We're currently taking steps to participate on the European Continent as the markets in those countries open to competition.

Driving all this is the creation of a new global energy industry that is creating immense global opportunities for American companies willing to change the way they think and do business.

It's very clear to us at UtiliCorp that if we and the U.S. economy are going to continue to be successful competitors, all of our people, policies, systems, processes and tools will have to adapt to reflect the best-of-class global standards that are shaping this new industry. Global markets are developing, customers are becoming available, and the competitive instincts of American business are creating a sense of urgency to capture those customers.

In fact, in an industry not typified in the past by venturing much beyond the monopoly-protected confines of highly regulated U.S. turf, we were one of the first—if not the first—to begin more than a decade ago to prepare for this new reality by exploring overseas markets as pathways to growth and greater opportunities for our shareholders and employees.

Achievement of these goals means UtiliCorp has to reinvent itself nearly every day, changing those things under our control to meet the demands of a constantly churning global marketplace, or coming here to Washington as I am today, to point to changes needed on matters beyond the control of the private sector.

The global need for energy is poised for explosive growth. Throughout the world, one third of humanity does not even have access to energy as we know it. As many as two billion people still meet their daily energy requirements by burning wood or cow dung. Some 80% of energy used around the world is not renewable.

So, the challenge that needs to be recognized by companies, governments and markets is that in order to meet these growing energy needs they must dramatically alter the way they do business. In the U.S., we need to adopt a philosophy of growth based on rational tax policies that enhance rather than impede the deployment of capital in order to create competition and develop emerging markets.

We must also continue to develop energy supply and efficient delivery system while pushing the boundaries to make renewable energy sources more economical and commercially viable as American companies move forward.

There are, of course, many places around the globe that don't have anything near the kind of energy infrastructure that would support a thriving competitive market, and American companies can capitalize on that. On the other end of the spectrum, there are a number of "gold plated" infrastructures out there, constructed when cost-plus regulation was a reality, that need to be simplified to take advantage of today's market.

Huge amounts of capital will be required to take advantage of these emerging opportunities. Unfortunately, outdated U.S. tax laws act as a strong disincentive, literally trapping American corporate funds in foreign countries where they cannot be efficiently utilized.

When U.S. companies doing business overseas prepare their returns under present law, tax on foreign income is paid in the foreign country and again in the U.S. but without full credit. That's double taxation, pure and simple.

Many of our foreign competitors have no such burden. Their profits from U.S. investments are free to go home to strengthen operations on their own turf, or to fund other international ventures, possibly even including additional U.S. acquisitions. As an American CEO, I'd love to have that choice. As it is, we have but one choice—to leave such funds overseas or take the double tax hit.

UtiliCorp has closely examined a number of investment opportunities in Portugal, the United Kingdom, South America, Canada and other parts of the world. In cases where we were competing against foreign buyers with tax laws more favorable than our own, it has been impossible to compete.

In some respects, the concerns I've raised would apply to many U.S. corporations doing business internationally, but my operating arena the utility industry is especially hurt by existing interest allocation rules. The current interest apportionment formula harms an industry such as mine because a disproportionate amount of U.S. interest is allocated to foreign source income, thereby reducing or eliminating the foreign tax credit and creating the double tax.

Contributing factors include:

- U.S. utility assets are older and more fully depreciated than our foreign assets. Since interest is allocated based on the ratio of foreign assets to total assets, and

foreign assets would be newer and less depreciated, an increased amount of interest is allocated to foreign source income which reduces the foreign tax credit and creates the double tax situation.

- U.S. utility assets are amortized using accelerated depreciation rules, while foreign assets are amortized using slower straight-line depreciation rules which again creates a disproportionately higher foreign asset base. This increases the amount of interest allocated to foreign income and further compounds the problem.
- Utilities are capital-intensive businesses holding long-lived assets and they tend to be more highly leveraged than companies in other industries. The greater the leverage, the greater the interest expense, thus creating a larger pool of interest to be allocated. This factor, coupled with the preceding points, causes an increased amount of interest to be allocated to foreign source income, thereby decreasing the foreign tax credit.
- Foreign utility companies generally are not subject to the same regulatory restrictions as U.S. utility companies in making foreign investments, thus creating a serious competitive disadvantage. U.S. tax law should not further compound this problem.
- Because the era of opportunity for U.S. investment in foreign utilities is relatively new, a federal tax stumbling block to exploitation of investment opportunities by U.S. utilities today will have long-lasting effects on our future competitiveness in foreign markets.
- Because of the inability to transport electricity or gas over long distances, particularly over the ocean, U.S. utilities must establish a taxable presence where the utility customers reside. This means that U.S. utilities generally do not have the ability to generate a low-tax foreign income to offset the disadvantage caused by the interest allocation rules. By contrast manufacturing, transportation, and communications industries generally can make cross-border sales and thereby generate low tax foreign source income.
- U.S. utility companies generally are not able to generate low-tax foreign source income through licensing of intangibles offshore, such as intellectual property. For example, utilities generally own little or no intellectual property, trademarks, trade names, and so on.

The proposed solution we'd like you to consider eliminates double taxation by changing the allocation rules to take into account foreign interest in the interest allocations formula. As I have stated, we believe the solution should be available to all U.S. companies eligible for the foreign tax credit. However, Mr. Chairman we understand there may be revenue constraints and if it is not possible to enact this with an immediate effective date, we hope you will consider a phased-in approach, a phase-in across all American industries with an initial focus on those most negatively impacted.

To sum up, Mr. Chairman, for our industry the market's expectations are a lot tougher today. In times past, in that earlier model in which we operated, we would just deliver safe, reliable, energy in our local monopoly territories—that was it. We could go home. Job done. Not so any more. That's just entry-level performance, and a far cry from global best-of-class.

To achieve that distinction we must consistently, each and every day, strive for the opportunity to reach and serve the global customer and make that customer more comfortable at home and more efficient in the workplace. That means we have to go beyond just delivering the energy. We have to understand our customers far deeper and better than we ever have before and make significant investments overseas and in the improved products and services the global customer base needs, expects and deserves.

If American companies don't do it, our foreign counterparts will. That's what competition is all about. The companies—and countries—that make this fundamental shift will thrive and grow at the leading edge of these global changes. The ones that do not will be swept aside to tumble in the wake of the leaders.

The people who run utilities and other companies overseas are savvy international business people. They realize that to be effective players on the global energy stage they've got to have a solid presence in the U.S. marketplace, the most advanced and lucrative in the world.

And one of the reasons our market is so attractive is that perhaps its most valuable asset is the skills and knowledge embedded in the experience of the Americans we employ. We don't export jobs, Mr. Chairman—but we do export that knowledge. It's a tremendously valuable commodity.

Mr. Chairman, American know-how, capital and muscle have built a truly "First Tier" energy system that's the envy of the world. That's why foreign investors already are moving aggressively to buy U.S. utilities, such as the acquisition of

PacifiCorp by Scottish Power and the U.K.'s National Grid acquisition of New England Electric System.

Earlier this month when approving the Scottish Power and National Grid acquisitions, FERC Chairman James Hoecker said the deals, and I quote, "illustrate(s) how attractive U.S. utility assets are to international markets."

But I hope you understand that I am not advocating protectionism. I am not asking for a bailout or special breaks or loop-holes. All I am seeking are straightforward tax rules that recognize this new global marketplace and help to provide an equitable solution for American companies and the U.S. economy.

There should be no question that U.S. enterprise knows how to compete, but it is absolutely vital that our government act to let us play to our strengths. If you don't, then the U.S. utility industry, which presently occupies the First Tier among the world's utilities, could quickly be relegated to a position on the second or third tier behind our foreign competitors.

U.S. tax policy should not unduly disadvantage U.S. companies in their efforts to expand internationally. We respectfully request relief from the double taxation we presently face under the existing interest allocation rules, which create an impediment to the ability of American enterprise to compete.

Acting now to sweep these tax impediments aside before a crisis develops is vastly preferable to coming back later to shore things up after the damage to the U.S. economy and U.S. companies is done.

Thank you for this opportunity to appear before you, Mr. Chairman. Now, I'd be pleased to address whatever questions you or the Committee may have.

Chairman ARCHER. Mr. Green, thank you.

Our next witness is Mr. John Loffredo. Mr. Loffredo, we are happy to have you with us. If you will identify yourself for the record, you may proceed.

STATEMENT OF JOHN L. LOFFREDO, VICE PRESIDENT AND CHIEF TAX COUNSEL, DAIMLERCHRYSLER CORP.

Mr. LOFFREDO. Thank you. My name is John Loffredo, and I am vice president and chief tax counsel for DaimlerChrysler Corp., the U.S. arm of DaimlerChrysler A.G. The merger of Chrysler Corp. and Mercedes Benz was a marriage of two global manufacturing companies, one with its core operations in North America and the other headquartered in Europe with operations around the world. I thought I would share with you today some of the tax considerations, just some of them, that went into determining whether the new company should be a U.S. company or a foreign company.

Both companies, Chrysler and Daimler Benz, knew that after the merger, these companies would continue to pay their fair share of taxes to the countries in which they operated. Therefore, the merger would not reduce or eliminate the company's taxes in the United States or Germany on operations in those countries. However, the new company was concerned that it only pay tax to the country where the income was earned and not a second time on dividends repatriated from its foreign operations. And, second, it would be subject to immediate taxation on normal, active business income earned outside the country of incorporation.

There was a clear, distinct choice to be made between the U.S. tax laws and those of most acceptable foreign countries. Management chose a company organized under the laws of Germany. The German tax system is based on the territorial theory. By contrast, the U.S. tax system follows a philosophy of taxing the worldwide

income of a U.S. company while allowing tax credits for taxes paid to foreign governments.

At the time of the merger, the German Territorial Tax System allowed qualified dividends received from foreign subsidiaries to be tax-free in Germany. Recent tax law changes in Germany now tax 15 percent of the dividends received from these companies. When DaimlerChrysler Corporation earns income in the United States and it elects to dividend some of its aftertax earnings from the United States to Germany, less a 5 percent withholding tax, these dividends are now taxed in Germany at 3.5 percent. Therefore, we have a degree of certainty as to the amount of tax that will be paid on the U.S. operations of DaimlerChrysler.

However, under the U.S. worldwide tax system, a U.S. parent company receiving dividends from its foreign affiliates does not have this certainty. The U.S. company must include the dividends and correspondent foreign taxes paid in its U.S. taxable income. Under certain restrictions put into the U.S. tax law over the past several decades, the U.S. taxpayer may never know beforehand whether these dividends will or will not be taxed by the United States. The result could be taxation of at least a portion of the earnings twice by two different countries.

Why does a U.S. company have a problem utilizing all its foreign tax credits so that foreign source income is only taxed once? The main reason for this problem is that the U.S. company has to apportion many of its domestic business expenses, especially interest, against its foreign source income, thus, reducing the amount of foreign income that may be taken into account in meeting the limitation. This would create unused foreign tax credits.

In DaimlerChrysler Corporation's case, if it were the parent of the new company, more than 50 percent of its interest expense incurred in the United States to finance a sale or lease of a vehicle in the United States would have been apportioned to foreign source income. This would have certainly resulted in double taxation of significant amounts of repatriated foreign earnings. Just for an example, if we sold a Dodge pick-up in Texas and incurred $1,000 of interest expense in our finance company, $500 of that interest would have been allocated to foreign source income.

There are other U.S. tax rules that also came into our decision. The treatment of foreign finance subsidiaries, which was corrected on a year to year basis, would not be a problem under German tax laws. Investment income earned by foreign subsidiaries would not be taxed by the German company. And foreign-based company sales where we manufacture in one company, sell it to a distribution company in a second country and then sell on to a third company, that had the potential of being taxed in the United States.

Finally, by becoming a subsidiary of a German company, DaimlerChrysler Corporation has minimized the possibility of paying additional tax—not taxes—on our foreign operation. This should help the U.S. operation of the company to continue to compete on a global scale. However, there are many U.S. companies which have foreign operations and they are put at a competitive disadvantage in the global economy because of the U.S. tax rules on their foreign operation.

Thank you.

[The prepared statement follows:]

Statement of John L. Loffredo, Vice President and Chief Tax Counsel, DaimlerChrysler Corporation

My name is John Loffredo, and I am Vice President and Chief Tax Counsel for DaimlerChrysler Corporation, the U.S. arm of DaimlerChrysler. The merger of Chrysler Corporation and Daimler Benz A.G. was a marriage of two global manufacturing companies, one with its core operations in North America and the other headquartered in Europe, with operations around the world. However, the U.S. tax system puts global companies at a decisive disadvantage. This issue became a major concern and when the time came to choose whether the new company should be a U.S. company or a foreign company, Management chose a company organized under the laws of Germany.

Generally, the German tax system is based on a "Territorial" theory. By contrast, the U.S. tax system follows the philosophy of taxing the worldwide income of a U.S. company while allowing tax credits for taxes paid to foreign governments. In theory, it is possible for both systems to result in the same tax being imposed on a company whether they are U.S. or German. However, in practice this does NOT happen.

Before I go further, I want to make it clear that the former Daimler Benz has been a good corporate citizen in the U.S. and has paid all taxes believed legally due on its U.S. operations. The same is true for the former Chrysler Corporation. In addition, Daimler and Chrysler will continue to be subject to the U.S. tax laws on their U.S. operations and will continue to pay their fair share of U.S. taxes. However, what we did not want to happen as part of this merger was to increase the company's tax burden by subjecting to U.S. tax Daimler Benz's non-U.S. operations that were NEVER subject to U.S. tax laws in the past.

As mentioned, the main reason that Germany's tax system on global corporations is preferable to the U.S. is the "Territorial" nature of their tax system. What does this mean from a practical standpoint?

1. WORLDWIDE VS. TERRITORIAL TAX SYSTEM

As of the date of our merger, the German Territorial Tax System exempted qualified dividends received from foreign subsidiaries from taxation . (Recent German law changes now tax 15% of such dividends). When DaimlerChrysler Corporation earns income in the U.S. it may elect to dividend some of its after-tax earnings from the U.S. to Germany, (less a 5% withholding tax). Before 1999 these dividends were not subject to German income tax but now 15% of the dividend is taxed (resulting in a 3.5% German tax on the gross dividend before U.S. tax).

However, under the U.S.'s worldwide tax system a U.S. parent company receiving dividends from its foreign affiliates must include the dividends and corresponding foreign taxes paid in its U.S. taxable income. Then it must determine the U.S. tax on those dividends. The U.S. company may be able to offset the U.S. tax on that income if it can meet certain limitations and utilize the foreign tax credits generated by these foreign subsidiaries. If the foreign tax rate is the same or higher than the U.S. tax rate, the foreign tax credits should, in theory, offset the U.S. tax on those dividends. If this occurred, the result would be the same in the U.S. as it is under the German Territorial System. That is, no further U.S. corporate tax would be imposed and the earnings will have been taxed by only one country. However, under restrictions put in the U.S. tax laws over the past several decades, this theoretical result is typically NOT achieved and, in many cases, the U.S. taxpayer can NEVER fully utilize all of the foreign taxes paid by its subsidiaries to offset the U.S. tax on foreign earnings. The result is taxation of at least a portion of the earnings twice, by two countries.

Under these circumstances, the German Territorial Tax System provides a greater degree of certainty for the new DaimlerChrysler company that corporate income earned outside of the country of incorporation for the parent will only be taxed once. (Although as of January 1, 1999 dividends remitted to Germany will be subject to the new tax equivalent of 3.5% of the gross dividend before U.S. tax).

Why does a U.S. company have a problem utilizing all its foreign tax credits so that foreign source income is only taxed once? The main reason for this problem is that a U.S. company has to apportion many of its domestic business expenses (especially interest expense) against its foreign source income, thus reducing the amount of foreign income that may be taken into account in meeting the limitation. This would create unused foreign tax credits.

2. APPORTIONMENT OF BUSINESS EXPENSES

The U.S. tax system requires certain domestic company's business expenses to be apportioned to foreign source income for purposes of determining the amount of foreign tax credits that may be claimed. This apportionment of expenses has the effect of reducing the amount of a taxpayer's foreign source income. The result is a taxpayer does not have sufficient foreign source income to utilize all of its foreign tax credits. In effect, this apportionment of expenses to foreign source income results in an amount of foreign income equal to the apportioned expenses being taxed in the U.S. with NO credit offset. This amount of income is thus subjected to tax twice, once by the foreign country and again by the U.S.

The expense apportioned to foreign source income that creates the most difficulty to a company like DaimlerChrysler, and to many other U.S. companies, is interest expense, which must be apportioned on the basis of the location of an affiliated group's assets. Since interest is apportioned on an asset basis, it is apportioned to foreign source income categories whether or not the foreign affiliates have current income subject to U.S. taxation (e.g., dividends that are paid from a foreign subsidiary).

DaimlerChrysler has a large affiliated finance company in the U.S. whose primary business purpose is to provide financing to Chrysler dealers and customers who buy Chrysler products in the U.S. However, under the U.S. tax laws, DaimlerChrysler must apportion its U.S. affiliated group's interest expense between its U.S. income and its worldwide income. Had the former Chrysler Corporation become the parent company of the merged group, substantially over 50% of the value of the assets of the combined companies would have been located outside of the United States. This would have meant that more than 50% of the U.S. affiliated group's interest would have been apportioned to foreign source income. This would have decreased the amount of foreign source income that was eligible for offset by the foreign tax credit. In effect, U.S. tax would have to be paid on the amount of foreign source income equal to the expenses allocated to that income, and that would have been quite a large number.

For example, let's examine what would happen where the German company is a subsidiary of the U.S. Company. Assume DaimlerChrysler Corporation sold one vehicle in the U.S. and made $1,000 of net taxable income on the sale. DaimlerChrysler's finance subsidiary financed the sale of the vehicle and that company incurred $100 of interest expense. Also, in that year, the former Daimler Benz AG earned $100, paid $50 in tax to the German tax authorities, and remitted a $50 dividend to the DaimlerChrysler parent company in the U.S.

Let's assume that 50% of DaimlerChrysler Corporation's assets were foreign. Therefore, 50% of the interest expense or $50 is allocated to foreign source income. Of DaimlerChrysler Corporation's total income subject to U.S. tax of $1,100 only $100 is foreign source income ($50 dividend plus $50 gross-up for German taxes). Under the method used to calculate foreign tax credits in the U.S., the $100 in foreign source income is reduced by the $50 U.S. interest expense apportioned to foreign source income. This results in net foreign source income of $50. The U.S. tax on that amount is $17.50 which is the maximum amount of credit that may be claimed on the $100 of German income. Therefore on the $100 earnings in Germany, 67.5% would be paid in taxes (50 in Germany; 17.5 in the U.S.). That is, a portion of the German income will have been taxed twice.

With DaimlerChrysler A.G. as the parent company, if its U.S. subsidiary earned $100 of income from U.S. sources, that income would have been subject to a tax at the 35% U.S. rate. A subsequent dividend to Germany would be subject to an additional 5% U.S. withholding tax and then the new German tax (equivalent to 3.5% of the $100 earned from U.S. sources) for a total effective tax of around 44%, rather than 67.5%.

In addition to the apportionment of expenses problem, there were three other areas of concern to DaimlerChrysler under the laws in the U.S. for taxation of foreign subsidiaries of U.S. companies:

(A) foreign finance subsidiaries;
(B) incidental investment income earned by foreign operating subsidiaries; and
(C) foreign base company sales income.

A. Foreign Finance Subsidiaries—Prior to 1997, foreign subsidiaries of U.S. companies who were carrying on an active finance business (borrowing and lending) in a foreign location had to be concerned that these operations were subject to U.S. tax on their earnings even though not distributed to the U.S. parent. The problem has been alleviated by recent legislation that has given taxpayers temporary relief to exclude such active business income from U.S. taxation. The German tax system would NOT tax such an active business. DaimlerChrysler Corporation, which con-

tinues to own active finance companies in Canada and Mexico, strongly supports this rule which allows active foreign finance company income to be exempt from U.S. taxation until remitted to the U.S. and urges that it be made permanent.

B. Incidental Investment Income Earned by Foreign Operating Subsidiaries—The U.S. will tax in the year earned passive foreign income (interest) if the tax rate in the foreign country is less than 90% of the U.S. tax rate or less than 31.5%. The Germans, on the other hand, will not tax incidental income (interest on working capital) earned at an active operating company. However, both the German's and the U.S. have similar rules when it comes to taxing foreign sourced passive income where such income is in a tax haven country. In Germany, the income is taxed immediately if it is not subject to a 30% tax rate in the country where it is earned and, as mentioned before, the U.S. rule is that such income must be taxed at a 31.5% tax rate to avoid immediate U.S. taxation.

C. Foreign Base Company Sales Income—DaimlerChrysler is in the business of selling vehicles worldwide. Let us assume DaimlerChrysler A.G., a German company, establishes a regional distribution center in the United Kingdom as a staging area for the sale of right-hand drive vehicles worldwide. Vehicles manufactured in Germany are sold to the distribution center in the U.K., and then on to a third country. The income earned by the U.K. distribution center would be taxed in the U.K. (and not Germany until a dividend was eventually paid to Germany in which case the new tax on 15% of the dividend would apply).

Now assume that DaimlerChrysler, a U.S. company, sent vehicles manufactured by its German subsidiary to the U.K. center. The vehicles in the U.K. will be sold throughout the world. Under U.S. tax laws the income earned by the U.K. distribution center on vehicles shipped to other countries would be taxed immediately in the U.S. The reason for this is because the new U.K. tax rate of 30% is less than 90% of the U.S. tax rate. In the above two scenarios there is no difference in operation for the DaimlerChrysler group, only a difference in tax results. The only change in facts is the country of incorporation of the parent company. The U.S. company is placed at a decisive disadvantage.

In the above three circumstances, the foreign source income included in U.S. taxable income is reportable in the year the income is earned by the foreign company. This is the case whether or not the income is repatriated to the U.S. or whether or not the U.S. taxpayer is in a net U.S. taxable income or loss position for the year. Because of the "basket" rules adopted in 1986, many taxpayers with losses may be in a position of including this income in their tax base but they cannot offset the tax on this income with current foreign tax credits. In these cases, the chance for double taxation on the foreign source income increases.

As can be seen from above, DaimlerChrysler Corporation, now a subsidiary of a German company, has minimized the possibility of paying ADDITIONAL tax (NOT TAXES) on its foreign operations. This should help the operations of the company to continue to compete on a global scale. However, there are many U.S. companies which have foreign operations and they are put at a competitive disadvantage in the global economy, just because they are competing against companies who do not have to follow the way the U.S. tax system taxes foreign operations.

[The Report, Entitled "THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY," dated March 25, 1999, is being retained in the Committee files.]

Chairman ARCHER. Thank you, Mr. Loffredo.

Our next witness is Mr. Lipner. Mr. Lipner, if you will identify yourself for the record, you may proceed.

STATEMENT OF ALAN J. LIPNER, SENIOR VICE PRESIDENT, TAXES, AMERICAN EXPRESS COMPANY, NEW YORK, NEW YORK

Mr. LIPNER. Good morning, Mr. Chairman and Members of the Committee. My name is Al Lipner. I am the senior vice president and chief tax officer of American Express Co. I am pleased to have this opportunity to testify on the effect the U.S. tax rules have on the international competitiveness of our business.

American Express has had a strong international business presence for more than a century and well before the Sixteenth amendment to the Constitution was ratified and the Federal income tax was first enacted. American Express offers products and services in some 200 countries and territories around the world. We offer American Express cards issued in 45 different currencies throughout the world. Our major competitors are overseas banks and other financial institutions that are incorporated and have headquarters outside the United States.

Before 1987, the Subpart F rules permitted U.S. tax to be deferred on income derived in the active conduct of banking or financing business until that income was distributed to a U.S. shareholder. In repealing deferral for active financing income, Congress focused on U.S.-controlled firms operating in tax havens. What Congress ignored was that the majority of U.S.-controlled banks, finance companies, and insurance companies operate overseas through a substantial presence in key markets rather than as tax haven paper companies.

While U.S. taxes might appear to be imposed at a relatively moderate nominal rate compared to the rates imposed by foreign countries, in practice U.S. taxes frequently exceed the effective tax rate due to more generous foreign country tax rules. When U.S.-owned firms are subject to a higher tax burden than their foreign competitors, this can significantly affect how much to invest in business development, how products are priced, and even whether or not to continue an investment or continue a business in a foreign market. Such factors have influenced some of my company's business decisions.

American Express purchased a Swiss bank in 1983. Its business operations were exclusively outside the United States and its customers were not U.S. persons. Its effective tax rate was 9 percent but was increased to 40 percent in 1987 when the U.S. Subpart F rules made its earnings subject to U.S. tax. Our subsidiaries thus became subject to a much higher tax rate than our foreign competitors solely because of U.S. ownership. We disposed of our controlling interest in the Swiss bank in 1990.

We considered purchasing a United Kingdom life insurance company. Although its nominal tax rate was about 34 percent, we were faced with the prospect of a tax rate of over 200 percent because of the inability to defer U.S. tax on profits and the disparities between the tax base under U.S. and foreign tax rules. We did not go forward with the purchase.

Congress has recently made significant progress in addressing some of these concerns by restoring deferral on certain active foreign financial services income. These new tax rules have significantly recognized that finance companies, other than banks, are eligible for deferral in appropriate cases. Unfortunately, the new tax rules expire at the end of this year. We hope Congress will enact a longer-term solution, rather than a 1-year extension of the current rules, since our business planning and investment decisions require a stable set of rules without the uncertainty presented by year-to-year changes.

Turning to the foreign tax credit, the present basket rules often make arbitrary distinctions between certain types of income earned

in an integrated business. For American Express, a noteworthy example concerns our travel business, which the regulations consider to be separate from and not incidental to our card and Travelers Cheque activities. As a result, a typical transaction with a single customer handled by a single American Express employee in an American Express Travel office overseas is considered to give rise to income and related taxes in two separate foreign credit baskets.

We appreciate the introduction earlier this month of H.R. 2018, the international tax simplification bill, presented by Representatives Houghton and Levin.

In conclusion, I would like to thank the Chairman and the Committee for their interest in addressing the impact of U.S. tax rules on international competitiveness. The business activities of American Express in key locations of the United States, including New York, Minneapolis, Phoenix, and Fort Lauderdale, serve our global operations and not just the U.S. market. Assuring a strong competitive position of our business overseas has a clear and positive effect on U.S. business and the U.S. employment base of American Express.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of Alan J. Lipner, Senior Vice President, Taxes, American Express Company, New York, New York

Good morning, Mr. Chairman and Members of the Committee. My name is Alan J. Lipner, Senior Vice President—Taxes of American Express Company. I am pleased to have this opportunity to testify on the effect U.S. tax rules have on the international competitiveness of our business. In addition to my oral remarks today, I have prepared a written statement that, with your permission, I would like to have entered into the official record of today's hearing.

As the chief tax officer of one of the world's leading financial services companies, I am well aware of the profound impact tax issues have on our business. In my role as Chairman of the Board of The Tax Council and through other groups such as the National Foreign Trade Council, I have discussed tax issues of this nature with several of my counterparts at other major U.S. companies. My testimony today will not focus in detail on the technical tax rules. Instead, I will try to illustrate how those tax rules can have an impact upon how our business and other U.S. businesses compete against those whose headquarters are outside the United States.

American Express has a long history of doing business outside the United States. This is well known by anyone who has traveled overseas and bought or cashed an American Express Travelers Cheque or used an American Express Card to charge a purchase. In fact, American Express has had a strong international business presence for more than a century—or well before the 16th Amendment to the Constitution was ratified and the Federal income tax was first enacted.

American Express began in 1850 as a shipping company that transported currency and other valuable items swiftly and safely to their destinations. A sizeable foreign exchange and foreign remittance business developed in the late 19th century as a service for new Americans and laid the groundwork for the Company's eventual major role in the international financial arena.

A great step in the company's international expansion came with the introduction in 1891 of the American Express Travelers Cheque. This revolutionary financial instrument, with its now familiar signature and countersignature, allowed travelers to obtain access to funds without the inconvenience of letters of credit that could be honored only within normal banking hours at specified correspondent banks in a very time consuming process. The international business expansion that followed led to the establishment of a chain of American Express offices—or "homes away from home"—in key cities throughout the world around the turn of the century.

Today, American Express offers its products and services in some 200 countries and territories around the world. As in the early days of its international business, the company continues to serve U.S. customers whose personal or business affairs require our financial services to be available wherever they need them. Over the years, our business has expanded to focus also upon non-U.S. customers. This is il-

lustrated by the fact that American Express Cards are now issued in 45 different currencies around the world. Our major competitors overseas are banks and other financial institutions that are incorporated and have their headquarters outside the United States.

The two major features of U.S tax rules that affect our international operations are the Subpart F rules and the foreign tax credit. Both these areas were modified substantially in 1986 in ways that adversely affected both the burdens of tax compliance and our competitive position vis-a-vis non-U.S. financial services firms.

Before 1987, the Subpart F rules permitted U.S. tax to be deferred on income derived in the active conduct of a banking or financing business until that income was distributed to a U.S. shareholder. In repealing deferral for active financing income, Congress focused on U.S.-controlled firms operating in tax havens and earnings that were manipulated for tax reasons. What Congress ignored was that the majority of U.S.-controlled banks, finance and insurance companies operate overseas through a substantial presence in key markets rather than as tax haven "paper" companies. These firms compete head-to-head with foreign-controlled companies whose home countries do not impose tax on unremitted, reinvested earnings. Also ignored was the impact of foreign banking or insurance regulations that often require these businesses to be operated by a locally incorporated subsidiary subject to local regulatory control.

While U.S taxes might appear to be imposed at a relatively moderate nominal rate compared to the rates imposed by foreign countries, in practice U.S. taxes frequently exceed the effective foreign tax rate due to more generous foreign rules for such items as bad debt deductions or certain preferential income. When U.S-owned firms are subject to a higher tax burden than their foreign competitors, this can obviously affect such factors as how much to invest in business development, how products are priced and even whether or not to invest or continue to do business in a foreign market. Such tax factors have influenced some of my company's business decisions:

> American Express purchased a Swiss bank in 1983. Its business operations were exclusively outside the U.S. and its customers were not U.S. persons. Its effective tax rate of about 9% increased to 40% in 1987 when the changes in the Subpart F rules made its earnings subject to U.S. tax. Our subsidiary thus became subject to a much higher tax rate than our foreign competitors solely because of its U.S. ownership. We disposed of our controlling interest in the Swiss bank in 1990.
>
> We considered purchasing a U.K. life insurance company. Although its nominal local tax rate was about 34%, we were faced with the prospect of an effective tax rate of over 200% because of our inability to defer U.S. tax on its profits and disparities between the tax base under U.S. and foreign tax rules. We did not go forward with the purchase.

Congress has recently made significant progress in addressing some of these concerns by restoring deferral of U.S. tax on certain active foreign financial services income. These new rules have specifically recognized that finance companies other than banks are eligible for deferral in appropriate cases. Unfortunately, the new rules expire at the end of this year. We hope Congress will enact a longer-term solution rather than a mere one-year extension of the current rules since our business planning and investment decisions require a stable set of rules without the uncertainty presented by year-to-year changes. We appreciate that a substantial number of the members of this committee have co-sponsored H.R. 681, legislation introduced by Representatives McCrery and Neal to provide greater certainty.

Turning to the foreign tax credit, the present separate limitation or "basket" rules often make arbitrary distinctions between certain types of income earned in an integrated business. For American Express, a noteworthy example concerns our Travel business, which the tax regulations consider to be separate from and not incidental to our Card and Travelers Cheque activities. As a result, a typical transaction with a single customer handled by a single employee in an American Express Travel office overseas is considered to give rise to income (and related taxes) in two separate foreign tax credit baskets. Another example is the so-called "high withholding tax interest" basket, which was intended to curb cross-border loans that were not economically sound on a pre-tax basis. By discouraging cross-border lending by U.S. financial institutions, the tax rules have given foreign-controlled lenders a tax-based competitive advantage in financing developing economies around the world. A third example is the separate basket for "joint ventures" or foreign corporations with between 10% and 50% ownership by U.S. firms. We support proposals to accelerate a repeal of these rules that inhibit U.S. firms from expanding business overseas by investing in strategic alliances with foreign partners.

Another area of concern to American Express is the excise tax on the purchase of frequent flyer mileage awards from airlines. Some have interpreted this tax to apply not only to frequent flyer points to be awarded to U.S. customers, but also to any points purchased anywhere in the world, from any airline, and for any customer, if there is a mere possibility that the points could be used to obtain an airline ticket to or from the U.S. Since foreign governments and companies have objected to this extraterritorial reach of the U.S. excise tax, the practical effect is that, absent rigorous global enforcement, the tax burden will fall only upon U.S. companies doing business overseas and the customers of U.S.-based airlines.

We appreciate the introduction earlier this month of H.R. 2018, the international tax simplification bill, by Representatives Houghton and Levin. This bill would address several of the problems I have highlighted above and would help simplify our complicated international tax rules and encourage competitiveness.

In conclusion, I would like to thank the Chairman and the Committee for their interest in addressing the impact of U.S. tax rules on international competitiveness. The business activities American Express conducts at its key locations in the United States, including New York, Minneapolis, Phoenix and Fort Lauderdale, serve our global operations and not just the U.S. market. Assuring a strong competitive position for our business overseas has a clear positive effect on our U.S. business and employment base. In addition, ensuring a strong position for the financial services sector reinforces a competitive strength for the U.S. economy as a whole, as indicated by the positive contribution the service sector makes to our overall balance of payments situation.

I would be pleased to respond to any questions the Chairman or Members of the Committee may have.

Chairman ARCHER. Thank you, Mr. Lipner.

Our next witness is Ms. Stiles. We are happy to have you here and welcome. You may proceed.

STATEMENT OF SALLY A. STILES, INTERNATIONAL TAX MANAGER, CATERPILLAR INC., PEORIA, ILLINOIS

Ms. STILES. Good morning, Mr. Chairman, Members of the Committee. I am Sally Stiles. I am an international tax manager for Caterpillar. It is a pleasure to be here this morning and to have the opportunity to talk with you about international taxation.

For those of you not entirely familiar with Caterpillar, let me begin with a few facts about the company. We are the world's largest manufacturer of constructing and mining equipment, natural gas and diesel engines, and industrial turbines.

We also own and operate subsidiaries that handle financing, insurance, leasing, and logistics services. We employ more than 40,000 employees in the United States and more than 65,000 employees worldwide. We posted sales last year of nearly $21 billion, including $6 billion in exports from the United States. These export sales directly support 15,000 U.S. jobs at our CAT facilities and an additional 30,000 jobs with our U.S. suppliers.

Mr. Chairman, Caterpillar applauds your efforts to reduce trade and tax barriers that U.S. companies face on a daily basis. We wholeheartedly agree with you that many of our tax policies don't reflect the current competitive environment facing companies like Caterpillar. International tax policies implemented in the sixties, and continually expanded in the years since, have not kept pace with the global marketplace.

The cross border emphasis embodied in the U.S. anti-deferral rules is rapidly becoming obsolete in a world where the marketplace is no longer defined by country borders. The dramatic events

unfolding in Europe are certainly the most convincing evidence of the changing marketplace. As the world recognizes the European Union as a single marketplace, so, too, should the U.S. tax law.

Mr. Chairman, we support your efforts to preserve two very important provisions in the current Tax Code. The Export Source Rule and the Foreign Sales Corporation provisions are critically important to U.S. exporters. These provisions and the recent decision to include active finance company income in the deferral rules have helped place U.S. companies on a more level playingfield with their foreign competitors. We strongly support permanent extension of the active finance provision.

Let me briefly explain to you why this provision is so important to Caterpillar.

Purchasing high value goods, like Caterpillar equipment, generally entails more than simply writing a check. Mr. Chairman, you have in front of you a model which represents the little brother to our largest mining shovels that are manufactured exclusively in our Joliet, Illinois facility. This mammoth equipment generally costs in excess of $1 million per unit. And let's bear in mind, many of our customers buy in fleets.

Caterpillar Financial Services Corporation and its subsidiaries offer competitive leasing and purchasing programs to all our customers, including the nearly 50 percent who are not in the United States.

Until the recent change in the U.S. tax law providing deferral for active finance income, the foreign source income generated from our foreign financing business was taxable in the United States on a current basis. Many of our foreign competitors are able to offer flexible financing programs to assist in the purchase of their competitive equipment without this additional home-country tax burden. The active finance exception has allowed us to remain competitive in these programs, but we run the risk of losing what we gained if we backtrack now.

If we are to maintain our primary philosophy of build it here and sell it there, we need a modern tax policy that is consistent with our global focus. U.S. tax rules must allow us to be competitive bidders when opportunities arise rather than placing us at an immediate disadvantage.

Several Members of this Committee have been instrumental in proposing and helping to enact simplification measures to our international tax system. We encourage those efforts to continue. The compliance cost associated with the incredibly complex U.S. international tax rules are enormous.

Let's keep our eye on the long-term benefits to the U.S. economy, ensuring U.S. companies remain globally competitive, recognizing and responding to the tax-related challenges of new technologies and new markets. By working together, we can assure our future generations an opportunity to participate in world markets, instead of apologizing for lost opportunities.

I will be happy to answer any questions at the appropriate time. Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of Sally A. Stiles, International Tax Manager, Caterpiller Inc., Peoria, Illinois

Good morning Mr. Chairman and members of the Committee, I am Sally Stiles, International Tax Manager for Caterpillar Inc. It's a pleasure to be here and to have the opportunity to talk with you about international taxation.

For those of you not entirely familiar with Caterpillar, let me begin with some facts about the company. We are the world's largest manufacturer of construction and mining equipment, natural gas and diesel engines, and industrial turbines.

We also own and operate subsidiaries that handle financing, insurance, leasing programs, countertrade and logistics services. We employ 65,000 employees worldwide and posted sales last year of nearly $21 billion, including $6 billion in exports from the United States. These export sales directly support 15,000 U.S. jobs and an additional 30,000 jobs with our U.S. suppliers.

Mr. Chairman, Caterpillar applauds your efforts to reduce trade and tax barriers that U.S. companies face on a daily basis. We wholeheartedly agree with you that many of our tax policies don't reflect the current competitive environment facing companies like Caterpillar. Tax policies implemented in the 1960's and continually expanded in the years since have not kept pace with the global marketplace.

The cross border emphasis embodied in the U.S. anti-deferral rules is rapidly becoming obsolete in a world where the marketplace is no longer defined by country borders. The dramatic events unfolding in Europe are certainly the most convincing evidence of the changing marketplace. As the world recognizes the European Union as a single marketplace so too should the U.S. tax laws.

Mr. Chairman we support your efforts to preserve two very important features of the current tax code. The Export Source Rule and the Foreign Sales Corporation provisions are critically important to U.S. exporters. These provisions and the recent decision to include active finance company income in the deferral rules have helped place U.S. companies on a more level playing field with their foreign competitors. We strongly support permanent extension of the active finance provision.

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If we are to maintain our primary philosophy of "build it here and sell it there," we need a modern tax policy that is consistent with our global focus. U.S. tax rules must allow us to be competitive bidders when opportunities arise rather than placing us at an immediate disadvantage.

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Let's keep our eyes on the long-term benefits to the U.S. economy, ensuring U.S. companies remain globally competitive, recognizing and responding to the tax-related challenges of new technologies and new markets. By working together, we can assure future generations of Americans an opportunity to participate in world markets—instead of apologizing for lost possibilities.

As stated in the discussion above, the U.S. anti-deferral rules must be reformed if U.S. companies are to fully participate in world markets. The Foreign Base Company Income rules and the Foreign Personal Holding Company Income rules make it impossible for U.S. companies to enjoy the same economies of centralized operations that are available to their foreign competitors. Under current U.S. rules, the cross border transactions that are inherent in centralized operations such as treasury centers, distribution operations, marketing and "back office" service centers are all currently taxable in the United States. Income associated with these centralized

operations is clearly active business income and should not be subject to current U.S. taxation.

The Foreign Tax Credit Limitation calculation is another area of the international tax law that is very much in need of reform. The rules dictating the segregation of income into the various baskets have become so overly complicated that compliance efforts are not only costly but also error prone. Acceleration of the provisions allowing look-thru treatment for dividends of Non-controlled Section 902 Corporations and extension of the allowable period for foreign tax credit carryforwards are measures that, if adopted, would provide some relief in this area.

The expense allocation and apportionment rules are no less complicated and burdensome than the income sourcing rules. In particular, the interest expense apportionment rules are not only a complex administrative burden but also unfairly penalize U.S. multinational companies with U.S. financial subsidiaries. Under current rules interest expense may not be netted against interest income and must be apportioned on the asset method. For U.S. companies with foreign subsidiaries a significant portion of this interest expense will be apportioned to foreign source income in spite of the fact that the expense was incurred solely to fund U.S. financial transactions.

The volume of information that must be collected from foreign locations to comply with the U.S. informational reporting requirements has become a tremendous burden on U.S. multinational companies. Adopting US GAAP accounting for the determination of Earnings and Profits for both informational and Subpart F calculations would greatly simplify this process.

Chairman ARCHER. Thank you, Ms. Stiles.

Our last witness on this panel is Mr. Finnerty, welcome. You may proceed.

STATEMENT OF PETER J. FINNERTY, VICE PRESIDENT, PUBLIC AFFAIRS, SEA-LAND SERVICE, INC., AND VICE PRESIDENT, MARITIME AFFAIRS, CSX CORPORATION, RICHMOND, VIRGINIA

Mr. FINNERTY. Thank you very much, Mr. Chairman and Members of the Committee. I am Peter Finnerty, Vice President, Public Affairs, Sea-Land Service. And I am very appreciative of the opportunity to testify today on the significant adverse impact of U.S. tax rules on the international competitiveness of the United States Merchant Marine and some proposed solutions.

Sea-Land is the largest ocean carrier in the United States, with a global fleet of about 100 container ships serving 120 ports in 80 countries. Thirty-five of our ships are registered in the United States. Our inter-modal network operates with about 220,000 freight containers, port terminals, extensive computer and communications technology on five continents. It is a highly capital intensive business.

As set forth in my full statement, U.S.-flag carriers are proud of our record of innovation. Sea-Land invented containerization in 1956 when the initial voyage sailed from New York to Houston, Texas. In the years since, however, the U.S.-flag fleet has been struggling under a heavy tax burden whereas foreign nations purposely do not tax their international shipping activities so they will be more competitive on the high seas.

The U.S. tax burden takes many forms. In addition to income tax and various fees, there is the alternative minimum tax and the very onerous 50 percent duty on U.S.-flag vessel maintenance and repair.

The administration now proposes to impose an added $1 billion a year in harbor dredging taxes. U.S. ocean carriers have testified, seeking relief from the heavy tax burden in the past. I testified before this Committee in 1980 on this same point. John Snow, our chairman of CSX Corp., our parent company, and John Lillie, then chairman of American President Companies, testified in 1993 before the Senate. And again in 1995, U.S.-flag carriers stressed that the tax gap between us and our foreign-flag competitors is large.

H.R. 2159, introduced June 10, 1999, by Congressman McCrery and cosponsored by Congressmen Herger, Jefferson, and Abercrombie, proposes a number of beneficial changes to the Capital Construction Fund to increase its effectiveness in helping U.S.-flag vessel operators to generate private investment capital for new U.S.-flag ships and operating equipment. The U.S.-flag maritime industry strongly supports this measure, and we urge its early approval by the Committee.

And I would like to submit a letter to that extent for the record.

[The information had not been received at the time of printing.]

Mr. FINNERTY. The Capital Construction Fund changes would include a broadening of the scope of U.S.-flag vessels "eligible" to make deposits into a CCF. U.S.-flag vessels operated in the oceangoing domestic trade and in trade between foreign ports would be included as qualified vessels. And containers and trailers which are part of the complement of an "eligible" vessel could be purchased with CCF funds. Qualified withdrawals from a CCF account for vessels would continue to be limited to U.S.-flag vessels built in the United States. A very important change would allow a CCF fundholder the right to elect a deposit into a CCF of all or a portion of the amount that would otherwise be payable to the Secretary of the Treasury as a duty on foreign repairs to U.S.-flag vessels imposed by section 466 of the Tariff Act of 1930.

These tax improvements would benefit the same U.S.-flag ships that the Department of Defense relies upon for support of the Armed Forces in such contingencies as Vietnam and Desert Storm.

The economic and national security of our country depend on this Nation's ability to guarantee the flow of goods in international commerce through U.S. ports. It is critical that the Committee approve H.R. 2159 to ensure future competitiveness of the U.S. Flag Merchant Marine.

Thank you.

[The prepared statement follows:]

Statement of Peter J. Finnerty, Vice President, Public Affairs, Sea-Land Service, Inc., and Vice President, Maritime Affairs, CSX Corporation, Richmond, Virginia

KEY POINTS

- By increasing the economic cost of new vessels for U.S. shipowners, U.S. tax rules have hindered the development of a United States-flag commercial merchant fleet in the foreign trades of sufficient size and capacity to maintain its share of U.S. international oceanborne trade over the last half of the 20th Century. As U.S. waterborne imports and exports increased five-fold, the share of that trade carried on United States-flag ships dropped from 60 percent (in 1947) to less than 3 percent (1997).
- This competitive handicap can be directly attributed to U.S. tax rules—not the competitiveness of the U.S. industry itself. During this period, technology and logistics innovations developed by the U.S. industry virtually revolutionized inter-

national shipping, and in every segment of the fleet today's U.S.-flag vessels are highly efficient and fully competitive with their foreign counterparts. For example, the U.S. liner industry today carries 25 percent more cargo than 30 years ago with 70 percent fewer ships.

- Nor is this a question of U.S. ship acquisition—United States-flag ships in the international trades can be purchased on the same international shipbuilding market as ships of our foreign competitors. The key difference is that because of U.S. tax rules, American shipowners must purchase those ships with after-tax dollars whereas foreign operators generally can do so with pre-tax funds. As a result, American shipowners face a 35 percent economic disadvantage before a ship even hits the water.
- Other aspects of U.S. tax rules have a similar impact on the availability of operating revenues for investment in new ships. On average, our new ships would pay about $1 million a year more in taxes, per ship, than our foreign competitors. Moreover, even in our unprofitable years, we remain subject to the Alternative Minimum Tax. If a United States-flag carrier and a foreign carrier each earns $10 million in operating revenues, after national taxes are applied, the foreign carrier still has $10 million available to reinvest, while the American carrier has only $6.5 million.
- H.R. 2159, the "United States-Flag Merchant Marine Revitalization Act of 1999," now before this Committee, proposes key changes to U.S.-flag tax rules to increase the international competitiveness of U.S.-flag shipping companies in international oceanborne trade. If enacted, these changes would make the existing Capital Construction Fund program a much more effective means of generating private investment capital for new ships and equipments for the United States-Flag Merchant Fleet.

STATEMENT

Mr. Chairman and Members of the Committee: Good morning my name is Peter Finnerty, Vice President of Public Affairs for Sea-Land Service, Inc. and of Maritime Affairs for CSX Corporation, Sea-Land's corporate parent.[1] I am pleased to appear before the Committee today to discuss the impact of U.S. tax rules on the international competitiveness of the United States maritime industry and to stress the importance of proposed changes to those rules as embodied in H.R. 2159, the United States-Flag Merchant Marine Act of 1999, now pending before this Committee.

I. INTRODUCTION

The ability of the American shipowner competing in international shipping markets to build and operate ships on a comparable economic basis as our foreign competitors is vital to the competitiveness of the U.S.-flag industry. And tax rules are key to that equation. The U.S. tax environment under which we must compete—but from which our foreign competitors are largely exempt—impacts both our day to day operating competitiveness and our ability to acquire new or replacement tonnage for our fleets.

The problem is not that these rules make it impossible for us to compete in international shipping. Make no mistake about it—today's United States-flag commercial fleet operating in the foreign trades is highly competitive and more than capable of out-performing our foreign-flag rivals in head-to-head competition on a level competitive playing field. For example, we carry as much cargo today as 40 years ago, but with fewer ships than at any point in our history.

The problem with U.S. tax rules, however, is that they force us to play catch-up from the very day we first contract to build a new ship. Even though we can build our ships in the same shipyards as our foreign competitors, for roughly the same delivered contract price, by and large our foreign competitors can purchase those ships with pre-tax dollars whereas under U.S. tax law the majority of our investment must come from post-tax dollars. Thus, we have to out-perform our competitors on the operating side just to catch-up economically.

Moreover, those same U.S. tax rules make it more difficult for us to compete economically in daily operations. For example, many of our competitors are based in countries whose tax regimes exempt earnings of national flag ships operated in international commerce from taxation altogether, whereas United States-flag operators are subject to U.S. tax law for all such revenues. Thus, not only can our foreign competitors invest pre-tax dollars in new ships, but the tax rules under which they

[1] Disclosure required under Truth in Testimony Rule: Sea-Land Service, Inc. contracts with the United States Government under the Maritime Security Act of 1996, 46 U.S.C. 652 et seq., and for oceanborne transportation services under 10 U.S.C. 2631 and 46 U.S.C. 901.

operate leave them more of such revenues with which to make those purchases. Similarly, if one of our ships and one of their ships go into the same foreign shipyard to receive the same repairs at the same contract cost, our repairs end up costing us 50 percent more due to U.S. tax rules that impose a 50 percent ad valorem duty on such repairs.

The cumulative effect of the economic penalties imposed on United States-flag shipping companies by U.S. tax rules over the last 50 years is clear. Immediately following the end of WWII, United States-flag ships carried almost 60 percent of U.S. oceanborne commerce moving in international trade (by tonnage). Today that figure is less than 3 percent.[2] Yet today's American ships are more efficient than ever—in the liner trades, for example, compared to 25 years ago, United States-flag ships carry 25–35 percent more cargo with 70–80 percent fewer vessels.

Why then has the percentage of cargoes carried by U.S.-flag ships in foreign trades declined so precipitously? Why are more than 97 out of every 100 tons of cargo entering or leaving a U.S. port in international commerce moving on foreign-flag ships? The answer is not that the U.S. fleet is inefficient—it is not—or that American companies simply cannot compete in international shipping. The answer is that even though the amount of cargo carried by American ships has remained unchanged for virtually the last 40 years, U.S. trade has increased almost five-fold over that same period—and virtually all of the increase is being carried by foreign-flag ships.

Operating under U.S. tax rules, the U.S.-flag fleet modernized and led the world in the introduction of new technologies that revolutionized international shipping. But at the same time, it failed to grow. Conversely, encouraged by their own, more favorable tax regimes, foreign shipping companies adopted the American companies' new technologies, invested in increasing numbers of modern, well-built ships (using tax-exempt dollars), grew in both vessel and total fleet capacity, and now dominate U.S. international waterborne commerce.

Following a brief introduction to Sea-Land and to the present state of the U.S.-flag industry, my testimony today will focus on two points:

- The impact of existing tax rules on the economic competitiveness of U.S.-flag ships and shipping companies in the foreign trades; and
- Proposed solutions to two aspects of that impact:
  - Investment in new ships; and
  - Repairs in non-U.S. shipyards.

In closing, I will also briefly address the role a portion of these proposed changes would play in the future modernization of the U.S.-flag fleet operating in the non-contiguous trades with the U.S. mainland, trades in which Sea-Land also operates. While not in direct competition with foreign shipping, the ability of U.S. carriers in those trades to replace existing tonnage with new ships as we enter the 21st Century in as cost-efficient a manner as possible will play an important role in our ability to continue to provide American shippers in those trades with the same safe, reliable and cost effective service as today.

II. Introduction to Sea-Land Service

Sea-Land Service, Inc., headquartered in Charlotte, NC, is a worldwide leader in container shipping transportation and related trade services. Sea-Land operates a fleet of about 100 containerships under both United States and foreign flags and approximately 220,000 containers. Placed end-to-end, this equates to a solid line of containers stretching from Washington, DC to somewhere between St. Louis, MO and Denver, CO (depending on whether they are 20- or 40-foot units). Sea-Land's ships serve 120 ports in 80 countries and territories.

III. The U.S.-Flag Fleet Today

In recent years, there has been much debate over the declining numbers of ocean-going U.S.-flag ships operating in the foreign trades. Those numbers, however, tell only a part of the story. It is important to look beyond the declining number of vessels in this part of the U.S.-flag fleet to assess its present state.[3] For example, be-

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[2] U.S. Department of Transportation, Maritime Administration, MARAD 98, at 49. The range in numbers results from variations in the categories of vessels counted for those trades across this period of time.

[3] Indeed, on the domestic side, where all vessels operate under the same tax rules, the United States-flag fleet has more than doubled in size (based on the same size vessel as discussed in the text) and tripled in productivity. Today, that fleet includes almost 1,900 such large commercial vessels (compared to only 861 in 1965) and carries over 1 billion tons cargo annually.

tween 1965 and 1995, the U.S.-flag oceangoing fleet decreased by 62 percent based on the numbers of vessels, but increased its total cargo carrying capacity by 15 percent. Moreover, productivity in that fleet—as measured by output (tons carried) per seagoing employee—increased at an annual rate (16 percent) that was 8 times the productivity gains being achieved by American business as a whole during the same period! Clearly American ships and crews can be competitive in international shipping markets.

The U.S.-flag dry cargo liner fleet provides a textbook example of increased productivity during this period. The Shipping Act of 1984 affirmed the longstanding U.S. policy of permitting U.S. carriers to participate in liner conferences on the same basis as foreign carriers that was first enacted in the Shipping Act, 1916. Under the stable investment climate created by those Acts, U.S. liner carriers became world leaders in the industry through technological development and marketing innovation. As containerships replaced breakbulks in the liner trades, the number of U.S.-flag vessels in the international liner trades declined, but the cargo carrying capacity of the U.S. liner fleet actually grew substantially. When non-liner vessels are excluded from the analysis of the U.S.-flag foreign trade fleet shown above and only the U.S.-flag liner fleet is considered—which is the portion of the fleet most affected by the Shipping Act—it becomes clear that to a great extent the changes in the size and composition of that fleet over the past 20 years represent a continuing process of downsizing and modernizing.

In 1975, for example, the total U.S. liner fleet (foreign and domestic trades) numbered 278 ships (compared to its current size of roughly 138 ships), but the 1975 fleet included 142 older, general cargo (or "breakbulk") vessels that were rapidly becoming commercially obsolete as a result of the general shift to containers for non-bulk dry cargo shipments. By 1995, the general cargo side of the liner fleet had dropped from 142 to just 16 ships—simply because that type of ship was no longer commercially viable. In contrast, although the number of intermodal vessels[4] (primarily containerships) in the U.S. liner fleet declined slightly between 1975 and 1995 (from 136 to 122 ships or by roughly 10 percent), the total deadweight tonnage, or cargo carrying capacity, of that part of the fleet actually increased by 35 percent as new, larger, faster vessels replaced the early, smaller classes of containerships.

This modernization process continued throughout the decade following the 1984 Shipping Act. Between 1984 and 1994, the number of intermodal ships in the U.S.-flag foreign trading liner fleet declined slightly (down 7 percent from 74 to 69 ships), but the deadweight tonnage of that same fleet increased by 19 percent over the same decade. The 69 ships in 1994 carried 25 percent more total cargo tonnage in international trade than did all 218 ships in the U.S. foreign trading fleet in 1975. Put simply, today's U.S.-flag foreign trade liner fleet carries 25 percent more cargoes in a year with almost 70 percent fewer ships. Thus, as these figures show, while its numbers may be less, the U.S.-flag liner fleet in the foreign trades today is substantially stronger and more productive than it was in 1975.

IV. Impact of U.S. Tax Rules on Competitiveness

If United States-flag ships and their American crews individually have been able to successfully compete in international trade for cargoes up to the amounts carried by U.S. ships historically over the last 30–40 years, why have U.S. shipping companies, or the United States-flag fleet overall, been largely unable to compete effectively for cargoes beyond that amount? The answer simply is in large part due to the impact of U.S. tax rules on the competitiveness of those American companies in international commerce.

A. Impact of U.S. Tax Rules

In recent years, American shipping companies have testified before Congress on numerous occasions detailing challenges faced by then in the international shipping market. And Congress has responded over the years, most recently with the Ocean

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[4] The term intermodal refers to transportation in the course of which the goods or passengers being carried transfer from one mode to another (e.g., from truck to railcar to oceangoing vessel). While this term can be used to describe virtually all modern transportation except trips in private automobiles, its use here is limited to referring to the movement of containerized goods or of wheeled vehicles (e.g., truck trailers) employing either containerships, roll-on/roll-off ships, or barges designed for those purposes whether operating separately or when carried on specially designed larger "LASH" ships. The remaining categories of waterborne freight transportation are bulk (cargo loaded "without mark or count") employing ships or barges described same term and general or breakbulk, which refers to cargoes loaded as individual items on board a ship or barge also described using that term, a practice generally no longer employed in much of the maritime industry.

Shipping Reform Act of 1998, which entered into effect this last May 1st. Indeed, the heightened competition in international liner shipping services that will occur as a result of that Act further highlight the need for Congress to address the tax rules applicable to the U.S.-flag shipping industry.

In 1993, for example, John Snow, the Chairman of CSX Corporation, and John Lillie, then Chairman of American President Companies, testified before the Merchant Marine Subcommittee of the Senate Committee on Commerce, Science and Transportation, that the tax difference between a U.S.-flag and a foreign-flag vessel amounted to an estimated $1 million annually for their companies per vessel.[5]

Two years later, in a Joint Statement submitted to the same committee, a group of U.S.-flag carriers again addressed the tax issue in the following manner:

The Tax Gap Between Us and Our Competitors Is Large. U.S.-based liner companies are subject to significantly higher taxes than their foreign-based counterparts. In testimony two years ago before this Committee, APL and Sea-Land submitted data showing that, as a result of shipping income tax exemptions, deferral devices, and accelerated depreciation, many of our foreign competitors pay virtually no income taxes (neither do their crews under many foreign tax regimes). Yet here at home, even in our unprofitable years, we are subject to the Alternative Minimum Tax. Consequently, U.S.-flag operators must earn more in the marketplace than their competitors in order to earn the same amount for reinvestment or distribution to shareholders. For example, if a U.S.-flag carrier and a foreign-flag carrier each earn $10 million, the foreign-flag carrier generally has $10 million left after applying national income taxes. The U.S.-flag carrier has only $6.5 million (applying a 35 percent Federal corporate rate and ignoring any State income tax considerations.[6]

At that time, the carriers stated they were not before the committee to seek maritime tax reform legislation, but acknowledged that such legislation "would be a great help."

Also in 1993, the General Accounting Office ("GAO") conducted a study that found the commercial maritime industry had been assessed $11.9 billion in taxes during fiscal year 1991. GAO identified 12 federal agencies as levying a total of 117 diverse assessments on the industry, 92 of which are specific to and paid only by the maritime industry. Such taxes included the Harbor Maintenance Tax (since repealed for exports only), vessel entry processing fees, the vessel tonnage tax, and an inland waterways fuel tax. These agencies included:

- Animal and Plant Health Inspection Service
- Coast Guard
- Customs Service
- Federal Communications Commission
- Internal Revenue Service
- Surface Transportation Board
- Maritime Administration
- National Oceanic and Atmospheric Administration
- Panama Canal Commission
- St. Lawrence Seaway Development Corporation

Since the 1993 study, additional taxes have been imposed. For example, the U.S. Coast Guard is now charging fees for a number of services it provides, including fees for vessel inspections (which it requires to be made), licensing and documentation of vessels, as well as fees charged to mariners for individual licenses and documentation. Moreover, the 105th Congress rejected an effort by the Office of Management and Budget to tax only commercial vessel operators for navigational assistance services, such as buoy placement and maintenance, vessel traffic services, and radio and satellite navigation systems.

B. Cumulative Impact on Competitiveness

The following graph illustrates the cumulative effect of these disparate economic conditions over the last 50 years. As noted above, immediately following the end of WWII, United States-flag ships carried almost 60 percent of U.S. oceanborne commerce moving in international trade (by tonnage). Today that figure is less than 3

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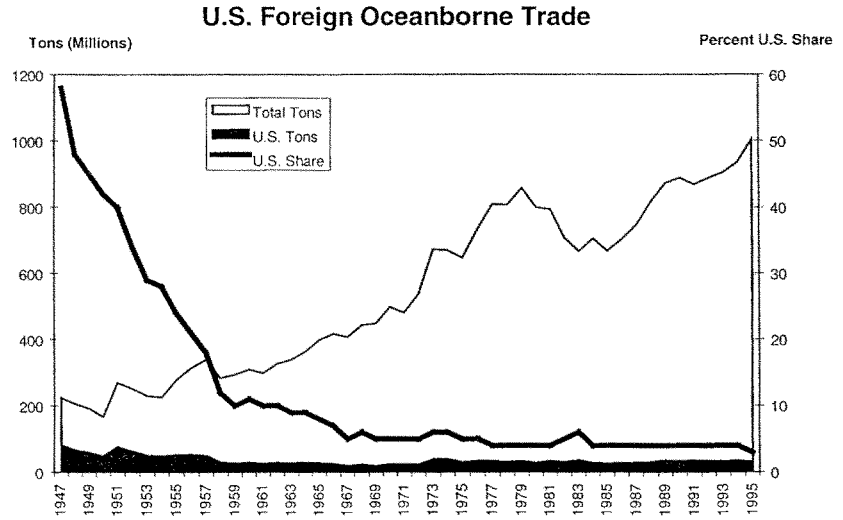
[5] Hearing before the Merchant Marine Subcommittee of the U.S. Senate Committee on Commerce, Science and Transportation, on the "Implications of the U.S. Government's Decision Not to Support a U.S.-Flag Fleet," August 5, 1993.

[6] Hearing before the Merchant Marine Subcommittee of the U.S. Senate Committee on Commerce, Science and Transportation, supporting "Prompt Enactment of Authorizing and Appropriations Legislation to Revitalize the United States-Flag Liner Fleet," July 26, 1995.

percent.[7] As U.S. trade grew, U.S.-flag shipping companies continued to compete effectively for generally the same amounts of cargo as over the last 40 years. Foreign-flag shipping companies, on the other hand, were able to take advantage of the favorable investment climates created by their national tax regimes to purchase large numbers of new ships, capturing virtually all of the growth in the U.S. market.



C. Opportunity Cost on Competitiveness

The preceding graph also illustrates the opportunity cost of U.S. tax rules on the United States-flag merchant fleet, particularly as those rules have limited the ability of American shipowners to purchase on a competitive basis the new vessels needed to expand the U.S.-flag fleet as required to capture ongoing growth in U.S. oceanborne trade, or, indeed, to even maintain existing market shares. This is amply demonstrated by the following example.

In 1965, the overall share of U.S. international trade moving on U.S.-flag ships on a tonnage basis was 7.5 percent (compared to 3.0 percent today). As the following table illustrates, had U.S. shipowners been able to invest in new tonnage as U.S. trade grew over the last 30 years—as did the foreign shipowners whose ships now carry those cargoes—today's United States-flag foreign-trading fleet could be almost 3 times its present size.

Impact of Lost Opportunity on U.S.-Flag Foreign Trading Fleet

Segment	1965 U.S.-Flag Share	Projected 1997 Tonnage	No. Ships (1997)	Notional Ships Based on Projected Tonnage
Dry Bulk	4.8%	19.6 M	8	20
Liner	22.8%	29.2 M	59	157
Tanker	5.5%	24.1 M	13	33
Total Ships			80	210

V. Proposed Changes to U.S. Tax Rules

Today, the Capital Construction Fund (";CCF") provides the primary means under the U.S. Tax Code for a U.S.-flag shipowner to accumulate capital to invest in new ships on a basis that even remotely approaches the economic benefits available to our foreign competitors under their national tax regimes. As illustrated above, while the U.S. system has enabled the U.S. fleet overall to stay even with its foreign com-

[7] U.S. Department of Transportation, Maritime Administration, MARAD 98, at 49. The range in numbers results from variations in the categories of vessels counted for those trades across this period of time.

petition in terms of the amount of cargo historically carried by U.S. ships in international commerce, it has failed to provide a basis for growth. As a result, the U.S.-flag fleet continues to lose market share to foreign ships and operators.

H.R. 2159, the "United States-Flag Merchant Marine Revitalization Act of 1999," introduced June 10, 1999, by Representative McCrery and co-sponsored by Representatives Herger, Jefferson, and Abercrombie, and referred to this Committee, proposes a number of changes to the CCF and the tax treatment accorded funds deposited therein to increase its effectiveness in helping to generate private investment capital for new United States-flag ships and operating equipment. We strongly support this measure and urge its prompt consideration by the Committee and its early enactment.

A. Capital Construction Fund

The Capital Construction Fund (or "CCF") Program set forth is section 607 of the Merchant Marine Act of 1936 and Section 7518 of the Internal Revenue Code of 1986 is designed to provide competitive tax treatment to U.S.-flag vessel operators and to encourage construction, reconstruction and acquisition in United States shipyards of new vessels for the U.S.-flag foreign, domestic non-contiguous, Great Lakes, and fisheries fleets. Under the CCF, maritime and fisheries operators enter into binding contracts with the federal government which allow them to defer U.S. income tax on certain funds to be used for an approved shipbuilding program. The deferred tax is then recouped by the U.S. Treasury through reduced depreciation as the tax basis of a vessel purchased with CCF funds is reduced to compensate for the tax deferral.

Under CCF, an operator is permitted to deposit into a CCF account revenues derived from the operation in the covered trades of an "eligible" vessel and to use those deposits for purchase of a new "qualified" vessel built in a U.S. shipyard. While the proposed changes will not alter this basic equation, they will reduce the competitive handicap of these U.S. tax rules by expanding the definitions of such vessels and how CCF funds are treated under the Code.

B. Proposed Changes

The purpose of the proposed changes is to revitalize the international competitiveness of the United States-flag merchant marine. This is accomplished by providing a tax environment which, as compared with current U.S. tax rules, more closely approximates the favorable tax environments provided by other maritime nations to their national flag merchant fleets. Absent the proposed tax reforms, U.S.-flag carriers will continue to face a formidable tax cost disadvantage against foreign flag carriers who pay little or no tax in their home countries. Moreover, U.S. operators in the domestic oceangoing coastwise and noncontiguous trades would be encouraged to invest in construction of new or replacement vessels for those trades in U.S. shipyards, with increased benefits to the American shippers served by those trades and the U.S. economy generally.

The proposed changes to the CCF and how CCF funds are treated under existing U.S. tax rules include the following:

- Modernize the scope of vessels covered by the CCF regime by including foreign-built, U.S.-flag vessels as eligible vessels for purposes of CCF deposits. Additionally, U.S.-flag vessels operated in the oceangoing domestic trade and in trade between foreign ports are to be included within the definition of qualified vessels for purposes of purchases using CCF. Moreover, containers and trailers that are part of the complement of a qualified vessel would become eligible for CCF purchase. Qualified withdrawals from a CCF account for vessels, however, would continue to be limited to U.S.-flag ships built in U.S. shipyards.
- Allow CCF withdrawals to be used to fund the principal amount of a lease of qualified vessels or containers if the lease is for a period of at least five years. This recognizes the widespread use of leasing as a modern financing technique for vessel acquisition, a change that has occurred since the original enactment of CCF.
- Allow fundholders the right to elect deposit into a CCF all or a portion of the amount that would otherwise be payable to the Secretary of the Treasury as a duty on foreign repairs to U.S.-flag vessels imposed by section 466 of the Tariff Act of 1930 (19 U.S.C. 1466)("ad valorem duty").
- Allow fundholders the flexibility to exceed the normal cap for deposits into the CCF during a taxable year where such excess results from an audit adjustment for a prior tax year which increases the deposit cap for that year. The excess that may be deposited equals only the amount which could have been deposited under the cap for that year, less the amount actually deposited.
- Broadens the category of investments into which CCF account funds can be invested. Thus, a CCF could invest not only in "interest bearing securities" but also

in "other income producing assets (including accounts receivable)" so long as the Secretary of Transportation approves the investment.

• As applicable, would make conforming changes to the Merchant Marine Act of 1936, the Internal Revenue Code, and other provisions of U.S. law needed to accomplish the foregoing changes.

VI. Benefit for Coastwise/Non-Contiguous Trades

As noted, the proposed changes would affect not only United States-flag ships operated in the foreign trades, but would provide similar benefits to ships in the oceangoing domestic coastwise, the non-contiguous, and the Great Lakes trades of the United States. In these latter cases, the issue is not so much the impact of U.S. tax rules on the international competitiveness of those ships themselves—inasmuch as they do not compete directly with foreign ships—but rather on the competitiveness of the American industries and local U.S. economies dependent on such shipping in domestic commerce.

The greater the efficiency and cost effectiveness of those segments of the U.S.-flag fleet in transporting domestic goods to market or to loading ports for foreign trade, the more competitive those industries can be in the global marketplace. The ability to build new, more modern ships for those trades—as provided under the proposed changes—will be an important factor in ensuring continued improvements in service and lowered costs for American shippers.

VII. Summary & Closing

For the last half-century, U.S. tax rules have hindered the international competitiveness of the United States-flag commercial merchant fleet in the foreign trades. Faced with competition from foreign-flag ships granted favorable tax treatment by their national states, U.S. ships and shipping companies have seen the share of U.S. international oceanborne commerce carried by U.S.-flag ships decline steadily over this period, despite a five-fold increase in such trade. As U.S. trade grew, foreign shipping companies were able to invest in newer, more numerous ships, using tax-free funds, while U.S. shipowners were generally limited to using primarily after-tax dollars for such investments.

Even where U.S. programs like CCF existed, their limited scope made it possible for U.S. companies to replace existing ships with newer ships, but not to expand their fleets to compete for new cargoes. As a result, foreign ships now dominate U.S. international trade. The economic and national security of the United States depend on this Nation's continued ability to guarantee the flow of goods in international commerce through U.S. ports. Where, as here, U.S. tax rules have hindered the competitiveness of the U.S.-flag shipping industry, it is critical for Congress to act to ensure future competitiveness.

Chairman Archer. The Chair is grateful to each of you because you are the epitome of what we are trying to focus on today. I am, as I mentioned in my preliminary remarks, extremely concerned about what our Tax Code does to reduce our competitiveness in the global marketplace, which is going to be absolutely vital to every working American in the next century, perhaps one of the most vital things facing the future of every working American in the next century. Particularly as we look at the extra burden on workers as a result of the demographic changes that are looming with the baby-boomer retirement and two workers for every retiree instead of three. We are going to have to increase productivity. We are going to have to increase savings. We are going to have to increase competitiveness in the global marketplace.

Frankly, I do not think we can stop in simply improving competitiveness. I think we need to give you, each of you, an advantage. I happened to be strongly enough American to where I do not think a level playingfield is what we should shoot for. I think we should shoot for giving you an advantage to overcome and replace the dis-

advantage that you have all spoken to that we have under the current law. Now whether we can achieve it ultimately is going to be a very, very long, difficult journey. In the meantime, we need to think about how we can immediately improve the current law, at least to some degree that will significantly help you in the near-term.

I was very interested, Mr. Loffredo, in your comments because what we are seeing, it seems to me, is the advent of a new chemistry that is beginning to develop in the world and that is the merger of larger corporations across country boundaries. That again is part of what we have got to expect more and more of in an inter-related world marketplace. Your company, Chrysler, has merged with Daimler, and I notice that it is not ChryslerDaimler, it is DaimlerChrysler. I wonder if our Tax Code were changed whether it would perhaps not be ChryslerDaimler or if perhaps the headquarters, the home office, the controlling corporation would be U.S. instead of German. Can you tell us what role, what impact the different Tax Codes had on the ultimate decision of the boards of directors in determining whether the resulting corporation would be German or whether it would be U.S.?

Mr. LOFFREDO. Taxes were one of several issues that determined the location and corporation—the country of incorporation. The point that should be made is the fact the United States never had a chance. There is no major foreign operation that would voluntarily submit itself to the U.S. international tax system. The way the structure is now, whether taxes was a controlling factor or just one of many, we never had the opportunity to broach the question because the tax system kept us from having any arguments to say it should be a U.S. company. So, basically, I can't tell you taxes was the reason. There were a lot of legal reasons, a lot of political reasons in Germany. But I can tell you the U.S. tax system did not give me any weapons to fight to make it a U.S. company.

Chairman ARCHER. What sort of advice did the boards of directors receive from their tax experts on both sides of the Atlantic relative to what the resulting corporation should be?

Mr. LOFFREDO. Once it was determined that the U.S. laws were not the proper place from a tax standpoint, and this means a lot because one of the major disadvantages of not being a U.S. company is that you are not treated the same way on the New York Stock Exchange and Standard & Poors. So you don't take such a decision lightly here. By giving up the U.S. corporate format, we were taken out of the Standard & Poors 500 and our stock suffered greatly.

But there were many reasons, there were legal, there were political, there were tax. But after we got through the point as to whether or not that we knew we could not be a U.S. company, we looked around Europe or the rest of the world as to what type of company we should be. We looked to The Netherlands and we looked to some of the tax havens. And then the German tax laws came in strongly to support the fact that it should be a German company because if you look at the German tax laws, even though they at that time they probably had an effective tax rate of 52 percent, which is significantly higher than ours, 45 of that being a Federal tax rate, when a German company pays a dividend to a

German shareholder, they receive 15 percent of those 45 percent points back. And then the integrated tax system in Germany comes to play. So, in effect, a German company is not a taxpayer when it has a German shareholder because the shareholder would get the credit for the corporate tax. So the integrated system favored a German company.

And, as you can see over the past year or so since the merger, we started out with 44 percent U.S. shareholders and we are down to around 25 percent shareholders. The attractiveness of this investment in Europe is growing. I can't say taxes was the major decisionmaker, but definitely I had no arguments from a U.S. standpoint to fight for it.

Chairman ARCHER. Well, you testified that by becoming a German company, your corporation was able to save 23.5 percent.

Mr. LOFFREDO. That is an example of—if we were comparing being a U.S. parent company and a German company on dividends coming into the parent. If the dividends came from Germany to the United States——

Chairman ARCHER. Sure.

Mr. LOFFREDO [continuing]. We would be unable to use the credits, our rate would have been significantly higher. Going into Germany, we know that the tax on U.S. dividends will be about 40, 41 percent. But, again, in any decision you make in business, taxes is just one of many that you do. It is not the controlling decision.

Chairman ARCHER. Well, certainly, that would be the case. You examine government regulation, you examine all types of things, but so many of the other things, we do not have much opportunity to change.

Mr. LOFFREDO. Right. No, I agree.

Chairman ARCHER. If the United States had no income tax and derived all of its revenue from a border adjustable consumption tax, would you have been able to make a strong recommendation to the board that they should emerge as a U.S. corporation?

Mr. LOFFREDO. I think my position would have been greatly enhanced because then I would have had the argument that any dividends coming into the United States would have been free of tax because we would have basically then been a similar territorial system like the German system is now. Plus, as you know, I have spent a lot of time over the last 15 years looking at border adjustable type taxes and with the advent—well, with the sale of close to 2 million Chrysler vehicles in the United States, Chrysler Jeeps and Dodges and Plymouths, and the sale of 200,000 Mercedes Benz in the United States, a third of those coming now from Alabama, I think it would have given me a strong argument for the United States being the seat of the corporation. Whether that would have changed the minds of the Daimler people, I can't say.

Chairman ARCHER. Well, I understand that you are to some degree limited in your position with the corporation today in what you can say publicly before the Committee, and I do appreciate what testimony you have given to us. Let me simply say to all of you that Princeton Economics did a survey of major foreign corporations in Europe and Japan and asked them this question: If the United States abolished its income tax and raised its revenue in the form of a sales tax, what impact would that have on your

decisions? The responses were that 80 percent said they would build their new factories in the United States and export from the United States. Twenty percent said they would move their international headquarters to the United States.

What we are seeing in reverse, as a result of our Tax Code, is DaimlerChrysler headquartered in Germany. I am not opposed to all of this inter-relationship, but in the long-term, it is certainly going to push ideas, concepts, purchases and the operation of the company more toward a consideration of the Germans than the United States. We have seen that happen with Bankers Trust, which is now Deutsche Bank of Germany because of our Tax Code. We have seen it happen with Amoco and now with Arco, which are now British corporations. If our Tax Code were different, there is no doubt in my mind that all of them would be U.S. corporations. Even though it is not the total factor in decisions, it is a massive factor in decisions.

So I am delighted to hear the testimony from you today that conveys to this Committee the need to do something about the way that we prejudicially tax foreign source income and to get American moving again, not just to compete but to win the battle of the global marketplace in the next century.

So I thank you very much. I am sure other members would like to inquire.

Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman. You spoke about competitiveness and there is one item that was brought up by this panel that to me just sticks out, not in the Tax Code but in our duty structure, as being uncompetitive or putting our American ocean carriers in a very uncompetitive position and that is the duty on foreign repairs. This Committee repealed that duty 2 years ago only to lose it in conference because of some other considerations.

But, Mr. Finnerty, so that the Members of this Committee will fully understand what happens, let me just describe a situation and you tell me if this is correct. If there is an American vessel leaving port in the United States carrying goods for export and it sails across the Atlantic, goes over to Europe, dumps its goods—not dumps, puts its goods into port for export, and then it has a mechanical problem, something goes wrong with the ship. And you got to have it fixed at a repair facility in Europe. Tell us what happens duty-wise when you have to make that repair overseas?

Mr. FINNERTY. Mr. McCrery, the law provides that after we pay the bill overseas, whether it be in Asia or Europe, when we call at the first port in the United States with that U.S.-flag vessel, we then owe the U.S. Government 50 percent of that bill. This does not apply to the foreign-flag vessels that we operate. And it does not apply to the foreign-flag vessels that are operated by all of our other competitors overseas. It only applies to U.S.-flag ships.

Mr. MCCRERY. So that repair costs you 50 percent more than it otherwise would because of the duty imposed by the U.S. Government?

Mr. FINNERTY. That is correct.

Mr. MCCRERY. Mr. Chairman, that, to me, is one of the more ridiculous provisions of our law that I have ever heard. And I hope this Committee once again will repeal that. But in lieu of repeal-

ing, the American-flag vessels have come up with an innovative way to turn that duty to the advantage of American shipyards. They are willing to allow that duty to continue to be imposed if they have the option of putting that 50 percent duty, rather than into the Treasury, into something that is already set up, the Capital Construction Fund, which would enable them to use that money at some point to build new ships in American shipyards. So it kind of creates at least a partial win-win for the industry. They still have to pay the 50 percent penalty, but at least the money would go into a ship construction fund that would have to be spent at shipyards here in the United States.

So, Mr. Chairman, I hope this Committee will give consideration to that approach if we do not just repeal that duty altogether.

Thank you.

Chairman ARCHER. Does any other member have any questions? Mr. Rangel?

Mr. RANGEL. Thank you. Mr. Loffredo, you had indicated that tax liability was one of the major factors in determining where you would have your headquarters, but the chairman was suggesting the abolishment of the entire Tax Code and substituting it with a national sales tax. What impact would that have had on the decision that your company made?

Mr. LOFFREDO. It would have at least given me the opportunity to present the case that a U.S. quarters should be—or a U.S. corporation should be the parent of the Daimler Group because one of the concerns of double taxation in the United States would have gone away, and we would be certain that the only tax we would pay would be on the products sold in the United States. And so at least I would have had an argument to go forward. Under the current system, I had no way—I mean as a tax director, it was very good to be able to give advice saying, ''Don't be a U.S. company.'' But as an American, that was very difficult advice to give our management that you don't want to end up being an American company. All kinds of companies are trying to flip out of the United States, and we have an opportunity to do it. And so from a tax standpoint, this advice is being given everyday. But it shouldn't be the advice that a U.S. citizen should give.

Mr. RANGEL. But tax relief or simplification or abolishment of the double taxation, any of these things could have provided you with a more favorable tax climate in the United States. The chairman read parts of a report from Princeton, which sounds so exciting. It suggests that if we just ''abolished the Tax Code as we know it,'' then you wouldn't have any decision to make. You would just bounce your firm right over here.

Mr. LOFFREDO. As you know, our partner was Daimler Benz, which is the largest manufacturer in Germany. So political decisions could have outweighed any tax decisions as to where the location of that facility would be. I can say from a tax standpoint, I could defend a U.S. corporation very well and probably from an investment standpoint because it would have been still in the Standard & Poors and still a normal stock on the New York Stock Exchange. But the political aspects of that, as you know are sometimes beyond my control.

Mr. RANGEL. What you are saying is that if we make it more favorable, it's a factor and——

Mr. LOFFREDO. Right.

Mr. RANGEL. And you have to weigh everything. Then you make a decision. But you certainly are not prepared to say that if we abolished the Tax Code you would be here.

How about the rest of you in terms of this approach that the chairman has suggested just wipe the Tax Code out, pull it up by the roots, start all over, go into a universal sales tax system, and get all you guys back here in the United States? Is there anyone who believes that this would really bring you all back home where you belong? Do you think it would be a tremendous advantage to be able to say that you are a U.S. firm, you are tax-free, you will be more productive, and if it is possible, you will help the economy improve to an even higher standard than the President's gotten it? You don't seem as nearly as excited about this as my chairman. How about you, Mr. Finnerty?

Mr. FINNERTY. Well, Mr. Rangel, I will defer to my colleagues on the specifics, but I can tell you of what I know of that proposal, it would have a very dramatic and beneficial impact on the U.S. economy. My own company does business primarily outside the United States with our ships, so it would not have as immediate an impact on us. But in terms of our customers that would be producing the exports from the United States, it would be a very powerful engine.

Mr. RANGEL. Let me ask this before the red light goes on. We know that taxes play an important role in deciding where you are going to set up your headquarters. What about the competency of your staff and the education of our workers and the transfer of technology? Do you find that United States workers are competitive with workers in other parts of the country with regards to your company needs? Are we in pretty good shape?

Mr. LOFFREDO. I would just make a point. Whether you are a U.S. company or a German company, it really doesn't dictate where you have to set up your physical location for your headquarters. At the current time, we have two headquarters within the DaimlerChrysler Group. We have a headquarters in Auburn Hills and we have a headquarters in Stuttgart. And it doesn't mean that eventually we may not have a headquarters in London or in New York to really be more of a holding company. So the country of incorporation doesn't have to dictate where you put your headquarters.

Mr. RANGEL. No, I am asking though whether the sophistication or the training of the employees, would that not be a factor too as to where you would place yourselves?

Mr. LOFFREDO. But it may not be a factor as to what country of incorporation you are in. It just may be where you have your offices.

Mr. GREEN. I can tell you in the emerging global energy industry that with the American workers and the skill of knowledge that we have in this country is unquestionably in the top-tier around the world. And that is really where we are coming from and having that capability to transfer that knowledge and skills. And I say knowledge and skills because we are an industry that cannot ex-

port jobs. We have to have a taxable presence with the other customers. So it is teaching that knowledge and that skill that we have learned in this country around the world. And to have that opportunity is what we are after. This has only been going on since about 1987. So it is a new situation in the global energy industry. And what we are talking about is foreign companies owning energy infrastructures, the very key driver to economies around the world. And for Americans to have the chance to be a part of that vital piece of other economies is very important. At the same time, we want to be able to protect our own economy and who owns our energy infrastructure here. So it is a very serious, important situation for us.

Mr. RANGEL. Thank you, Mr. Chairman.

Chairman ARCHER. Does any other Member have questions?

Mr. Levin.

Mr. LEVIN. Just briefly, a couple of comments. Mr. Chairman, I think the discussion about the impact of our tax system on our competitiveness needs to be undertaken seriously and openly and with open-mindedness. I hope we will bring the same spirit when we talk about trade legislation and be willing to look at new ideas and also have the same sensitivity to the impact on U.S.—on American productiveness and production.

I take it the answer on the sales tax would be affected to some extent by the amount of the sales tax. I would think that my friend from Chrysler would be the first to acknowledge that that has some impact.

Let me just say, Mr. Chairman, it is important that we talk about the basic system, and I think you will agree, we also need to continue to focus on changes that we might make in the present system. For example, the discussion of active finance income. I hope we will continue to think about that because that is one item that has some cost to it in our bill. And unless there is substantial support for it, it isn't likely to be continued on a long-term basis.

I also want to join with Mr. McCrery in urging we do take a look at 2159 to try to solve that dilemma.

Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Mr. Levin. The Chair recognizes Mr. Weller and then Mr. McDermott.

Mr. WELLER. Thank you, Mr. Chairman. And I would like to direct my question to Ms. Stiles of Caterpillar. And, of course, in my conversations with your company, you employ almost 8,000 workers in the district that I represent in the south suburbs and rural areas that I represent. And you folks make a lot of these. And this is a fraction of the size of the actual equipment that is produced. But very clearly, Caterpillar has always indicated how important global trade is in our conversations. And I just wonder can you tell me what percent of the product you produce is sold overseas today?

Ms. STILES. I believe we are at 49 percent of our sales are overseas.

Mr. WELLER. And that area, is it growing?

Ms. STILES. It has grown in the past years. I think we are actually down a percent maybe last year from 50 percent.

Mr. WELLER. Is your chief competitor a U.S. company?

Ms. STILES. We do not regard our chief competitor as a U.S. company. I would say more that it is a Japanese Co., Kamutzu, would be I believe one of—it is spread a bit between Japanese, Korean, and, of course, we do have competitors in the United States. But especially on that large equipment, like you have sitting there, it would not be a U.S. company, no.

Mr. WELLER. You mention that the deferral for finance, active finance income helps you provide a more level playingfield when you are competing with the Japanese and the Koreans and the others in the global market. Can you elaborate on why this is the case? Why that deferral for active finance income helps put you on a more level playingfield?

Ms. STILES. Certainly. As I discussed earlier, given the average price of Caterpillar equipment, the majority of our sales are very closely tied to the ability to provide an attractive financing package to our customers. We have found at Caterpillar, we maintain a very close relationship with our customers, not only for the machine and the servicing and sale of the machine but also for the financing.

In order to do this in international settings, we have to compete with our foreign competitors based on the local tax law because most of our foreign competitors will not be subject to an additional incremental tax in their home country. Now when we absorb those costs, which we must if we are going to offer the same type of financing packages that they do, over the course of billions and billions of sales transactions, this becomes a very significant cost for Caterpillar. If, on the other hand, we find that we simply cannot offer the same type of package, due to the incremental tax costs facing our companies, we risk not only losing the finance transaction, but we risk losing the sale of the equipment, which is basically the reason we have a finance company is to sell CAT equipment.

Mr. WELLER. So the loss of your ability to offer finance income would severely hamper your ability to compete with the foreign competition?

Ms. STILES. That is correct.

Mr. WELLER. The last two hearings on international simplification, including the one this past week, they have disclosed there are major problems with the United States treatment of foreign tax credits. And I was wondering what you would recommend to remedy this problem?

Ms. STILES. Well, there are several things, two of which we would recommend highly are included in the current legislation, the extension of the carry-forward period for foreign tax credits and the acceleration of the provisions related to the 902 non-controlled foreign corporations. But in addition to that, there are several places where it is noted we need a study of allocation of interest expense and apportionment.

I would go a little further than that in that I don't know of a company that the interest expense apportionment rules are not having a very detrimental effect on them for a variety of different reasons. In our case, we have a U.S.-captive financial company. And because of the interest expense that is incurred by that company, we feel we are unfairly penalized with that expense because

a very large portion of that is apportioned to foreign assets under the current rules. This expense is incurred solely to fund U.S. transactions. It should be consolidated within that financial company.

Also, the basket rules have become so complex that they are not only costly procedures but error prone. We have to devote an entire staff of people for 8 to 10 weeks to calculate one number on our tax return, the foreign tax credit limitation.

And while I am on the simplification, the use of U.S. gap earnings and profits, I think would go very far in the eyes of most companies to simplifying this process, and I believe making it a more accurate process than what we have now.

Mr. WELLER. OK, thank you. I see my time has expired. Thank you, Mr. Chairman.

Chairman ARCHER. The Chair recognizes Mr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman. As one of the non-tax lawyers on this Committee, I have a question. Mr. Loffredo, you talk about the Germans are territorial. Are they talking Germany or they talking the common market?

Mr. LOFFREDO. No, worldwide. Prior to this recent law change, any dividends received by a German company from a foreign subsidiary would not have been taxed in Germany. It is not only the common market.

Mr. MCDERMOTT. It is the whole world?

Mr. LOFFREDO. Our dividends from the United States to them would have also gone in tax free.

Mr. MCDERMOTT. And explain to me, just trying to understand historically why this happened, why are we in the position that we are that makes an American company say, "Gee, we would be better to be registered in Germany." Explain what are the—how did that happen?

Mr. LOFFREDO. I think it began, as the chairman started the hearings with in 1962, with the beginning of Subpart F and the evolution of that over the last 35 or 37 years making it more and more difficult for U.S. companies to utilize their foreign tax credits. And once you make it more difficult to utilize foreign tax credits, which are taxes paid by our foreign subsidiaries, you are then subjecting to yourself to a double taxation in the United States when you bring the funds home.

Mr. MCDERMOTT. But in other words, the Congress kind of used a sledge hammer to deal with the Cayman Islands, or wherever the tax havens were, and they hit the rest of you?

Mr. LOFFREDO. Right, the abuses were out there and there were definitely abuses out there. But when they went after the abuses, they brought in the normal business transactions also.

Mr. MCDERMOTT. Do you think it is possible to divide the baby here and deal with legitimate foreign operations and the kind of tax haven operations of the Caymans?

Mr. LOFFREDO. I question whether whatever law comes up, I think someone would be able to find a way around it.

Mr. MCDERMOTT. Guys as smart as you could find a way around it, right?

Mr. LOFFREDO. Yes, a decision has to be made whether or not you are going to maybe set a rule, you are going to tax all foreign

income at 35 percent. If you proved you paid it someplace else, then you don't pay any more into the United States. If you didn't pay it someplace else, then you pay it to the United States. I mean something that arbitrary may have to be the only way to do it. But any rule you try to create will just create a 1,000 tax lawyers getting around it.

Mr. MCDERMOTT. In other words, trying to devise a rule that defines a paper corporation?

Mr. LOFFREDO. Right.

Mr. MCDERMOTT. Is pretty difficult?

Mr. LOFFREDO. Pretty difficult.

Mr. MCDERMOTT. I have a second question for Mr. Finnerty. My understanding that your taxation, when you say when you tie up in an American port, you have to pay 50 percent of the cost of the repair. That is a trade law. That is not an income tax law, is that correct?

Mr. FINNERTY. It is a customs duty, Mr. McDermott. It is not an income tax, it is a customs duty.

Mr. MCDERMOTT. So the chairman's idea of taking out the income tax, that really wouldn't do anything for what you are talking about because you are not taxed?

Mr. FINNERTY. No, not on that particular piece. But the balance of my discussion about the Capital Construction Fund, which is a tax deferral account, does relate to income.

Mr. MCDERMOTT. OK, thank you. The other question I have for the panel really is a question of what you are saying here today is the tax laws are slanted the wrong way and we want to slant them the other way. There must be some reason why your companies stay here or don't—for instance, Caterpillar, why don't you go find some small equipment manufacturer somewhere overseas and do what DaimlerChrysler did? Why don't you do that? What makes you stay here?

Ms. STILES. Well, in the first place, for Caterpillar to move would be a very expensive proposition. Our plants are not easily moveable. We have to sink three stories into the ground just to lift our equipment, and we have a manufacturing base right now whereby 70 percent of our assets are in the United States. We would like to keep it that way.

Mr. MCDERMOTT. But that is true for Chrysler, too? They did that. They didn't move any of their plants. They just simply moved the headquarters people and the tax people and changed the line on the door that said a German company?

Mr. LOFFREDO. There is a rule in the tax law currently that says if you basically flip out to a foreign jurisdiction and re-incorporate, unless you meet certain tests, which we met in our merger, your shareholders are subject to tax on the gain. So there is some control on becoming a non-U.S. company currently in the tax law. If Chrysler were larger than Daimler, we would have had the potential of a U.S. tax problem if we became a German company. But in our tax situation, Daimler was larger than Chrysler.

Mr. MCDERMOTT. So Caterpillar's real problem is that they are too big?

Mr. LOFFREDO. Right.

Mr. MCDERMOTT. They can't find anybody bigger than them to join with?

Mr. LOFFREDO. But one of the things I have noticed is you can start doing a pyramid scheme because we have come from $60 billion, well, let's say they were $80 billion when they acquired us, and we were $60. And now we are maybe $140 billion company. And now we can look at a Caterpillar where you could almost pyramid your way out.

Mr. MCDERMOTT. Thank you, Mr. Chairman. I don't think I understand everything yet.

Chairman ARCHER. Does any other member wish to inquire? The Chair would like to comment briefly to your inquiry, Mr. McDermott. If we went to the simplified 35 percent of foreign source income tax, you would still have to define foreign source income. You can not avoid that. You can not simplify it because you are inevitably coming back and having to change what is and what is not income and no two economists agree on what is or is not income. That is the problem. Your testimony today for the most part, if we could get this change in the Code, we would not be at this great disadvantage. Then you start to examine how you make these changes and it is the most complex part of the Tax Code that we have.

I would like to ask each one of you what disadvantages are present in deciding between remaining a U.S. corporation compared to being a foreign corporation other than the Tax Code?

Mr. GREEN. I will speak for the utility industry. That really is the primary disadvantage, quite frankly. Here we have the energy system that is the envy of the world, the skill and knowledge and the workers, and what we are seeing is the globalization of an industry that has only been going on for 10 or 12 years. So really getting Americans competitive in this industry is to preempt the event that we simply can't be competitive.

Chairman ARCHER. Does any one want to cite other aspects of being in the United States where you are at a disadvantage other than the Tax Code?

Mr. LOFFREDO. May I just—two things I have noticed is that first of all, the reaction to Wall Street has been negative, the fact that we are not a U.S. company any longer, which is really critical in a lot of respects. Second, from a personal standpoint, the morale of U.S. employees I think has been a negative.

Chairman ARCHER. You think there is higher morale of employees in other countries than there is in the United States?

Mr. LOFFREDO. No, I think there was higher morale at Chrysler when we were a U.S. company.

Chairman ARCHER. OK. So you have not cited any other inherent disadvantage to being in the United States other than the Tax Code?

Mr. LOFFREDO. And Wall Street.

Chairman ARCHER. And Wall Street. Let me make sure I understand this. In other words, U.S. corporations are at a disadvantage to foreign corporations because of Wall Street?

Mr. LOFFREDO. No, no, I'm sorry. Tax Code, but a disadvantage of being a foreign corporation is that you are no longer allowed certain rights on Wall Street.

Chairman ARCHER. OK. So that is an advantage to being in the U.S.?

Mr. LOFFREDO. Yes.

Chairman ARCHER. OK. I am asking you to cite any other disadvantage to being in the U.S. other than the Tax Code? The reason I do that is because of the inference in other questions that the Tax Code is only a small factor and all these other factors are things that have to be considered. If the Tax Code is the only negative factor in being a U.S. corporation, then clearly it is of major significance because all of these decisions are made at the margin. We could not see, for example, up until the last five to 10 years, what is happening now with DaimlerChrysler, Banker's Trust, Deutsche, Case, foreign corporation, Amoco, Arco, foreign corporations taking over. This is a new phenomenon in an inter-related world marketplace. It is clear that it is driven by the Tax Code. It is clear that it will continue into the next century when the conditions are at the margin where the Tax Code will make that determination.

That is not in the best interest of the United States of America. God help us if we do not do something about this. It is the single biggest thing we can do to help in this regard unless you think of something else, it is a disadvantage in the United States where we ought to help on that.

Mr. WATKINS. Mr. Chairman?

Chairman ARCHER.

Mr. Watkins.

Mr. WATKINS. I think the point is well-taken that you are making. And I think we are, in all respect, we are dealing with tax individuals here and I would like them to broaden their thinking just a little because you are right on the tax policy. And one of the reasons why I came back to Congress was we need to have a 21st century globally competitive economy in the United States allowing us to be competitive around the world. In all respects, tax policy is on your mind. That is a major problem, and we have got to address that.

But there are three areas that I have studied, and tax policy, yes. Second, regulatory. And I guarantee you talk to other people in your company and the regulator policies are affecting big time. Third, litigation, product liability, other things we put right here in this country. Those are some of the things that also have to be addressed if we are going to be competitive companies around the world. But tax policy I know is the issue right today. But I think we need to talk to other people in our corporations because those two things are putting an overburden of about 15 percent on a lot of our products.

Chairman ARCHER. Thank you very much for testifying today, and I hope that all of you realize that I am not coming down on any of you in my enthusiasm for trying to do something to help you to be more competitive in the world marketplace in the next century. If we do not change the Tax Code, we are driving jobs out of this country. We are reducing our capability to compete. We are reducing our ability to export. We are undermining the ability of workers in this country to earn more in the next century. Those are major items I think we need to attend to.

I do want to ask one specific question, relative to interest allocation, which has come up a couple of times. Would the Senate 86 proposal basically remedy this problem if we were to adopt it in the tax bill this year?

Mr. GREEN. That wouldn't take care of our problems. I think that that is a very good bill, and we need to work with that. But there are two issues with that, one the 80 percent ownership requirement. In the energy industry and the privatization going on around the world, many times the privatization is less than 50 percent. So we would fall out of that qualification. The second piece of it that we would like to work with them on deals with changing the measuring of the assets to a fair market value or a tax book value. That, again, becomes misleading for a utility that has depreciated long-lived assets and really exacerbates the problem we have with the interest allocation formula. But on the whole, it is a bill that we think is a good one, and we would like to work with it to see if we can get our solution inside that.

Chairman ARCHER. Do you think from your expert counsel on this very complicated issue, that we can improve the Senate 86 approach without losing significant additional revenue, which may make it prohibitive in the Tax Code?

Mr. GREEN. That certainly is our intent, understanding that we are very sensitive to that revenue estimate. At the same time, I would also like to encourage looking at this at a phased-in approach perhaps, to maybe spread that a little bit more and at least start the action to change in this area.

Chairman ARCHER. Well, we most definitely will need to do that. Whatever tax relief bill that we propose will have very little revenue to use in the first couple of years. So whatever we establish as tax policy for the future, all of it is will be phased in with a few exceptions. Then expanded as the wedge grows out. That is a generic format that we will need to follow.

Again, thank you very much. We appreciate your testimony. You are excused, and we will get ready to hear our next panel.

The Chair announces that, at the conclusion of the next panel, we will recess today for lunch. I hope we can do that no later than 12:15 and come back at 1.

Gentlemen, welcome. We are ready to hear your testimony. Dr. Hubbard, if you would lead off, we would appreciate it. Again, if you will keep your oral testimony to within 5 minutes, we would appreciate it. Your entire written statement will be printed in the record. Identify yourself before you proceed.

STATEMENT OF R. GLENN HUBBARD, PH.D., RUSSELL L. CARSON PROFESSOR OF ECONOMICS AND FINANCE, GRADUATE SCHOOL OF BUSINESS, COLUMBIA UNIVERSITY, NEW YORK, NEW YORK, AND RESEARCH DIRECTOR, INTERNATIONAL TAX POLICY FORUM

Mr. HUBBARD. Thank you, Mr. Chairman, Mr. Rangel, Members of the Committee. I am Glenn Hubbard, a professor of economics at Columbia and research director of the International Tax Policy Forum. The Forum is a diverse group of U.S.-based multinationals that sponsors economic research and policy education about international tax policy.

Racing against the red light, I only want to make three points and focus on the last two of those. First, U.S. multinationals make quite significant contributions to the U.S. economy. Second, following up on the points raised by the last panel, tax policy matters a lot for a range of investment decisions of multinationals. And, third, the current anti-competitive U.S. tax policy toward multinationals can lead to runaway headquarters with significant potential losses in national well-being.

I will not dwell on the role that U.S. multinationals play in our economy. It is in my written testimony, and I am sure other members of the panel will emphasize it. But I think it is important to note that the United States has a significant interest in ensuring that its tax rules do not hinder the competitiveness of U.S. multinationals.

Tax policy matters a lot. Unfortunately, the discussion here often centers on an academic debate between economic efficiency and competitiveness. On the one hand, the United States has traditionally advocated so-called capital export neutrality, which is a long economic-sounding phrase simply stating that a resident should pay the same rate of tax whether an investment is made at home or abroad. This sounds simple. The idea is not to bias the location of investment, and the hope is to promote worldwide economic efficiency.

From a competitiveness perspective, on the other hand, the United States has actually become one of the least attractive countries in which to locate the headquarters of a multinational. This reflects restrictions on the use of foreign tax credits, strong antideferral rules, and the lack of integration of the corporate individual income tax systems.

Why should we care? U.S. companies can compete successfully against foreign firms only if they are adequately efficient to overcome this artificially imposed tax disadvantage.

More important, this academic debate about efficiency versus competitiveness is actually based on a false choice. First, the United States has not, and probably will not, follow the capital export neutrality doctrine that it espouses. Implementation of capital export neutrality requires not just eliminating deferral, which is often talked about before you, but the granting of an unlimited foreign tax credit. Moreover, worldwide efficiency, economists' holy grail, emerges only if all countries simultaneously embrace the doctrine, a rather unlikely outcome. It is an old lesson in economics that going only part of a way toward an efficient outcome seldom makes us better off.

Second, the models used to support the conclusion of capital export neutrality abstract from many important features of the real world, including imperfect competition. Economists who study multinationals outside of the tax area stress those features as absolutely critical for understanding multinationals.

In a recent paper, Michael Devereux and I find that using realistic assumptions about strategic competition, deferral of U.S. taxation on foreign-source income can actually increase the well-being of U.S. residents.

What are the bottom lines of U.S. multinationals? A continuation of the current emphasis of U.S. tax policy could lead to a decline

in the share of multinational income earned by companies headquartered here. It is not just academic. We have been hearing it all morning. In several recent high-profile mergers among United States and European multinationals, including BP-Amoco, Daimler-Chrysler, and Deutsche Bank Bankers' Trust, a merged entity is chosen to be a foreign headquartered company.

More important, looking down the road, future investments made by these companies outside the United States are not likely to be made through U.S. subsidiaries since tax on those operations could be removed from the U.S. corporate tax system by simply making them through the foreign parent. To be blunt, while some have suggested that reductions in the U.S. tax on foreign-source income could lead to the movement of manufacturing operations outside the U.S., so-called runaway plants, the far more likely scenario for you to consider is that a non-competitive U.S. tax system might lead to runaway headquarters, an increase in the foreign control of U.S. assets. Bottom line: U.S. tax rules can significantly alter the ability of U.S. multinationals to compete successfully around the world and ultimately at home.

On behalf of the International Tax Policy Forum, I urge you, Mr. Chairman and Members of the Committee, to review carefully the U.S. international tax system in order to root out the major impediments limiting U.S. multinationals' ability to compete globally with foreign-based multinationals.

[The prepared statement follows:]

Statement of R. Glenn Hubbard, Ph.D., Russell L. Carson Professor of Economics and Finance, Graduate School of Business, Columbia University, New York, New York, and Research Director, International Tax Policy Forum

I. Introduction

I am R. Glenn Hubbard, Russell L. Carson, Professor of Economics and Finance, Graduate School of Business, Columbia University. I am testifying today on behalf of the International Tax Policy Forum, of which I am the research director. Founded in 1992, the International Tax Policy Forum is a diverse group of U.S.-based multinationals, including manufacturing, service, energy, financial service, and technology companies. The Forum sponsors research and education regarding the U.S. taxation of income from cross-border investments. As a matter of policy, the Forum refrains from taking positions on legislative proposals. John M. Samuels, Vice President and Senior Counsel for Tax Policy and Planning of General Electric, is chairman of the Forum. PricewaterhouseCoopers LLP acts as consultant to the Forum. A list of member companies is attached as Appendix A of this testimony.

The Forum welcomes the opportunity to testify today on the effect of U.S. tax rules on the international competitiveness of U.S. companies. Increasingly, the markets for our companies have become global, and our competitors are foreign-based companies operating under tax rules that are often much more favorable than our own.

The existing U.S. tax law governing the activities of multinational companies has been developed in a patchwork fashion over many years. In many instances, current law creates barriers that harm the competitiveness of U.S. companies. These rules also are horribly complex both for U.S. multinational companies to comply with and for the Internal Revenue Service to administer. That is why the Forum believes it is important for this Committee to review the current U.S. international tax rules with a view to reducing complexity and removing impediments to U.S. international competitiveness.

II. The Role of U.S. Multinational Corporations in the U.S. Economy

The primary motivation for U.S. multinationals to operate abroad is to compete better in foreign markets, not domestic markets. Investment abroad is required to provide services that cannot be exported, to obtain access to natural resources, and

to provide goods that are costly to export due to transportation costs, tariffs, and local content requirements. More than one-half of all foreign affiliates of U.S. multinationals are in the service sector, including distribution, marketing, and servicing U.S. exports.[1] Foreign investment allows U.S. multinationals to compete more effectively around the world, ultimately increasing employment and wages of U.S. workers.

A. Exports

Much research has shown that U.S. operations abroad produce a net trade surplus for the United States. Foreign affiliates of U.S. companies rely heavily on exports from the United States. Foreign affiliates of U.S. multinationals purchased just under $200 billion of merchandise exports from the United States in 1996. Additional exports by U.S. multinationals to unaffiliated foreign customers accounted for an additional $213 billion in merchandise exports. Altogether, exports by U.S. multinationals were $407 billion in 1996—or 65 percent of all U.S. merchandise exports.[2]

A recent study by the Organization for Economic Cooperation and Development complements other academic research in finding that each dollar of outward foreign direct investment is associated with $2.00 of additional exports and an increase in the bilateral trade surplus of $1.70.[3]

B. U.S. Employment

Foreign investment by U.S. multinationals generates sales in foreign markets that generally could not be achieved by producing goods entirely at home and exporting them. The strategy used by U.S multinationals of using foreign affiliates in coordination with domestic operations to produce goods allows U.S. multinationals to compete effectively around the world while still generating significant U.S. exports. These U.S. exports result in additional employment of U.S. workers at higher than average wage rates.[4]

A number of studies find investment abroad generates additional employment at home through an increase in the domestic operations of U.S. multinationals. As noted by Professors David Riker and Lael Brainard:

> The fundamental empirical result is that the labor demand of U.S. multinationals is linked internationally at the firm level, presumably through trade in intermediate and final goods, and this link results in complementarity rather than competition between employers in industrialized and developing countries.[5]

This relationship between foreign operations and domestic employment was also noted by the Council of Economic Advisers in the 1991 *Economic Report of the President:*

> In most cases, if U.S. multinationals did not establish affiliates abroad to produce for the local market, they would be too distant to have an effective presence in that market. In addition, companies from other countries would either establish such facilities or increase exports to that market. In effect, it is not really possible to sustain exports to such markets in the long run. On a net basis, it is highly doubtful that U.S. direct investment abroad reduces U.S. exports or displaces U.S. jobs. Indeed, U.S. direct investment abroad stimulates U.S. companies to be more competitive internationally, which can generate U.S. exports and jobs. Equally important, U.S. direct investment abroad allows U.S. firms to allocate their resources more efficiently, thus creating healthier domestic operations, which, in turn, tend to create jobs.[6]

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[1] Matthew Slaughter, Global Investments, American Returns. Mainstay III: A Report on the Domestic Contributions of American Companies with Global Operations, Emergency Committee for American Trade (1998).

[2] National Foreign Trade Council, The NFTC Foreign Income Project: International Tax Policy for the 21st Century, chapter 6 (1999).

[3] OECD, Open Markets Matter: The Benefits of Trade and Investment Liberalization, p. 50 (1998).

[4] Mark Doms and Bradford Jensen, Comparing Wages, Skills, and Productivity between Domestic and Foreign-Owned Manufacturing Establishments in the United States, mimeo. (October 1996).

[5] David Riker and Lael Brainard, U.S. Multinationals and Competition from Low Wage Countries, National Bureau of Economic Research Working Paper no. 5959 (1997).

[6] Council of Economic Advisers, Economic Report of the President, p. 259 (1991).

C. U.S. Research and Development

Foreign direct investment allows U.S. companies to take advantage of their scientific expertise, increasing their return on firm-specific assets, including patents, skills, and technologies. Professor Robert Lipsey notes that the ability to make use of these firm-specific assets through foreign direct investment provides an incentive to increase investment in activities that generate this know-how, such as research and development.[7]

Among U.S. multinationals, total research and development in 1996 amounted to $113 billion, of which $99 billion (88 percent) was performed in the United States.[8] Such research and development allows the United States to maintain its competitive advantage in business and be unrivaled as the world leader in scientific and technological know-how.

D. Summary

U.S. multinationals provide significant contributions to the U.S. economy through:

- A strong reliance on U.S.-provided goods in both domestic and foreign operations;
- Additional domestic employment of employees at above average wages; and
- Critical domestic investments in equipment, technology, and research and development.

As a result, the United States has a significant interest in insuring that its tax rules do not hinder the competitiveness of U.S. multinationals.

III. Tax Policy and U.S. International Competitiveness

The increasing integration of the world economies has magnified the impact of U.S. tax rules on the international competitiveness of U.S. multinationals. Foreign markets represent an increasing fraction of the growth opportunities for U.S. businesses. At the same time, competition from multinationals headquartered outside of the United States is becoming greater. As an example of this heightened worldwide competition, between 1960 and 1996 the number of the world's 20 largest corporations headquartered in the United States declined from 18 to just 8.

A. Why Tax Policy Matters

With the increasing globalization of the world economies, it has become critical for U.S. businesses to compete internationally if they wish to remain competitive at home. If U.S. businesses are to succeed in the global economy, they will need a U.S. tax system that permits them to compete effectively against foreign-based companies. This requires that U.S. international tax rules not place U.S.-headquartered multinationals at a competitive disadvantage in foreign markets.

From an income tax perspective, the United States has become one of the least attractive industrial countries in which to locate the headquarters of a multinational corporation. This is because there are several major respects in which U.S. tax law differs from that of most of our trading partners.

First, about half of the OECD countries have a territorial tax system (either by statute or treaty), under which a parent company is not subject to tax on the active income earned by a foreign subsidiary.[9] By contrast, the United States taxes income earned through a foreign corporation when it is repatriated or deemed to be repatriated under various "anti-deferral" rules in the tax code.

Second, even among countries that tax income on a worldwide basis, the active business income of a foreign subsidiary is generally not subject to tax before it is remitted to the parent.[10] This differs from the U.S treatment of foreign base company sales and service income, and certain other types of active business income, which are subject to current U.S. tax even if such income is reinvested abroad.[11]

Third, other countries with worldwide tax systems have fewer restrictions on the use of foreign tax credits than does the United States. The United States, on the other hand, has a variety of rules that limit the crediting of foreign taxes. Such rules include: the use of multiple "baskets," restrictions imposed by the alternative

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[7] Robert Lipsey, "Outward Direct Investment and the U.S. Economy," in The Effects of Taxation on Multinational Corporations, p. 30 (1995).

[8] U.S. Department of Commerce, Survey of Current Business (September 1998).

[9] Organization for Economic Cooperation and Development, Taxing Profits in a Global Economy (1991).

[10] Organization for Economic Cooperation and Development, Controlled Foreign Company Legislation (1996).

[11] Foreign source income relating to active financing income was taxed on a current basis until the 1997 Act. Such income presently is exempted from current taxation, although this exemption is slated to expire on December 31, 1999.

minimum tax, the apportionment of interest and certain other deductions against foreign source income, and the attribution to a foreign subsidiary of a larger measure of income for U.S. purposes ("earnings and profits") than is used by other countries.[12] These rules can result in the incomplete crediting of foreign taxes and, as a result, the double taxation of foreign source income earned by U.S. multinational corporations.

Fourth, among the OECD countries, the United States, the Netherlands, and Switzerland are the only countries that fail to provide some form of integration of the corporate and individual income tax systems.[13] This integration is provided by the major trading partners of the United States in order to reduce or eliminate the extent to which corporate income is double taxed by recognizing that dividends are paid to shareholders from income previously taxed at the corporate level.

The net effect of these tax differences is that a U.S. multinational operating through a foreign subsidiary frequently pays a greater share of its income in foreign and U.S. tax than does a similar foreign subsidiary owned by a competing multinational company headquartered outside of the United States.[14] This makes it more expensive for U.S. companies to operate abroad than their foreign-based competitors. In such circumstances, U.S. companies can only successfully compete against foreign-based multinationals if they are sufficiently more efficient than the competition to overcome this artificially imposed tax disadvantage.

B. Capital Export Neutrality

While concerns for competitiveness require a U.S. multinational operating in a foreign country to pay the same tax as a foreign-based multinational operating in that country, another efficiency concern is frequently proffered to support taxing a U.S. investor equally whether the investment is made at home or abroad. This latter notion is referred to as "capital export neutrality." Capital export neutrality seeks to ensure that a resident of a given country pays the same rate of tax whether the investment is made at home or abroad. In general terms, capital export neutrality is thought to not bias the location of investment from the investor's perspective. Capital export neutrality requires that all foreign source income be taxed on a current basis by the home country and that the home country provides an unlimited foreign tax credit for all taxes paid.

The principles of competitiveness and capital export neutrality necessarily conflict whenever effective tax rates differ across countries. U.S. international tax policy has frequently wrestled with the tradeoffs between these two principles. In a recent speech, Treasury Assistant Secretary of Tax Policy, Donald Lubick, noted the tradeoff between these principles.[15]

The Internal Revenue Service issuance last year of Notice 98–11, in which the IRS announced that Treasury would issue regulations to prevent the use of certain "hybrid branch" arrangements deemed contrary to the policies and rules of Subpart F, demonstrated the Treasury's concern for capital export neutrality.[16] The hybrid branch arrangements targeted by this Notice reduced foreign taxes, not U.S. taxes. Indeed, the use of these arrangements can only serve to increase total U.S. tax paid by U.S. multinationals since aggregate foreign tax credits would be reduced.

The debate regarding the principles of competitiveness and capital export neutrality dates back at least to 1961, when President Kennedy proposed the current taxation of all foreign source income earned by foreign subsidiaries of U.S. companies (except in developing countries). The legislation ultimately enacted in 1962, however, put traditional concerns of competitiveness ahead of the Kennedy Administration's concerns for capital export neutrality.[17]

C. Does Capital Export Neutrality Promote Efficiency?

The theoretical model in which capital export neutrality results in worldwide efficiency in the allocation of capital resources is a fairly simple model. In its simplest

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[12] Price Waterhouse LLP, Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues, Financial Executives Research Foundation (1996).

[13] Sijbren Cnossen, Reform and Harmonization of Company Tax Systems in the European Union, mimeo., Erasmus University (1996).

[14] Organization for Economic Cooperation and Development, Taxing Profits in a Global Economy (1991).

[15] Donald C. Lubick, Treasury Assistant Secretary of Tax Policy, Speech before the George Washington University/IRS Institute (December 11, 1998).

[16] Regulations that would have created subpart F income with respect to such transactions were proposed in March 1998, but their withdrawal was subsequently announced by Notice 98–35. Notice 98–35 expresses the intention to re-issue similar rules.

[17] See National Foreign Trade Council, The NFTC Foreign Income Project: International Tax Policy for the 21st Century, chapter 2 (1999).

form, savings in every country is in fixed supply and is not responsive to market opportunities. As a result, each dollar of foreign direct investment by a domestic resident results in one less dollar of domestic investment. The model makes a number of simplifications, but, even so, capital export neutrality leads to worldwide efficiency only if all countries follow a tax system imposing capital export neutrality. As noted earlier, in practice a substantial number of the major trading partners of the United States—half of the OECD—exempt active foreign source income from taxation. In such a case, an attempt by the United States to maintain capital export neutrality does not necessarily improve either worldwide efficiency or U.S. well-being. A well-known economic theorem shows that when there is more than one departure from economic efficiency, correcting only one of them may not be an improvement.18 Unilateral imposition of capital export neutrality by the United States may fail to advance both worldwide efficiency and U.S. national well-being.

The simple model supporting capital export neutrality fails to consider a number of real-world features that significantly affect the tax policy conclusions one should draw regarding the tax principles that promote worldwide efficiency and U.S. well-being. For example, the model fails to consider that competition among multinational corporations takes place in a strategic environment where companies can increase their income by achieving economies of scale. In work co-authored with Michael Devereux, we show that, when these assumptions are relaxed, deferral of home-country taxation on foreign source income can increase the well-being of domestic residents relative to a system of current inclusion of foreign earnings.[19]

The simple model supporting capital export neutrality also fails to consider the possibility that foreign direct investment is complementary to domestic investment—rather than a substitute for domestic investment. As discussed earlier, a number of economic studies find that, at the firm level, foreign direct investment results in an increase in exports from the home country to foreign subsidiaries.

Another important example of the simple model's failings is that it ignores the possibility that domestic residents can transfer their savings abroad through portfolio investment as an alternative to foreign direct investment. As recently as 1980, portfolio investment abroad by U.S. investors was only about one-sixth the size of U.S. direct investment abroad. By 1997, however, portfolio investment abroad was 40 percent larger than U.S. direct investment abroad.[20] If U.S. tax law disadvantages U.S. multinationals, U.S. investors today have the opportunity to direct their savings to portfolio investment in foreign multinationals, the foreign investments of which are not subject to U.S. corporate income tax.

For these reasons, contemporary economic analysis offers little reason to believe that unilateral adoption of the principle of capital export neutrality can improve either worldwide efficiency or U.S. well-being.

D. Implications for U.S. Multinationals

As noted earlier, from a tax perspective the United States is one of the least favorable industrial countries in which a multinational corporation can locate. Over time, these U.S. tax rules could lead to a reduction in the share of multinational income earned by companies headquartered in the United States. This decline in the importance of U.S. multinationals should be a concern for the very real loss in economic opportunities such a decline would bring about for American workers and their families.

Professor Laura Tyson, former Chair of the Council of Economic Advisers and former Director of the National Economic Council, points out a number of political, strategic, and economic reasons why maintaining a high share of U.S. control over global assets remains in the national interest.[21] These include:

- U.S. multinationals locate over 70 percent of their assets and employment in the United States;
- U.S. multinationals invest more per employee and pay more per employee at home than abroad in both developed and developing countries; and
- U.S. multinationals perform the overwhelming majority of their research and development at home.

If the United States wishes to attract and retain high-end jobs, the U.S. tax system must not discourage multinationals from establishing their headquarters here.

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[18] R.G. Lipsey and K. Lancaster, "The General Theory of the Second Best," Review of Economic Studies, pp. 11–32 (1956–57).

[19] Michael P. Devereux and R. Glenn Hubbard, "Taxing Multinationals," mimeo. (January 1999).

[20] U.S. Department of Commerce, Survey of Current Business (July 1998).

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

In several recent high-profile mergers among U.S. and European multinational corporations (including AEGON-Transamerica, BP-Amoco, Daimler-Chrysler, Deutsche Bank-Bankers Trust, and Vodafone-AirTouch) the merged entity has chosen to be a foreign-headquartered company. In recent testimony before the Senate Finance Committee, DaimlerChrysler's vice president and chief tax counsel specifically implicated the overly burdensome U.S. international tax regime as a key factor in the merged firm's decision to be a German-headquartered company.[22] Future investments made by these companies outside of the United States are unlikely to be made through the U.S. subsidiary since tax on these operations can be permanently removed from the U.S. corporate income tax system by instead making them through the foreign parent.

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

While some have suggested that reductions in the U.S. tax on foreign source income could lead to a movement of manufacturing operations out of the United States ("runaway plants"), a far more likely scenario is that a noncompetitive U.S. tax system will lead to "runaway headquarters"—a migration of multinational headquarters outside the United States and an increase in the foreign control of corporate assets.

The decline in the market share of multinationals headquartered in the United States has important implications for the well-being of the U.S. economy. High-paying manufacturing jobs and high-paying executive jobs are lost with the movement of these headquarters. Research and development may be shifted abroad, in addition to jobs in high-paying service industries, such as finance, associated with headquarters' activities. Further, foreign-based multinationals operating in the United States rely significantly more on inputs and supplies produced offshore than do U.S.-owned companies. At the same time, the channeling of new investment outside of the United States through foreign subsidiaries owned by the foreign parent results in the generation of income completely outside of the U.S. tax system. A desire to tax foreign source income at rates higher than those of our competitors may ultimately insure that that there is little income left to tax.

IV. Conclusions

In summary, U.S. tax rules can have a significant impact on the ability of U.S. multinationals to compete successfully around the world and, ultimately, at home. On behalf of the International Tax Policy Forum, I urge that this Committee carefully review the U.S. international tax system with a view to removing impediments that limit the ability of U.S. multinationals to compete globally on the same terms as foreign-based multinationals. Such reforms would enhance the well-being of American families and allow the United States to retain its world economic leadership position into the 21st century.

Appendix International Tax Policy Forum Member Companies.

American Express Company
America Online, Inc.
Associates First Capital Corporation
Bank of America
Bristol-Myers Squibb Company
Caterpillar Inc.
CIGNA Corporation
Cisco Systems, Inc.
Citigroup
Dow Chemical Company
Eastman Kodak Company
Emerson Electric Co.
Enron Corporation
Exxon Corporation
Ford Motor Company
General Electric Co.
General Motors Corporation
Georgia-Pacific Corporation
Goodyear Tire & Rubber Company
Hewlett-Packard Company
Honeywell, Inc.
IBM Corporation
ITT Industries, Inc.
Johnson & Johnson, Inc.
Merrill Lynch & Co., Inc.
Microsoft Corporation
Morgan Stanley, Dean Witter & Co.

[22] John L. Loffredo, "Testimony before the Senate Finance Committee" (March 11, 1999).

PepsiCo, Inc.
Philip Morris Companies, Inc.
Premark International, Inc.
The Procter & Gamble Company
The Prudential Insurance Company
Tenneco, Inc.
Tupperware Corporation
United Technologies Corporation
Warner-Lambert Company

Chairman ARCHER. Thank you, Dr. Hubbard.

The next witness is Mr. Murray. Welcome, and you may proceed.

STATEMENT OF FRED F. MURRAY, VICE PRESIDENT FOR TAX POLICY, NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. MURRAY. Thank you, Mr. Chairman. Good morning and good morning to the distinguished Members of the Committee. My name is Fred Murray. I am Vice President for Tax Policy for the National Foreign Trade Council. With me today are Mr. Phil Morrison, director of the International Tax Services Group in the Washington national office of Deloitte & Touche and formerly International Tax Counsel at the Treasury. And also, Mr. Peter Merrill, director of the National Economic Consulting practice at Pricewaterhouse-Coopers in their Washington national office, and who was formerly chief economist for the Joint Committee on Taxation.

Our testimony relates to the Foreign Income Project of the National Foreign Trade Council. My written statement and a copy of our report is before you in your packets.

In addition to the three of us, the Project has been drafted and reviewed by more than 50 distinguished professionals, former Treasury and IRS officials, including Assistant Secretaries and Deputy Assistant Secretaries for Tax Policy, International Tax Counsels, a Commissioner of Internal Revenue, and other distinguished lawyers and economists, corresponding professionals from Hill offices, and, finally, distinguished lawyers, accountants, and economists from some of America's most prominent companies, professional firms, and universities.

The NFTC is an association of businesses with some 550 members founded in 1914. Most of the largest U.S. manufacturing companies and most of the 50 largest U.S. banks are Council members, accounting for at least 70 percent of all U.S. non-agricultural exports and 70 percent of U.S. private foreign investment.

In 1997, the NFTC launched this project in response to growing concerns about the disparity between U.S. trade policy and U.S. tax policy. Foreign competition faced by U.S.-based businesses has greatly intensified in recent years. The globalization of business has also greatly accelerated. We believe it is important to pause to look at these changes and at their implications.

We focus our study on the last 40 or so years because in 1962, Congress made major changes in our international tax system in enacting Subpart F. Subpart F was shaped in a global economic environment that has changed almost beyond recognition as the 20th century comes to a close. The gold standard has been abandoned. The exchange rate of the dollar is no longer fixed. The United States is now the largest importer of capital, with foreign investment in U.S. assets exceeding U.S. investment in foreign assets by over $100 billion per year.

Our current rules, to the extent they were enacted for more than revenue considerations, are often based on economic underpinnings that no longer apply. Mr. Merrill will elaborate on these issues in his remarks.

Our study today leads us to several broad conclusions:

United States-based companies are much 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.

United States-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.

Changes in U.S. tax law in recent decades have on balance increased the taxation of foreign income. And, as Mr. Morrison will discuss in a greater detail, we have also concluded that U.S. taxation of foreign income is far more complex and burdensome than that of other significant trading nations and far more complex and burdensome than what is required by appropriate tax policy. We have tried to lead other countries to our position, but none have followed us to where we are.

United States tax laws impose rules that are different in important respects than those imposed by many other nations upon their companies. Other countries also tax the worldwide income of their nationals and companies doing business outside their territories. But such systems are generally less complex, and provide for deferral subject to less significant limitations. Importantly, many have territorial systems of taxation and/or border adjustable VAT systems.

The U.S. foreign tax credit system is very complex, particularly in the computation of applicable limitations under section 904. Systems imposed by other countries are in all cases less punitive. The current U.S. international tax system contains many anomalies that make little sense when considered in the context of the matters we discussed today, and that create many "heads, I win, tails, you lose," scenarios that are difficult to justify on a principled basis. One of those that has been noted a number of times today is the allocation of interest expense between domestic and foreign subsidiaries for the purpose of determining the foreign tax credit limitation.

Finally, in a 1991 OECD study, 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. These findings have an ominous quality, given the recent spate of acquisitions of large U.S.-based companies by their foreign competitors. In fact, of the world's 20 largest companies, ranked by sales in 1960, 18 were headquartered in the United States. By the mid-nineties, that number had dropped to eight and is probably less today. That trend is starkly reflected in the banking sector. After recent acquisitions, only two, CitiCorp and Chase Manhattan, of the world's largest 25 financial services companies are headquartered in the United States.

In closing, Mr. Chairman, the NFTC strongly supports H.R. 2018, introduced by Mr. Houghton, Mr. Levin, and Mr. Johnson, and joined by Mr. Crane, Mr. Herger, Mr. English, and Mr. Matsui. We congratulate them on their efforts to make these amendments. They address important concerns of our companies in their efforts to export American products and to create jobs for American workers.

And we congratulate you on holding this hearing this morning. That concludes my oral remarks. I will be pleased to answer questions.

[The prepared statement follows:]

Statement of Fred F. Murray, Vice President for Tax Policy, National Foreign Trade Council, Inc.

Mr. Chairman, and Distinguished Members of the Committee:

My name is Fred Murray. I am Vice President for Tax Policy for the National Foreign Trade Council, Inc. I was formerly Special Counsel (Legislation) for the Internal Revenue Service, and before that represented taxpayers for seventeen years in private practice before joining the Treasury. With me today are Mr. Phil Morrison, Director of the International Tax Services Group in the Washington National Office of Deloitte & Touche LLP and formerly International Tax Counsel at the U.S. Treasury, and Mr. Peter Merrill, Director of the National Economic Consulting Practice at Pricewaterhouse Coopers in their Washington National Tax Services Office and formerly Chief Economist for the Joint Committee on Taxation. We intend to summarize for you the analysis and conclusions that have been reached in the ongoing National Foreign Trade Council Foreign Income Project. In addition to the two gentlemen here with me today, the project has been drafted and reviewed by more than fifty distinguished professionals: former Treasury and IRS officials including Assistant Secretaries and Deputy Assistant Secretaries for Tax Policy, International Tax Counsels, a Commissioner of Internal Revenue, and other distinguished lawyers and economists, corresponding professionals from Hill offices, and finally distinguished lawyers, accountants, and economists from some of America's most prominent companies, professional firms, and universities.

The National Foreign Trade Council, Inc. (the "NFTC" or the "Council") is appreciative of the opportunity to present its views on the impact on international competitiveness of certain of the foreign provisions of the Internal Revenue Code of the United States.

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.

THE COUNCIL BELIEVES THAT WE MUST RE-EVALUATE CURRENT INTERNATIONAL TAX POLICIES

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

The foreign competition faced by U.S.-based companies has intensified as the globalization of business has accelerated. At the same time, U.S.-based multinationals increasingly voice their conviction that the Internal Revenue Code places them at a competitive disadvantage in relation to multinationals based in other countries. In 1997, the NFTC launched an international tax policy review project, at least partly in response to this growing chorus of concern. The project is presently divided into two parts, the first dealing with the United States' anti-deferral regime, subpart F, the second dealing with the foreign tax credit. The two parts are in turn divided into two phases. In both, an analytical report examining the legal, economic and tax policy aspects of the U.S. rules will be followed by legislative and policy recommendations based on the analytical report.

On March 25, 1999, the NFTC published a report analyzing the competitive impact on U.S.-based companies of the rules under subpart F of the tax code, which accelerate the U.S. taxation of income earned by foreign affiliates.[1] The data and analysis presented in Part One support several significant conclusions:

- Since the enactment of subpart F more than 35 years ago, the development of a global economy has substantially eroded the rules' economic policy rationale.
- The breadth of subpart F exceeds the international norms for such rules, adversely affecting the competitiveness of U.S.-based companies by subjecting their cross-border operations to a heavier tax burden than that borne by their principal foreign-based competitors.
- Most importantly, subpart F applies too broadly to various categories of income that arise in the course of active foreign business operations, and should thus be substantially narrowed.

Our present testimony is in part based upon the findings described in the Report.

FUNDAMENTAL CHANGES IN THE ECONOMIC UNDERPINNINGS OF OUR INTERNATIONAL TAX SYSTEM

The compromise embodied in a significant portion of our present international tax system was shaped in the global economic environment of the early 1960s—a world economy that has changed almost beyond recognition as the 20th century draws to a close.

In the decades since subpart F was enacted in 1962, the global economy has grown more rapidly than the U.S. economy. By almost every measure—income, exports, or cross-border investment—U.S.-based companies today represent a smaller share of the global market. At the same time, U.S.-based companies have become increasingly dependent on foreign markets for continued growth and prosperity. Over the last three decades, sales and income from foreign subsidiaries have increased much more rapidly than sales and income from domestic operations. To compete successfully both at home and abroad, U.S.-based companies have adopted global sourcing and distribution channels, as have their competitors.

Changes introduced since 1962 in subpart F and other important rules in our international tax system have imposed current U.S. taxation on ever-larger categories of active foreign income. These two incompatible trends -decreasing U.S. dominance in global markets set against increasing U.S. taxation of CFC income—are not claimed to have any necessary causal relation. However, they strongly suggest that re-evaluation of the balance of policies that underlie our rules is long overdue.

Because economic arguments advanced against the backdrop of the 1962 economy are the foundation upon which subpart F was erected, the balance that was struck in 1962 may no longer be appropriate. The same is true for other provisions of our international tax system that were constructed with far different bases in mind.

Accordingly, with U.S.-based companies less dominant in foreign markets, but at the same time more dependent on those markets, U.S. international tax rules that are out of step with those of other major industrial countries are more likely to hamper the competitiveness of U.S. multinationals than was the case in the 1960s. The growing economic integration among nations -especially the formation of common markets and free trade areas -raises questions about the appropriateness of U.S. tax rules regarding "base" companies that transact business across national

[1] The NFTC Foreign Income Project: International Tax Policy for the 21st Century; Part One: A Reconsideration of Subpart F (hereinafter referred to as "Part One" or "the Report").

borders with affiliates. Finally, the eclipsing of foreign direct investment by portfolio investment calls into question the importance of tax policy focused on foreign direct investment for purposes of achieving an efficient global allocation of capital.

We will discuss these issues in greater detail in the balance of my testimony and in that of my colleagues.

WHERE WE CAME FROM AND WHERE WE ARE TODAY

In 1962, the Kennedy Administration proposed to subject the earnings of U.S. controlled foreign corporations (CFCs) to current U.S. taxation. At this time, the dollar was tied to the gold standard, and the United States was the world's largest capital exporter. These capital exports drained Treasury's gold reserves, and made it more difficult for the Administration to stimulate the economy. Thus, the proposed repeal of deferral of tax on the foreign income of U.S. multinationals was intended by Treasury Secretary Douglas Dillon to serve as a form of capital control, reducing the outflow of U.S. investment abroad.

The 1962 Legislation

Some commentators have taken the view that subpart F as enacted in 1962 reflected a compromise between two competing tax policy goals. Treasury itself has recently described subpart F as enforcing a balance between the goal of maintaining the competitiveness of U.S. business, on the one hand, and on the other of maintaining neutrality as between the taxation of domestic and foreign business (capital export neutrality [2]). The compromise between competitiveness and neutrality that was struck in 1962 has been seriously disrupted by the legal and economic changes of nearly four decades.

The United States has never enacted an international tax regime that makes capital export neutrality its principal goal with respect to the taxation of business income. Indeed, during the period 1918–1928, the formative era for U.S. tax policy regarding international business income, the United States ceded primary taxing jurisdiction over active business income to the country of source.[3] Rules were formulated to protect the ability of the United States to collect tax on U.S.-source income, and the foreign tax credit was introduced allowing U.S. income tax to be imposed whenever the foreign country where the income was sourced failed to tax the income. The dominant purpose of the U.S. international tax system put in place then—a system that still governs U.S. taxation of international income—was to eliminate the double taxation of business income earned abroad by U.S. taxpayers, which had been imposed under the taxing regime enacted at the inception of the income tax.[4]

When the foreign tax credit was first enacted in 1918, the United States taxed income earned abroad by foreign corporations only when that income was repatriated to the United States. In addition to implementing the basic policy decision to grant source countries the principal claim to the taxation of business income, this "deferral of income" [5] reflected concerns both about whether the United States had the legal power to tax income of foreign corporations (even if owned by U.S. persons) and about the practical ability of the United States to measure and collect tax on income earned abroad by a foreign corporation.[6] Deferral of tax on active business income remained essentially unchanged for the next 44 years—until 1962. The only

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[2] "Capital export neutrality" is a term used to describe a situation in which tax considerations will play no part in influencing a decision to invest in another country.

[3] *See* Michael J. Graetz & Michael O'Hear, The Original Intent of U.S. International Taxation, 46 Duke L.J. 1021 (1997).

[4] *Id*. The original system had allowed only a deduction for foreign income taxes.

[5] The 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 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.

[6] See supra note 3.

exception to this rule was the result of "foreign personal holding company" legislation enacted in 1937 to curb the use of foreign corporations to hold income-producing assets and to sell assets with unrealized (and untaxed) appreciation. The foreign personal holding company rules tax currently certain kinds of "passive" income of a narrow class of corporations in the hands of their owners.[7]

However, President Kennedy urged a reversal of this longstanding U.S. tax policy in 1961. The President called for the "elimination of tax deferral privileges in developed countries and 'tax haven' privileges in all countries."[8] President Kennedy's 1961 State of the Union Address, elaborated on in his tax message of April 20, 1961, prompted Congressional consideration during 1961 and 1962 of changes in the U.S. taxation of controlled foreign corporations. In addressing broad balance of payments concerns, Kennedy announced in his State of the Union Address that his administration would ask Congress to reassess the tax provisions that favored investment in foreign countries over investment in the United States. The President, in his April tax message, urged five goals for revising U.S. tax policy: (1) to alleviate the U.S. balance of payments deficit; (2) to help modernize U.S. industry; (3) to stimulate growth of the economy; (4) to eliminate to the extent possible economic injustice; and (5) to maintain the level of revenues requested by President Eisenhower in his last budget.

In addition to changes in foreign income tax provisions, President Kennedy, in both his State of the Union Address and tax message, called for the introduction of an 8 percent investment tax credit on purchases of machinery and equipment to "spur our modernization, our growth and our ability to compete abroad."[9] Kennedy urged that this credit be limited to expenditures on new machinery and equipment "located in the United States."[10] [Emphasis added.]

Specifically, with regard to the taxation of foreign income, the President stated that "changing conditions" made continuation of the "deferral privilege undesirable," and proposed the elimination of tax deferral in developed countries and in tax havens everywhere. The President stated:

> To the extent that these tax havens and other tax deferral privileges result in U.S. firms investing or locating abroad largely for tax reasons, the efficient allocation of international resources is upset, the initial drain on our already adverse balance of payments is never fully compensated, and profits are retained and reinvested abroad which would otherwise be invested in the United States. Certainly since the post-war reconstruction of Europe and Japan has been completed, there are no longer foreign policy reasons for providing tax incentives for foreign investment in the economically advanced countries."[11]

The Kennedy Administration's recommendations with respect to deferral and the investment tax credit were not neutral toward the location of capital.

It is clear that neither the House nor the Senate embraced the Kennedy Administration's call. The President's proposal was rejected by the Congress, and the legislation that eventually passed as the Revenue Act of 1962 provided for much narrower constraints on deferral of the taxation of active business income. Congress aimed to curb tax haven abuses rather than to end the deferral of U.S. income tax on active business income in developed countries. The 1962 legislation, as ultimately enacted, was targeted at eliminating certain "abuses" permitted under prior law, although, the historical record is far from clear about exactly what the "abuses" were that Congress intended to curb.

The abuses that the Revenue Act of 1962 sought to rectify changed substantially as the legislation made its way through the legislative process. Under President Kennedy's original proposal contained in his tax message of April 1961, and urged throughout the Congressional process by Treasury Secretary Dillon, any deferral of U.S. taxation constituted an abuse. An exception to current taxation would have been provided for (and limited to) investments in less developed countries, but this exception was explicitly grounded in foreign policy, not tax policy, considerations.

Treasury's proposal of July 20, 1961, implicitly treated as abusive the deferral of tax on income from transactions between a foreign corporation and a related party outside the country in which the foreign corporation was organized.[12] In the Senate

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[7] See I.R.C. §§ 552 and 553.

[8] Message of the President's Tax Recommendations, April 20, 1961, *reprinted in* H.R. Doc. No. 87–140, at 6 (1961).

[9] *See* H.R. Rep. No. 87–2508, at 2 (1962)(Conference Report).

[10] *See* Message of the President's Tax Recommendations (April 20, 1961), reprinted in H.R. Doc. No. 87–140, at 4 (1961).

[11] *Id.*, at 6–7.

[12] Staff of the Joint Comm. on Internal Revenue Taxation, 87th Cong., General Explanation of Comm. Discussion Draft of Revenue Bill of 1961, at 5 (Comm. Print 1961).

Finance Committee hearings, Secretary Dillon singled out as abusive the use of foreign corporations that market their goods or services in third countries with the subjective intent of "reducing taxes."[13] The potential of transfer pricing abuses between related companies were a concern.

In the legislation sent to the House by the Committee on Ways and Means and adopted by the House, the abuse appeared to be the avoidance of "taxation by the United States on what could ordinarily be expected to be U.S. source income."[14] As stated above, this concern was consistent with U.S. tax policy dating back to the formative period of 1918–1928, and can be viewed, not as a change in policy, but rather as an application of longstanding policies to new circumstances.

It is clear, however, that Congress did not intend to reverse the policy of generally permitting deferral of active business income earned abroad. Ultimately, no clear Congressional understanding of exactly what constituted an abuse can be determined from the history of the 1962 Revenue Act. Indeed, the Act left determinations of abuse—at least to some extent—up to the Treasury on a case-by-case basis. What these provisions seek to do is still mysterious even today.

The Importance of Transfer Pricing Developments

In reviewing Secretary Dillon's concerns, and the subsequent enactment of the base company rules, it is clear that the subpart F provisions were intended to be a "backstop" to the then existing transfer pricing regime of the Code. Very significant changes have taken place in the field of transfer pricing administration since the 1962 legislation, as Treasury itself has testified in recent years.

When subpart F was enacted, the use of improper transfer pricing to shift income into tax haven jurisdictions was a major concern of Treasury and Congress. Although contemporaneous efforts were being made to address transfer pricing concerns via regulations under section 482, significant aspects of subpart F were specifically intended to backstop transfer pricing enforcement by imposing current U.S. tax on various forms of tax haven income, thus reducing U.S. taxpayers' incentives to shift income into tax havens. In particular, this was one of the stated reasons for the rules relating to foreign base company sales and services. By limiting the benefit of maximizing sales or services profits in a tax haven, these rules were intended to relieve some of the pressure on the still-nascent transfer pricing regime's ability to police the pricing of cross-border transactions.[15]

Nearly four decades later, transfer pricing law and administration have undergone profound changes that call into serious question the continued relevance of subpart F to transfer pricing enforcement. Most conspicuously, based on legislative changes in the 1986 and 1993 tax acts, Treasury has promulgated detailed regulations that have drastically altered the transfer pricing enforcement landscape.[16] These regulations clarify many areas of substantive transfer pricing controversy, but perhaps more importantly they implement a structure of reporting and penalty rules that have had a considerable impact on taxpayer behavior. Further, although audit experience with the new rules is still limited, it is anticipated that the widespread availability of contemporaneous transfer pricing documentation will markedly enhance the Internal Revenue Service's ability to perform effective transfer pricing examinations.

Almost as important is the globalization of transfer pricing enforcement efforts; partly in response to U.S. initiatives in the area, and partly because of compliance concerns of their own, many of the United States' major trading partners have recently stepped up their own transfer pricing enforcement efforts, enhancing reporting and penalty regimes and increasing audit activity. As a result, the role of the Organisation for Economic Cooperation and Development (OECD) as a forum for the development of international consensus on transfer pricing matters has attained new prominence, with the United States making notable efforts to ensure that its own transfer pricing initiatives win international acceptance via the OECD.

Accordingly, the ability of U.S. taxpayers to shift income into a sales base company by manipulating the pricing of transactions is far more circumscribed than it was when transfer pricing as a discipline was in its infancy. This basic change in the landscape, in combination with the general development of a global economy, suggests that transfer pricing considerations no longer provide much support for the base company sales and services rules. Indeed, treating international transactions

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[13] *Id.*

[14] H.R. Rep. No. 87–1447, at 58 (1962)(Committee on Ways and Means, Revenue Act of 1962).

[15] Transfer pricing was not, of course, the sole or even the principal rationale for these rules; they were also said to be justified by "anti-abuse" notions that related to protection of the U.S. tax base and, in the views of some, capital export neutrality.

[16] I.R.C. §§ 482 (last sentence) and 6662(e); Treas. Reg. §§ 1.482–1 through –8 and 1.6662–6.

through centralized sales or services companies as per se tax abusive ignores the current realities of both transfer pricing enforcement and the globally integrated business models demanded by the global marketplace.

DEVELOPMENT OF SUBPART F

A lack of clarity in the historical record of the 1962 Act about what constituted an abuse of tax deferral in international transactions has resulted in ongoing debates about the proper scope of subpart F that continue to this day. Legislation since 1962 has changed the rules for when current taxation is required, but has not resolved the basic debate that raged in 1962. Interpretations of the 1962 Act subsequent to its enactment have sometimes described as abusive any transaction where a foreign government imposes lower tax than would be imposed by the United States on the same transaction or income.[17] This cannot be right. In 1962, Congress clearly rejected making capital export neutrality the linchpin of U.S. international tax policy. Attempting to force a strained interpretation of the legislation it did enact into an endorsement of capital export neutrality by defining anything that departs from capital export neutrality as an abuse flagrantly disregards the historical record.

Nevertheless, in the years since 1962, subpart F has been the subject of numerous revisions, including substantial overhauls in 1975 and 1986: by the addition of new categories of subpart F income; by the narrowing of exceptions to subpart F income; and by the creation of additional anti-deferral regimes (*i.e.*, the Passive Foreign Investment Company provisions). This constant tinkering has created both instability and a forbiddingly arcane web of general rules, exceptions, exceptions to exceptions, interactions, cross references, and effective dates, generating a level of complexity that cannot be defended. Further, while Congress has over the years modified the rules in ways that both tightened and relaxed the anti-deferral rules, it is clear that the overall trend has been to expand the scope of those rules. Particularly with the changes made in 1975 and 1986, Congress has brought more and more income within the net of current taxation, to the point where Treasury now feels justified in positing that current taxation is the general rule, with deferral permitted only as an exception.

A review of this legislative activity makes it clear that U.S. international tax policy has remained largely unchanged for more than three decades. Legislative activity has continued to focus on perceived abuses of deferral (as well as the foreign tax credit), with relatively little consideration given to the changing relationship between the U.S. economy and the rest of the world.

1999 IS NOT 1962

The compromise embodied in subpart F was shaped in the global economic environment of the early 1960s—a world economy that has changed almost beyond recognition as the 20th century draws to a close. The gold standard was abandoned during the Nixon Administration, and the exchange rate of the dollar is no longer fixed. The United States is now the world's largest importer of capital, with foreign investment in U.S. assets exceeding U.S. investment in foreign assets by over $100 billion per year.

With the completion of the post-World War II economic recovery in Europe and Japan, the growth of an industrial economy in many countries in Asia and elsewhere, and the overall development of a global economy, U.S. dominance of international markets is only a memory. The competition from foreign-based companies in U.S. and international markets is far more intense today than it was in 1962.[18] While competition in international markets has grown stiffer, those markets have simultaneously become more important to the prosperity of U.S.-based companies, as foreign income has come to constitute an increasing percentage of U.S. corporate earnings.

The relentless tightening of the subpart F and foreign tax credit rules since 1962, plus the enactment of additional anti-deferral regimes, has steadily increased the tension between U.S. international tax policy and the competitive demands of a

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[17] *See* Stanford G. Ross, *Report on the United States Jurisdiction to Tax Foreign Income*, 49b Stud. on Int'l Fiscal L. 184, 212 (1964).

[18] Some Treasury officials have suggested that the loss of U.S. dominance is simply a function of the rest of the world "catching up" after the devastation of World War II. This may well be true, but it is also irrelevant: whatever the reasons for the loss of U.S. dominance, the point is that the competitive landscape is completely different today, so that it is high time to reconsider the competitive impact of legislative provisions enacted when the world was a very different place.

global economy. A comparison between the policy goals of our international tax system and changes in the global economy is thus long overdue.

RELEVANT TAX POLICY CONSIDERATIONS

Without foreclosing the consideration of other factors, it should be noted that Treasury officials in recent months have suggested that five tax policy considerations will need to be taken into account in the process of reforming subpart F:

- Capital export neutrality
- Competitiveness
- Conformity with international norms
- Minimizing compliance and administrative burdens
- Meeting revenue needs in a fair manner

Capital Export Neutrality

As explained in detail in the Report, and as further explained by my colleagues with me on the panel this morning, the NFTC believes that the historical significance of capital export neutrality ("CEN") in the enactment of subpart F has come to be exaggerated by subsequent commentators. More importantly, the Report finds numerous reasons to reject CEN as a foundation of U.S. international tax policy. Briefly summarized, these reasons include:

- The futility of attempting to achieve globally efficient capital allocation by unilateral action.
- The similar futility of attempting to advance investment neutrality by focusing solely on direct investment, particularly in light of the fact that international portfolio investment now significantly exceeds direct investment.
- The failure of the United States itself to take CEN seriously as a matter of tax policy, other than in the one relatively narrow area of subpart F, where it appears to operate largely as a rationale of convenience.
- Growing criticism of CEN in current economic literature.
- The anomalousness of adopting a tax policy that encourages the payment of higher taxes to foreign governments.

The fact that CEN is the wrong starting point for our international tax policy is particularly well illustrated by the last item. Several provisions of subpart F have the effect of penalizing a taxpayer that reduces its foreign tax burden, apparently based on the CEN principles. Presumably the idea is that preventing U.S. taxpayers from reducing foreign taxes will ensure that they do not make investment decisions based on the prospect of garnering a reduced rate of foreign taxation (while deferring U.S. taxation until repatriation). However, insisting that U.S. taxpayers pay full foreign tax rates when market forces require that they do business in another jurisdiction is a flawed policy from at least three perspectives. First, from the standpoint of the tax system, insisting on higher foreign tax payments obviously increases the amount of foreign taxes available to be credited against U.S. tax liability, thus decreasing U.S. tax collections in the long run. Second, from the standpoint of competitiveness, it leaves U.S.-based companies in a worse position than their foreign-based competitors: the U.S. company must either pay the high local rate, or if it attempts to reduce that tax it will instead trigger subpart F taxes at the U.S. rate, while the foreign competition will reduce their local taxes through perfectly normal transactions such as paying interest on a loan from an affiliate, and trigger no home country taxes by doing so.[19] Third, the belief that the level of foreign investment by U.S. companies will be significantly increased by the ability to reduce foreign taxes (while deferring U.S. taxation) is seriously antiquated in the context of the global economy. Such a belief may have been justified in the early 1960's, when the business reasons for U.S. companies to invest offshore were more limited. But today, when the principal opportunities for expansion are offered by foreign markets, so that U.S.-based companies derive an ever-greater proportion of their earnings from offshore activities, a presumption that foreign tax reduction will generate tax-motivated foreign investment is not merely out of touch with economic reality, but seriously harmful to the competitiveness of U.S.-based companies (as further discussed below). We submit that the at best highly theoretical global capital allocation benefits that may be achieved by subpart F's haphazard pursuit of CEN principles do not even come close to justifying the fiscal and competitive damage caused by deny-

[19] Local tax authorities may well scrutinize the amount of outbound deductible payments under transfer pricing and thin-capitalization principles, but subject to that discipline there is nothing inherently objectionable about an allocation of functions and risks among affiliates that gives rise to a deductible payment in a high-tax jurisdiction. Treasury has not made a case that protection of the foreign tax base should in any event be a concern of the U.S. tax system.

ing U.S. companies the ability to reduce local taxes on the foreign businesses that are critical to their future prosperity and that of their workers.

Accordingly, the NFTC believes that CEN is not a sound basis on which to build U.S. international tax policy for the coming century, and recommends that in redesigning subpart F it be given no greater weight than it has been given in the case of other major international provisions such as the foreign tax credit.

Competitiveness

Accelerating the U.S. taxation of overseas operations (while permitting a foreign tax credit) means that a U.S.-based company will pay tax at the higher of the U.S. or foreign tax rate. If the local tax rate in the company of operation is less than the U.S. rate, this means that locally-based competitors will be more lightly taxed than their U.S.-based competition. Moreover, companies based in other countries will also enjoy a lighter tax burden, unless their home countries impose a regime that is as broad as subpart F, and none have to date done so. While the competitive impact of a heavier corporate tax burden is difficult to quantify, it is clear that a company that pays higher taxes suffers a disadvantage vis-a-vis its more lightly taxed competitors. That disadvantage may ultimately take the form of a decreased ability to engage in price competition, or to invest funds in the research and capital investment needed to build future profitability, or in the ability to attract capital by offering an attractive after-tax rate of return on investment. Whatever its ultimate form, however, it cannot be seriously questioned that a heavier corporate tax burden will harm a company's ability to compete.[20]

Competitiveness concerns were central to the debate when subpart F was enacted, even at a time when U.S.-based companies dominated the international marketplace. This apparent dominance did not convince Congress that the competitive position of U.S. companies in international markets could be ignored. Thus, although the Administration originally proposed the acceleration of U.S. taxation of most foreign-affiliate income, that proposal was firmly rejected by Congress based largely on concerns about its competitive impact.[21]

If competitiveness was a consideration when subpart F was enacted, there are compelling reasons to treat it as a far more serious concern today.

CONFORMITY WITH INTERNATIONAL NORMS

As will be further developed by my colleagues on the panel this morning, conformity with international norms is important from a competitiveness standpoint, but it bears further emphasis here that our principal trading partners have consistently adopted rules that are less burdensome than subpart F. We do not dispute the fact that subpart F established a model for the taxation of offshore affiliates that has been imitated to a greater or lesser degree in the CFC legislation of many countries. But looking beyond the superficial observation that other countries have also enacted CFC rules, the detailed analysis in the Part One Report showed that in virtually every scenario relating to the taxation of active offshore operations, the United States imposes the most burdensome regime. Looking at any given category of income, it is sometimes possible to point to one or two countries whose rules approach the U.S. regime, but the overall trend is overwhelmingly clear: U.S.-based multinationals with active foreign business operations suffer much greater home-country tax burdens than their foreign-based competitors.

The observation that the U.S. rules are out of step with international norms, as reflected in the consistent practices of our major trading partners, supports the conclusion that U.S.-based companies suffer a competitive detriment vis-a-vis their multinational competitors based in such countries as Germany and the United Kingdom, and that the appropriate reform is to limit the reach of subpart F in a manner that is more consistent with the international norm.

Some commentators have suggested that the competitive imbalance created by dissimilar international tax rules should be redressed not through any amelioration of the U.S. rules, but rather through a broadening of comparable foreign regimes. As a purely logical matter the point is valid—a see-saw can be balanced either by pushing down the high end or pulling up the low one. However, the suggestion is

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[20] Congress has previously acknowledged the connection between corporate tax burden and competitiveness. For example, in connection with the enactment of the dual consolidated loss rules under Code section 1503(d) as part of the Tax Reform Act of 1986 (the "'86 Act"), Congress observed that the ability of a foreign corporation to reduce its worldwide corporate tax burden through the use of a dual resident company enabled such corporations "to gain an advantage in competing in the U.S. economy against U.S. corporations." Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (the "'86 Act General Explanation"), at 1065.

[21] *See* Part One, Chapter 2.

completely impractical for several reasons—conformity and competitive balance are far more likely to be achieved through a modernization of the U.S. rules. For one thing, since the U.S. rules are out of step with the majority, from the standpoint of legislative logistics alone it would be far easier to achieve conforming legislation in the United States alone, rather than in more than a dozen other countries. More fundamentally, there is no particular reason to believe that numerous foreign sovereigns, having previously declined to adopt subpart F's broad taxation of active foreign businesses, will now suddenly have a change of heart and decide to follow the U.S. model.

Further, recent OECD activities relating to "unfair tax competition" do not increase the likelihood of foreign conformity with subpart F's treatment of active foreign businesses. It is important to recognize that those activities relate to efforts by OECD member countries to limit the availability and usage of "tax haven" countries and regimes. By imposing abnormally low rates of taxation, such countries or regimes may be viewed as improperly reducing other countries' tax bases and distorting international investment decisions. The failure of a country to impose any type of CFC legislation can be viewed as offering a type of tax haven opportunity, since it may permit the creation of investment structures that avoid all taxation. Thus, the OECD has recommended that countries without CFC regimes "consider" enacting them. However, in encouraging countries that have no CFC rules to enact them, the OECD has done nothing to advance the degree of conformity among existing CFC regimes. Based on the materials that are publicly available, it does not appear that the OECD has sought to address the lack of conformity between the highly-developed CFC rules of the United States and its major trading partners, particularly as they affect active foreign business operations.

In conclusion, the U.S. rules under subpart F are well outside the international mainstream, and should be conformed more closely to the practices of our principal trading partners. We emphasize that, contrary to the suggestions of some commentators, we advocate only that the U.S. rules be brought back to the norm so as to achieve competitive parity—not that they be loosened further in an effort to confer competitive advantage.

Minimizing Compliance and Administrative Burdens

The NFTC applauds Treasury's inclusion of administrability among the principal tax policy goals that will be considered in reforming our international tax system. Subpart F includes some of the most complex provisions in the Code, and it imposes administrative burdens that in many cases appear to be disproportionate to the amount of revenue at stake. There are several sources of complexity within subpart F, including the following:

- The basic design and drafting of the subpart F regime was complex;
- That initial complexity has been exacerbated over the years by numerous amendments, which have created an increasingly arcane web of rules, exceptions, exceptions to exceptions, etc.; and
- The subpart F rule require coordination with several other regimes that are themselves forbiddingly complex, including in particular the foreign tax credit and its limitations.

The complexity of the rules long ago reached the point that the ability of taxpayers to comply, and the ability of the IRS to verify compliance, were both placed in serious jeopardy. The NFTC therefore urges that administrability concerns be given serious weight in the process of modernizing the tax system. To that end, we urge that the drafters of the Code and regulations consider not only the legal operation of the rules, but also their practical implementation in terms of forms and recordkeeping requirements. In addition, we urge that fuller consideration be given to the interaction of multiple complex regimes; it may be possible to read section 904(d) and its implementing regulations and conclude that the provision can be understood, and it may likewise be possible to read section 954 and its implementing regulations and conclude that that provision is also understandable, but when the two sets of rules must be read and implemented together, we submit that the limits of human understanding are rapidly exceeded.

Meeting Revenue Needs in a Fair Manner

The final policy criterion recently mentioned by Treasury is fairness. While no one could quarrel with the notion of fairness in tax policy, what fairness means in practice is somewhat less clear. Our understanding is that Treasury is concerned about preservation of the corporate tax base: it would be unfair if U.S.-based multinationals could eliminate or significantly reduce their U.S. tax burden through the use of CFCs. This analysis presumably requires that a distinction be drawn between

those cases in which it is "fair" to accelerate the U.S. taxation of foreign affiliates' income, and those in which it is not.

There should be general agreement about two cases in which accelerated U.S. taxation is appropriate: first, where passive income is shifted into an offshore incorporated pocketbook, and second, where income is inappropriately shifted offshore through abusive transfer pricing. The first case is well-addressed by the extensive subpart F rules concerning foreign personal holding company ("FPHC") income, while the second case is addressed by extensive transfer pricing and related penalty rules which give the IRS ample authority to curb transfer pricing abuses. Thus, little needs to be done to advance fairness in these regards.

Conversely, it should generally be agreed that it is not fair to accelerate U.S. taxation when a foreign subsidiary engages in genuine business activity in its foreign country. Unless Treasury is considering a radical redefinition of the scope of U.S. international taxing jurisdiction, the normal U.S. rules that impose U.S. tax only when income is repatriated should continue to be viewed as fair.

This leaves a relatively narrow band of potential controversy: whether there are certain types of income that should be taxed currently even though they are associated with active foreign business operations. Subpart F currently identifies a number of such categories, and imposes current tax on them for reasons that are not always clear, but appear to be generally bound up with the notion of capital export neutrality, as advanced by Treasury at the time of the 1962 legislation. We have already stated our view that U.S. international tax policy needs a firmer foundation than the economic theorizing that underlies CEN, and would only add here that CEN should be of no relevance to the definition of fairness in international tax policy.

Finally, we conclude by noting that as a practical matter, Treasury concerns for the preservation of the corporate tax base and distributional equity in the U.S. tax system should not be exaggerated in the context of the relatively modest reforms that we advocate. We do not believe that the rationalizations of subpart F and the foreign tax credit to be proposed will alter historical patterns of offshore investment and profit repatriation (although they will improve our companies' ability to compete). Those patterns show that U.S. companies invest and operate overseas in response to market rather than tax considerations, that offshore operations do not substitute for investments in U.S. operations, that offshore investments in fact have a positive impact on U.S. employment, and that a significant percentage of offshore profits will be repatriated currently regardless of the applicable tax rules. Accordingly, while the distributional equity of the U.S. tax system is really not at stake here, the fairness of the system will be meaningfully improved by rationalizing and modernizing the taxation of U.S. companies that compete in the global marketplace.

CONCLUSION

The NFTC believes that the tax policy criteria of competitiveness, administrability, and international conformity all support a significant modernization of our international tax systemat this time, and that fairness considerations are at worst a neutral factor. Finally, even if Congress and the Administration are persuaded to given continued weight to the policy of capital export neutrality (which we do not believe to be justified), the countervailing considerations are sufficiently powerful to justify meaningful reform.

IMPROVEMENT OF THE U.S. INTERNATIONAL TAX SYSTEM IS NECESSARY

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 Committee, which focuses the spotlight on U.S. international tax policy, is valuable and should be applauded.

The NFTC is concerned that this 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 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 previous sections of this testimony, make U.S.-based 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" subject to less significant limitations 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.[22]
- 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. In some cases, U.S. rules by themselves cause double taxation, as for example, in one of the more significant anomalies, that of the allocation and apportionment of interest expense.
- The current U.S. international tax system contains many other anomalies that make little sense when considered in the context of the matters we discuss today. Under present law, the treatment of subpart F income and the treatment of losses generated by subpart F-type activities are not symmetrical, creating many "heads-I-win-tails-you-lose" scenarios that are difficult to justify on a principled basis. Income from subpart F activities is always recognized currently on the U.S. tax return, but if those activities should instead generate losses they will generally be given no current U.S. tax effect. (As a threshold matter, we can't resist noting that this restrictive treatment of losses realized by CFCs, as compared with the treatment of losses realized by domestic affiliates, is a distinct departure from CEN principles, since it creates a genuine tax disincentive to carry out certain activities abroad. If the activities targeted by subpart F are carried out in a foreign corporation, subpart F will accelerate any income but defer any losses. If those activities were instead placed in a U.S. corporation, both income and losses would be recognized for U.S. tax purposes. Since the likelihood of any given activity's producing losses rather than income is not generally known at the outset, the system creates a structural bias in favor of U.S. investment, rather than anything approaching neutrality. But as we noted elsewhere, U.S. allegiance to CEN as a tax policy principle has been haphazard at best.) The rules carry this bias not only in their basic structure, but also in the way they apply to carryover restrictions, consolidation of affiliate losses, and the offsetting of losses among subpart F income categories.

Similarly, other provisions in the Code apply in an asymmetrical way. This is true with respect to the rules relating to overall foreign losses. Other rules determine the composition of affiliated groups for the filing of consolidated returns and do not allow the inclusion of foreign corporations, except in very limited circumstances.

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[22] We start from the fundamental assumption that the United States taxes the income of its citizens and domestic corporations on a worldwide basis. We do not attempt to address either the desirability or the implications of the adoption of a territorial system of taxation, an alternative that could itself be the subject of substantial analysis and debate. Therefore, for this analysis the question is stated not as whether but as when should foreign income be taxed.

• 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, and as my colleague will discuss in greater detail, 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.

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.[23]

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.[24] 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 U.S. based companies.

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.[25] These findings have an ominous quality, given the recent spate of acquisitions of large U.S.-based companies by their foreign competitors.[26] 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.

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[23] See 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).

[24] *Id.*

[25] OECD, Taxing Profits in a Global Economy: Domestic and International Issues (1991).

[26] *See, e.g.*, testimony before the Committee on Finance, U.S. Senate, March 11, 1999.

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, the NFTC strongly supports the International Tax Simplification for American Competitiveness Act of 1999, H.R. 2018, recently introduced by Mr. Houghton, and Mr. Levin, and Mr. Sam Johnson, and joined by four other members: Mr. Crane, Mr. Herger, Mr. English, and Mr. Matsui. We congratulate them on their 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.

The NFTC is preparing 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.

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.
- The U.S. international tax system is much more complex and burdensome than that of our trading partners.
- 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 Committee for beginning the process of reexamining of 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 Committee.

Chairman ARCHER. Thank you, Mr. Murray.

Mr. Morrison you may proceed.

STATEMENT OF PHILIP D. MORRISON, PRINCIPAL AND DIRECTOR, WASHINGTON INTERNATIONAL TAX SERVICES GROUP, DELOITTE & TOUCHE LLP.; ON BEHALF OF THE NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. MORRISON. Thank you, Mr. Chairman, distinguished Members of the Committee, and staff. My name is Phil Morrison. I am a principal with Deloitte & Touche and the director of Deloitte's Washington International Tax Services Group. I appear today on behalf of the National Foreign Trade Council.

I am one of the co-authors of the NFTC's report on Subpart F, and we are currently working on a second report, as Mr. Murray said, on the foreign tax credit. My role with respect to both of these

reports is a comparative law one, to compare the U.S. regime with the comparable regimes of our major trading partners, specifically Canada, France, Germany, Japan, the Netherlands, and the United Kingdom. It is the large multinational corporations from these countries that form the chief competition of U.S. companies when they operate abroad.

The Subpart F comparison that we completed illustrates that, in many important respects, the U.S. CFC provisions in Subpart F are much harsher than the rules of foreign countries' comparable regimes. While the foreign tax credit comparison is still a work in progress, preliminary results indicate that the use of the credit, U.S. limitations on the use of the credit, and expense allocation provisions, particularly interest expense, as has been mentioned this morning several times, are both more complex and more likely to result in double tax than comparable regimes in the foreign countries surveyed. This is particularly true with respect either to highly leveraged industries or those that produce significant foreign losses during the startup years abroad, such as telecommunications or power generation.

The 1-page table that appears at the end of my written testimony summarizes several of the practical examples that we examined in the Subpart F report. As Example 1 shows, none of the countries surveyed eliminates deferral for active financial services income received by a CFC from unrelated persons. Such income is universally recognized as active business income, and except in the United States, is not subject to the anti-defferal regime. Thus, if the temporary active financing provision enacted for this year were permitted to expire at the end of 1999, the United States would be clearly out of step with international norms.

Examples 2, 3, and 4 in the table address the situations where an active business CFC receives dividends, in Example 2; interest, in Example 3; and royalties, in Example 4, from a related active business CFC resident in a different country. In each case, the United States is the only country that always denies deferral.

Example 5 deals with foreign-based company oil-related income, that is, income from downstream activities, such as refining.

Under Subpart F, the income of the CFC always would be attributed to U.S. shareholders. In the other countries, oil-related income is subject to the same rules as other types of active business income; only France would tax oil-related income.

In Example 6, a CFC is engaged in buying and selling property that it does not manufacture. The property is bought from related parties outside the CFC's residence country and sold to unrelated parties, also outside the CFC's country. Again, because of tax disparities, Canadian, Dutch, German, and Japanese multinationals all have a competitive advantage over U.S. multinationals.

Example 7 demonstrates that none of the countries examined have a section 956 surrogate. None require inclusion in income by a CFC shareholder for an increase in earnings invested in the home country of the CFC.

These comparisons demonstrate that, due to Subpart F, U.S. multinationals operate at a competitive disadvantage abroad as compared to multinationals from our major trading partners. By pointing out this competitive disadvantage, and despite the chair-

man's invitation earlier, we don't mean to imply that the United States should inaugurate a "race to the bottom," a race to provide the most lenient tax rules in the United States. The comparison does demonstrate, however, quite clearly, that the rest of the developed world has not joined the United States in a "race to the top." In the 37 years since the enactment of Subpart F, while each jurisdiction studied has approached CFC issues somewhat differently, none has adopted a regime as harsh as Subpart F.

The U.S. anti-deferral rules are out of step with international norms. The relaxation of Subpart F, even to the highest common denominator among other countries' regimes, let alone to a more moderate middle ground, would help redress the competitive imbalance created by Subpart F without contributing to the feared race to the bottom.

While we have yet to complete our study that will be part of the foreign tax credit report, our preliminary work reveals that the U.S. credit system, again, particularly with respect to interest allocation and the treatment of foreign losses, is also out of step with international norms. It appears that this too contributes to a competitive disadvantage for most U.S. multinationals.

Thank you very much for your attention.

[The prepared statement follows:]

Statement of Phillip D. Morrison, Principal and Director, Washington International Tax Services Group, Deloitte & Touche LLP; on behalf of the National Foreign Trade Council, Inc.

Mr. Chairman, distinguished Members of the Committee, and staff: My name is Phil Morrison. I am a Principal with Deloitte & Touche LLP and the Director of Deloitte's Washington International Tax Services Group. I appear today on behalf of the National Foreign Trade Council ("NFTC").

I. INTRODUCTION

I am co-author of the NFTC's report on subpart F [1] and am currently working with others on an NFTC-sponsored report on the foreign tax credit. My role with respect to these reports was to compare the United States subpart F and foreign tax credit regimes to the comparable regimes of Canada, France, Germany, Japan, the Netherlands, and the United Kingdom.

These countries were selected for comparison because they constitute, together with the United States, the countries with the most corporations that are among the world's largest 500 corporations. In the aggregate, these countries are home to 412 of the 500 largest corporations in the world,[2] and it is large multinational corporations from these countries that are the competition for U.S. corporations that conduct business abroad.

The subpart F comparison illustrates that, in many important respects, the U.S. controlled foreign corporation (CFC) provisions in subpart F are harsher than the rules in the foreign countries' comparable regimes.[3] While the foreign tax credit comparison is still a work-in-progress, preliminary results indicate that the U.S. limitations on the use of the credit and expense allocation provisions are both more complex and more likely to result in double taxation than the foreign countries' comparable regimes. These comparisons demonstrate that U.S. multinationals operate at a competitive disadvantage abroad as compared to multinationals from these other major jurisdictions.

By pointing out this competitive disadvantage, we do not mean to imply that the United States should inaugurate a "race to the bottom," a race to provide the most lenient tax rules. The comparison does demonstrate, however, that the rest of the developed world has not joined the United States in a "race to the top." If the rest

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[1] International Tax Policy for the 21st Century: A Reconsideration of Subpart F, (March 25, 1999).

[2] Based upon the Financial Times 500, The Financial Times, January 22, 1998.

[3] For convenience, the anti-deferral regimes of all of the countries will be referred to as "CFC regimes." The actual names of the particular regimes vary.

of the developed world is not going to join the United States and mimic the harshness of subpart F and the complexity of our foreign tax credit rules, and history has shown that it will not, then it is incumbent upon Congress to carefully examine whether the resulting competitive imbalance is warranted for other policy reasons. Since, as the NFTC report demonstrates and as is summarized in the testimony of Messrs. Murray and Merrill, it is not, it would be sensible to relax the U.S. rules. This relaxation need not be a relaxation to the lowest common denominator but only to a more reasonable middle position among those adopted by our competitor countries.

The unstated assumption of those who raise the spectre of a race to the bottom, is that any significant deviation from the U.S. model that exists in another country indicates that the other government has yielded to powerful business interests and has enacted tax laws that are intended to provide its home-country based multinationals a distinct competitive advantage. It is seldom, if ever, acknowledged that the less stringent rules adopted in other countries might reflect a conscious but different balance of the rival policy concerns of neutrality and competitiveness.

The unstated assumption is incorrect. The CFC regimes enacted by the countries studied, for example, all were enacted in response to and after several years of scrutiny of the U.S. subpart F regime. They reflect a careful study of the impact of subpart F and, in every case, include some significant refinements of the U.S. rules. Each regime has been in place long enough for each respective government to study its operation and to conclude whether it is either too harsh or too liberal. While each jurisdiction has approached CFC issues somewhat differently, each has adopted a regime that, in at least some important respects, is materially less harsh than subpart F.

The proper inference to draw from this 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, let alone to a moderate middle ground, would help redress the competitive imbalance created by subpart F without contributing to a race to the bottom.

II. Anti-Deferral or CFC Regimes—Generally

Each of the countries examined in the NFTC study on subpart F has enacted a regime aimed at preventing taxpayers from obtaining deferral with respect to certain types of income of, or income earned by certain types of, CFCs. At the same time, however, each country has balanced its anti-deferral concerns with the need not to interfere with the ability of domestic taxpayers to compete in genuine business activities in international markets. Resolution of the conflict between these two policy objectives typically hinges on the definition of what constitutes genuine foreign business activity. Genuine business activity gains deferral; a lack of genuine business activity triggers the anti-deferral regime. As might be expected, the definition of genuine foreign business activity varies widely.

There are two primary ways in which countries prevent what they consider to be improper deferral of domestic taxation of foreign-source income earned by CFC's. A country may end deferral with respect to certain types of "tainted" income that it believes should not receive deferral. This transactional approach is the approach taken by the United States, Canada, and Germany. The alternative is to deem all income to be tainted when a CFC meets certain criteria (such as having a significant amount of tainted income or being located in certain jurisdictions). If the CFC does not meet the criteria for application of the regime, deferral is allowed for all of the income. This jurisdiction-based approach is taken by France, Japan, and the United Kingdom. Both approaches provide exemptions and modifications that tend to minimize the differences between them, however. The Netherlands, through a participation exemption, broadly exempts foreign income of CFCs. While the participation exemption is denied for certain passive investments, liberal safe harbors preserve the exemption in most cases.

Deferral is ended (and current inclusion achieved) by attributing either the tainted income or all income earned by the CFC to certain shareholders (usually those holding a minimum percentage ownership). Shareholders must include the attributed income in their own income currently. CFC regimes that attribute only tainted income provide for exclusions that remove specific types of income from classes of income that normally are considered to be tainted. CFC regimes that attribute all income provide exemptions that remove all or certain income from attribution under the regime.

III. Specific Comparison of CFC Regimes with Respect to Particular Types of Income [4]

A. Active Financial Services Income

Prior to 1986, a CFC's active financial services income was treated much the same as other types of active income. From 1986 until 1998, however, most income earned by a CFC of a U.S. financial services company was subject to tax when earned, apparently because Congress believed that deferral of such income provided excessive opportunities to route income through foreign countries to maximize tax benefits.[5] The pre–1986 treatment for active financial services income was temporarily restored in 1997,[6] with the addition of rules to address the concerns that led to the repeal in 1986.

The active financing income provision was revisited in 1998, in the context of extending the provision for the 1999 tax year. Considerable changes were again made to address concerns relating to income mobility. The newly crafted provision is narrowly drawn. Under the 1999 active financing provision, a financial services business must have a substantial number of employees carrying on substantial managerial and operational activities in the foreign country. The activities must be carried on almost exclusively with unrelated parties, and the income from the activities must be recorded on the books and records of the CFC in the country where the income was earned and the activities were performed.[7] In addition, an active banking, financing, securities, or insurance business is painstakingly defined by statute and accompanying legislative history. The activities that may be taken into account in determining whether a business is active also are carefully delineated in the statute and legislative history and substantially all of the CFC's activities must be comprised of such activities as defined.

As Example 1 on the attached table shows, none of the countries surveyed eliminates deferral for active financial services income received by a CFC from unrelated persons. Such income is universally recognized as active trade or business income. Thus, if the active financing provision were permitted to expire at the end of 1999, U.S. banks, insurers, and other financial services companies would find themselves at a significant competitive disadvantage in relation to all their major foreign competitors when operating outside the United States.

Other major industrialized countries provide more lenient requirements for a CFC to be able to defer the taxation of its active financing income. German law merely requires that the income must be earned by a bank with a commercially viable office established in the CFC's jurisdiction and that the income results from transactions with customers. Germany does not require that the CFC conduct the activities generating the income or that the income come from transactions with customers solely in the CFC's country of incorporation. The United Kingdom has an even less restrictive deferral regime than Germany. The United Kingdom does not impose current taxation on CFC income as long as the CFC is engaged primarily in legitimate business activities primarily with unrelated parties.

B. Dividends, Interest, and Royalties from Active Earnings Received from Related Parties

Example 2 on the attached table addresses the case where a CFC engaged in the active conduct of a trade or business receives dividends from a subsidiary CFC, incorporated in a different country, also engaged in the active conduct of a trade or business.

For U.S. tax purposes, the dividend income would be taxed to (attributed to) the CFC's U.S. shareholders. There would be no attribution to Canadian shareholders because dividends received from other foreign related parties out of active earnings are excluded from attribution. French shareholders would be exempt because the CFC is engaged in an active business. The dividend income would not be considered to be tainted income in Germany provided the parent CFC's holdings in the subsidiary CFC are commercially related to its own excluded active business operations (*e.g.,* CFC is also engaged in a similar manufacturing business) or if the dividends

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[4] In each of the examples below, it is assumed that a single home-country shareholder (a parent company) owns 100% of the CFC. Because of this, in each of the examples outlined below, the Dutch anti-deferral regime (exceptions from the Dutch exemption system) will not apply.

[5] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 966 (Comm. Print 1986).

[6] Pub. L. No. 105–34, § 1175(a); H.R. Rep. No. 105–220, at 639–645 (1997)(Taxpayer Relief Act of 1997, Conference Report to H.R. 2014).

[7] See H.R. Rep. No. 105–825, at 921 (1998)(Conference Report to H.R. 4328, section 1005 of the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999).

would have been exempt if received directly by the German corporation. Japanese shareholders would be exempt because the business of CFC is conducted primarily in its country of incorporation (even if business were not conducted in that country, Japanese shareholders would be exempt if the main business of CFC were wholesale, financial, shipping, or air transportation because it is engaged in business primarily with unrelated parties). U.K. shareholders would be exempt from attribution because the recipient CFC is principally engaged in an active business and the business operations of CFC are carried on principally with unrelated parties.

Thus, in the case of an active business CFC that receives a dividend from a CFC subsidiary engaged in active business in a country other than the recipient CFC country, the United States is the only country that always attributes the income to CFC shareholders. While the foreign countries allow for situations where legitimate active businesses earn dividend income in the normal course of business, the United States puts its multinational corporations at a disadvantage by always taxing dividend income currently unless the extremely narrow same country exception applies.

Example 3 assumes the same facts as Example 2 but deals with interest. Thus, in Example 3, a CFC engaged in an active trade or business pays interest to a parent or sister CFC in another country that is also engaged in an active business.

Canadian, French, Japanese, and U.K. CFCs are allowed to lend money to active business subsidiaries without being penalized by the CFC rules. German CFCs are allowed to lend money to foreign active business subsidiaries as long as the loan is long-term and the money is borrowed by the CFC on foreign capital markets. U.S. multinational corporations generally are not able to provide a loan from a CFC engaged in active business with an excess of cash to a subsidiary of the CFC that is engaged in active business with a need for cash, without incurring current U.S. taxation on the interest paid from the subsidiary to the CFC. The only time U.S. multinationals are able to provide such a loan without current U.S. taxation is if both the CFC and the subsidiary are in the same country. Although income used to pay the interest is earned in an active foreign business by a party related to the U.S. multinational and the income is reinvested in an active foreign business, the U.S. rules still tax the income currently.

Once again, U.S. multinationals are at a competitive disadvantage in the international marketplace. This situation, like the dividend example in Example 2, hamstrings U.S. multinationals groups from redeploying foreign earnings of their CFC group from jurisdiction to jurisdiction without triggering an end to deferral.

Example 4 on the attached table is identical to Examples 2 and 3 except that it deals with royalties. Royalties are paid by an active CFC in one country to an active CFC in another country.

The Canadian CFC rules provide an exception that deems amounts paid to a CFC by a related foreign corporation to be active business income if the amount is deductible in computing the income of the payer corporation. Therefore, the royalty payments would be excluded from attribution. Income would not be attributed to French shareholders or Japanese shareholders because CFC is principally engaged in an active business carried on in its residence country. Germany does not consider royalty income to be passive tainted income provided the CFC has used its own research and development activities without the participation of German shareholders or an affiliated person to create the patents, trademarks, know-how, or similar rights from which the income is derived. U.K. shareholders would be exempt from attribution because CFC is principally engaged in an active business and the business operations of CFC are carried on principally with unrelated parties.

Only members of U.S. multinational groups cannot pay royalties to a CFC that actively develops intangibles without triggering an anti-deferral regime. Even if earned in an active business, royalties from related parties are subpart F income. In each of the competitor countries' cases, such royalties are not tainted income or otherwise attributable to the CFC's shareholders.

C. Oil-Related Income

In 1982, the United States expanded subpart F income to include "foreign base company oil-related income."[8] Congress claimed that, because of the fungible nature of oil and because of the complex structures involved, oil income is particularly suited to tax haven type operations.[9] Under the changes made foreign base company oil-related income was defined as foreign oil-related income other than: (1) income derived from a source within a foreign country in connection with oil or gas extracted from an oil or gas well located in that foreign country; or (2) income from

[8] Pub. L. No. 97–248, § 212(a).

[9] Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 72.

oil, gas, or a primary product of oil or gas that is sold by the foreign corporation for use or consumption within the foreign country or is loaded in such country on a vessel or aircraft as fuel for such vessel or aircraft.[10]

Example 5 compares the U.S. rules with respect to foreign base company oil-related income to those applicable to CFCs of companies incorporated in our competitor countries. Example 5 assumes that CFC operates a refinery in country X. CFC earns oil-related income in X from purchasing oil extracted from a country other than X and sells the refined product for consumption outside of X. CFC's sales are primarily conducted with unrelated parties.

Under subpart F, the income of CFC would be attributed to its U.S. shareholders. None of the other countries have singled out oil-related income as a type of income that should be tainted. In the other countries, oil-related income is subject to the same rules as other types of active business income. In this example, however, income would be attributed to French shareholders because CFC makes sales primarily outside the CFC country. In the other countries examined, the income would not be taxed.

Thus, U.S.-based and French-based multinational oil companies are, in these circumstances, at a competitive disadvantage in relation to oil companies from the other compared countries with respect to income earned from downstream activities. Only for U.S. and French multinational oil companies will income from an active downstream business conducted in a subsidiary in a foreign jurisdiction be attributed to shareholders. In each of the other surveyed jurisdictions, such income would be entitled to deferral or exemption.

D. Base Company Sales Income

For U.S. tax purposes, foreign base company sales income generally is income derived from the purchase and re-sale of property that is not manufactured by the CFC where either the seller or the buyer is related to the CFC.

In Example 6, CFC is engaged in the buying and selling of personal property that it does not manufacture. The property is bought from related parties outside CFC's residence country and sold to unrelated parties outside CFC's residence country.

The income of CFC would be attributed to U.S. shareholders. In Canada, CFC's income would be exempt from attribution because the income is earned in active business. The income would be attributed to French shareholders because the business is conducted primarily outside the CFC country. Germany's exemption for commercial activities does not generally apply when goods are acquired by the CFC from, or sold to, a related German party. If the goods are both purchased and sold outside Germany, however, the sales income is exempt, even if the goods are sold to a related party and the German shareholder of the CFC actively participates. In this example, therefore, there would be no attribution. To qualify for exemption from attribution, a Japanese sales company must conduct its business primarily with unrelated parties. To be conducting business primarily with unrelated parties for Japanese purposes, the CFC must either purchase more than 50 percent of its goods from unrelated parties or sell more than 50 percent of its goods to unrelated parties. The income of CFC would not be attributed to Japanese shareholders because more than 50 percent of the goods are sold to unrelated parties. A CFC controlled by U.K. shareholders is subject to the CFC regime and income is attributed to its shareholders if the main business of the CFC is dealing in goods for delivery to or from the United Kingdom or to or from related parties. The main business of the CFC is dealing in goods from related parties, so the income of the CFC would be attributed to its shareholders.

Canadian, German, and Japanese multinationals have a competitive advantage over U.S. multinationals when goods bought from related parties outside the home and CFC countries are sold to unrelated parties outside the home and CFC countries.

E. Increase in Investment in the Home Country

In Example 7, CFC has nothing invested in home country property at the beginning of the year. CFC purchases tangible property located in the home country for use in its business during the year. CFC has earnings and profits in excess of the value of the property.

Under subpart F, U.S. shareholders would have to include the entire amount invested by the CFC in U.S. property for the taxable year in its income.[11] None of the other countries studied have a provision that requires an inclusion in income by the CFC shareholders for an increase in earnings invested by the CFC in the

[10] I.R.C. § 954(g).
[11] I.R.C. §§ 951(a)(1)(B), 956(a).

home country. Canada and Germany have decided that, if the income earned from that property invested in the home country is of a type for which deferral should not be granted, then it is sufficient to subject the income from that investment to the anti-deferral regime (note that the CFC itself may be subject to tax in the home country because the income may be sourced in the home country). France, Japan, and the United Kingdom do not even subject the income from such property to tax under their anti-deferral regime, even if the income is of a type for which deferral should not be granted, if the CFC is engaged primarily in active business.

IV. Conclusion—Anti-Deferral or CFC Regimes

Anti-deferral or CFC regimes have been enacted in each of the countries studied. Most were enacted in the two decades following the enactment of subpart F in the United States. It is possible to argue that other countries, albeit slowly, have followed the United States' lead. But no country has followed our lead, even after 37 years, nearly as far as we have gone. The United States clearly imposes the most burdensome regime. Looking at any given category of income, it is sometimes possible to point to one or two countries whose rules approach the U.S. regime, but the overall trend is overwhelmingly clear: U.S.-based multinationals with active foreign business operations suffer much greater home-country tax burdens than their foreign-based competitors.

The observation that the U.S. rules are out of step with international norms, as reflected in the consistent practices of our major trading partners, supports the conclusion that U.S.-based companies suffer a competitive disadvantage vis-a-vis their multinational competitors based in other countries. The appropriate reform is to limit the reach of subpart F in a manner that is more consistent with the international norm.

Some commentators have suggested that the competitive imbalance created by dissimilar international tax rules should be redressed not through any amelioration of the U.S. rules, but rather through a broadening of comparable foreign regimes. As a purely logical matter the point is valid—a see-saw can be balanced either by pushing down the high end or pulling up the low one. However, the suggestion is completely impractical for several reasons. For one thing, since the U.S. rules are out of step with the majority, from the standpoint of legislative logistics alone it would be far easier to achieve conforming legislation in the United States alone, rather than in more than a dozen other countries. More fundamentally, there is no particular reason to believe that numerous foreign sovereigns, having previously declined to adopt subpart F's broad taxation of active foreign businesses despite 37 years of the U.S. setting the example, will now suddenly have a change of heart and decide to follow the U.S. model. Clearly our competitor jurisdictions have studied our subpart F and chosen a somewhat less harsh balance between competitiveness and neutrality. It is unwarranted and naive to think they have made this choice without careful consideration or solely in an effort to maintain a competitive advantage for "their" multinationals.

Further, recent OECD activities relating to "unfair tax competition" do not increase the likelihood of foreign conformity with subpart F's treatment of active foreign businesses. It is important to recognize that those activities relate to efforts by OECD member countries to limit the availability and usage of "tax haven" countries and regimes. The failure of a country to impose any type of CFC legislation can be viewed as offering a type of tax haven opportunity, since it may permit the creation of investment structures that avoid all taxation. Thus, the OECD has recommended that countries without any CFC regime "consider" enacting them. However, in encouraging countries that have no CFC rules to enact them, the OECD has in no way endorsed an effort to promote conformity among existing CFC regimes, let alone conformity with the U.S. system.

In conclusion, the U.S. rules under subpart F are well outside the international mainstream, and should be conformed more closely to the practices of our principal trading partners. We emphasize that, contrary to the suggestions of some commentators, we advocate only that the U.S. rules be brought back to the norm so as to achieve competitive parity—not that they be loosened further in an effort to confer competitive advantage.

V. Foreign Tax Credit

As mentioned above, the NFTC foreign tax credit study is a work-in-progress. While I am unable to report definitive conclusions from the comparative law portion of that study, we are far enough along to make some general observations. First, while superficially less complex, exemption or territorial systems have the potential for significant complexity. Because, under an exemption or territorial system, for-

eign source income is exempt, sourcing rules are as important and susceptible of as much pressure as under a foreign tax credit system with a complex limitation. Similarly, because income of foreign subsidiaries is exempt under a territorial system, transfer pricing rules can come under significant pressure. Finally, most jurisdictions with exemption or territorial systems find the need to not exempt certain types of passive income. Thus, there may be a foreign tax credit system just for this type of income, as well as an anti-deferral or CFC regime.

Second, no other country studied limits averaging between high-and low-tax countries with either the severity or the complexity of the U.S. foreign tax credit basket system. Even the U.K., with a juridical per item limitation mitigates the complexity and harshness of such a rule by permitting the utilization of so-called "mixer" companies. Other credit countries, such as Japan, adopt a straight-forward overall limitation such as the United States has had in the past.

Third, no country studied appears to have anywhere near as complex an expense allocation regime, particularly with respect to interest, as the United States'. The U.S. interest allocation rules appear, based on our preliminary work, to be vastly more complex and unfair than the expense allocation rules applicable in any of the other jurisdictions.

Finally, none of the other jurisdictions studied appear to have a rule such as the U.S. overall foreign loss ("OFL") recapture rule. That rule, which causes U.S. multinationals with OFLs to recapture future foreign source income as domestic income, essentially eliminates the benefit of a foreign tax credit in industries such as telecommunications and power generation where significant capital outlays in early years of foreign operations produce significant early years losses.

In sum, our preliminary findings show that, like subpart F, the U.S. foreign tax credit regime places U.S. multinationals at a competitive disadvantage versus multinationals from the other countries studied. This is particularly true with respect to either heavily leveraged industries or those that produce significant foreign losses in the early years of operation abroad.

VI. Overall Conclusion

The U.S. subpart F and foreign tax credit regimes are both more complex and harsher than the comparable regimes in the six other countries studied. The higher administrative cost in dealing with this complexity, together with the higher domestic tax on foreign-earned income, generally places U.S. multinationals at a competitive disadvantage versus multinationals based in these other countries.

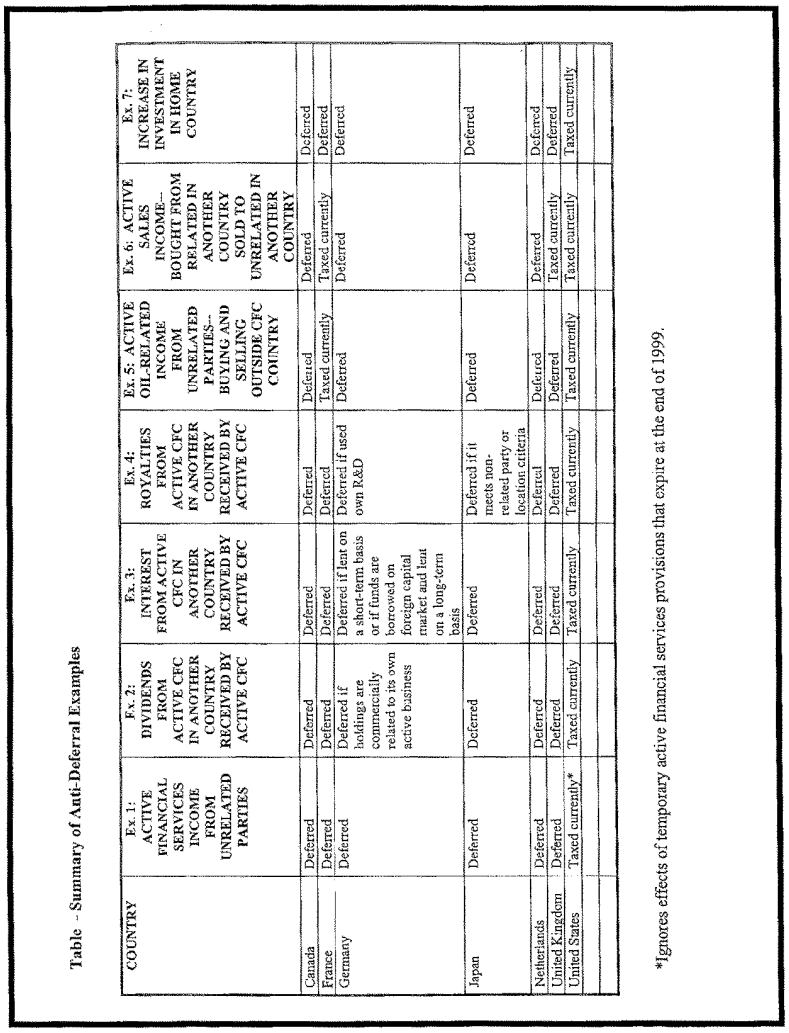

Table - Summary of Anti-Deferral Examples

COUNTRY	Ex. 1: ACTIVE FINANCIAL SERVICES INCOME FROM UNRELATED PARTIES	Ex. 2: DIVIDENDS FROM ACTIVE CFC IN ANOTHER COUNTRY RECEIVED BY ACTIVE CFC	Ex. 3: INTEREST FROM ACTIVE CFC IN ANOTHER COUNTRY RECEIVED BY ACTIVE CFC	Ex. 4: ROYALTIES FROM ACTIVE CFC IN ANOTHER COUNTRY RECEIVED BY ACTIVE CFC	Ex. 5: ACTIVE OIL-RELATED INCOME FROM UNRELATED PARTIES--BUYING AND SELLING OUTSIDE CFC COUNTRY	Ex. 6: ACTIVE SALES INCOME--BOUGHT FROM RELATED IN ANOTHER COUNTRY SOLD TO UNRELATED IN ANOTHER COUNTRY	Ex. 7: INCREASE IN INVESTMENT IN HOME COUNTRY
Canada	Deferred	Deferred	Deferred	Deferred	Deferred	Deferred	Deferred
France	Deferred	Deferred	Deferred	Deferred	Taxed currently	Taxed currently	Deferred
Germany	Deferred	Deferred if holdings are commercially related to its own active business	Deferred if lent on a short-term basis or if funds are borrowed on foreign capital market and lent on a long-term basis	Deferred if used own R&D	Deferred	Deferred	Deferred
Japan	Deferred	Deferred	Deferred	Deferred if it meets non-related party or location criteria	Deferred	Deferred	Deferred
Netherlands	Deferred	Deferred	Deferred	Deferred	Deferred	Deferred	Deferred
United Kingdom	Deferred	Deferred	Deferred	Deferred	Deferred	Taxed currently	Deferred
United States	Taxed currently*	Taxed currently	Taxed currently	Taxed currently	Taxed currently	Taxed currently	Taxed currently

*Ignores effects of temporary active financial services provisions that expire at the end of 1999.

Chairman ARCHER. Thank you, Mr. Morrison.

Our next witness is Mr. Merrill.

STATEMENT OF PETER R. MERRILL, PRINCIPAL, WASHINGTON NATIONAL TAX SERVICES, AND DIRECTOR, NATIONAL ECONOMIC CONSULTING GROUP, PRICEWATERHOUSECOOPERS, LLP; ON BEHALF OF THE NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. MERRILL. Thank you, Mr. Chairman and the Committee, for the opportunity to testify before you this morning. I am director of the National Economic Consulting Group at Pricewaterhouse-

Coopers here in Washington. I am appearing today in my capacity as a member of the drafting group of the NFTC study on Subpart F.

I would like to cover today four points. First, how has the global economy changed in the 37 years since Congress enacted the Subpart F regime? Second, is foreign investment by U.S. companies harmful to the domestic economy? Third, does the competitiveness of U.S.-headquartered companies matter for our national economic well-being? Fourth, how does U.S. tax policy affect the competitiveness of U.S. companies?

I am going to conclude my testimony today by summarizing some of the results from a new study that PricewaterhouseCoopers has just completed, which looks at the question that the chairman raised in announcing the hearing, which is are American companies the losers in recent cross-quarter mergers?

In 1962 when Subpart F was enacted, the United States was on the gold standard, exchange rates were fixed, and the United States was the world's largest capital exporter. Treasury was concerned about keeping capital in the United States, preventing it from flowing out. That was one of the main rationales for the Subpart F regime, adopted in 1962—to keep the capital at home. Today, of course, the gold standard is gone. The dollar floats. The United States is the world's largest capital importer. There is obviously hardly any reason that we need tax legislation designed to keep the capital at home.

The world has become a much more competitive place for U.S. multinationals. In 1967, U.S. multinationals had a 50 percent market share in cross-border investment. Today, they have a 25 percent share. As Mr. Murray has mentioned, in 1960, 18 of the 20 largest corporations in the world were headquartered in the United States. But, today, just eight are headquartered in the United States. Obviously, U.S. multinationals face much heightened competition compared to what they did in 1962.

Second, does U.S. foreign direct investment abroad help or hurt the U.S. economy? Obviously, some have argued that U.S. investment abroad comes at the expense of the domestic economy. Under this view, Subpart F and various rules that penalize U.S. investment abroad are necessary to protect U.S. workers. I will quote to the Committee a recent study by the OECD. It is a very good study. It is called ''Open Markets Matter.'' The OECD found that domestic firms and their employees, ''generally gain from the freedom of businesses to invest overseas. As with trade, foreign direct investment generally creates net benefits for the host and the source countries alike.''

A few other points about U.S. investment abroad. First, companies that don't invest abroad pay 5 to 15 percent lower wages than similar U.S. multinational companies.

Second, U.S. multinationals account for $407 billion of exports in 1996. That is in two-thirds of all exports a U.S. multinational is involved in the export.

Third, the OECD study that I mentioned before found that for each dollar of outward investment, there is an additional $1.70 of contribution to the trade balance, a net trade surplus of $1.70. U.S. multinationals certainly are a key component of exports.

Companies that invest abroad invest to do so for foreign markets. You heard in the earlier panel, that over 90 percent of what U.S. companies abroad sell is destined for foreign markets, not the U.S. market.

Thus, international competitiveness of U.S. multinationals matter for the domestic economy. Laura Tyson, former Chair of the Council of Economic Advisors in this administration and the former director of the National Economic Council said, in an article in the American Prospect Magazine, Yes, it is important to have headquarters of companies here. She pointed out that 70 percent of the assets and jobs of U.S. multinationals are located in the United States and 88 percent of the R&D they perform is located in the United States. U.S.-headquartered companies overwhelmingly have U.S. leadership and they source the supplies for the products they make from U.S. suppliers predominately.

Last, why do we think that it is important that we have a competitive U.S. tax policy? If the United States taxes foreign-source income of its multinationals more heavily than other countries, then ultimately the world market share of U.S. multinationals will decline. This can happen in a variety of ways. It can happen through cross-border mergers. It can happen because U.S. individuals invest in foreign mutual funds. The portfolio capital that moves to foreign-headquartered companies avoids the U.S. corporate tax rules.

I would like to in the last minute call your attention to a recent PricewaterhouseCoopers' study. We just released this today. It is a summary of large U.S. cross-border mergers and acquisitions for 1998. We looked at all of the mergers and acquisitions that were completed in 1998 involving transactions of over $500 million. What we found—it is in the study—is very striking.

We found that a net of $127 billion of U.S. assets moved from U.S.-headquartered companies to foreign-headquartered companies in 1998, that is, $127 billion moved out of U.S.-headquartered companies. Future foreign investment by these companies will generate income that will not ever be taxed by the United States. Out to be, out of 51 transactions, 34 were acquisitions of U.S. companies by foreigners, only 17 were acquisitions of foreign companies by U.S. companies. Of the $175 billion of deals, there were $151 billion where foreigners acquired U.S. companies. Only $24 billion were U.S. acquired foreign companies. So you can see that clearly there is a net movement of $127 billion of U.S. assets out of U.S.-headquartered companies.

I will conclude my testimony there and take questions.

[The prepared statement follows:]

Statement of Peter R. Merrill, Principal, Washington, National Tax Services, and Director, National Economic Consulting Group, PricewaterhouseCoopers LLP; on behalf of the National Foreign Trade Council, Inc.

I. INTRODUCTION

I am Peter Merrill, a principal in the Washington National Tax Services office of PricewaterhouseCoopers LLP, and director of the National Economic Consulting group. I am testifying today as a member of the drafting group of a recent National Foreign Trade Council report on International Tax Policy for the 21st Century: A

Reconsideration of Subpart F.[1] This report is a comprehensive legal and economic review of the U.S. anti-deferral rules that have applied to U.S. multinational companies since they were enacted by Congress in 1962.

This testimony[2] briefly addresses four key economic issues that are discussed more fully in the NFTC report:

1. How has the global economy changed during the 37 years since subpart F was enacted?
2. Is foreign investment by U.S. companies harmful to the domestic economy?
3. Does the competitiveness of U.S.-headquartered companies matter for U.S. well being?
4. How does U.S. tax policy affect the competitiveness of U.S. multinational companies?

II. Global Economic Change Since 1962

In 1962, the Kennedy Administration proposed to subject the earnings of U.S. controlled foreign corporations to current U.S. taxation. At that time, the dollar was tied to the gold standard, exchange rates were fixed, and the United States was the world's largest capital exporter. These capital exports drained Treasury's gold reserves, and made it more difficult for the Administration to stimulate the economy. Thus the proposed repeal of deferral was intended by Treasury Secretary Douglas Dillon to serve as a form of capital control, reducing the outflow of U.S. investment abroad.

The compromise adopted by Congress, in response to the Kennedy Administration's proposal, was shaped by the global economic environment of the early 1960s—a world economy that has changed almost beyond recognition as the 20th century draws to a close. The gold standard was abandoned during the Nixon Administration, and the exchange rate of the dollar is no longer fixed. The United States is now the world's largest importer of capital, with net capital outflows of over $200 billion per year.

National economies are becoming increasingly integrated. Globalization is being fueled both by technological change of almost unimaginable rapidity, and a worldwide reduction in tariff and regulatory barriers to the free flow of goods and capital.

Foreign Direct Investment

In the 1960s, the United States completely dominated the global economy, accounting for over 50 percent of worldwide cross-border direct investment, and 40 percent of worldwide Gross Domestic Product (GDP). In 1960, of the world's 20 largest corporations (ranked by sales), 18 were headquartered in the United States (see Table 1).

Three decades later, the United States confronts far greater competition in global markets. As of the mid-1990s, the U.S. economy accounted for about 25 percent of the world's foreign direct investment and GDP, and just 8 of the world's 20 largest corporations were headquartered in the United States. The 21,000 foreign affiliates of U.S. multinationals now compete with about 260,000 foreign affiliates of multinationals headquartered in other nations.[3] The declining dominance of U.S.-headquartered multinationals is dramatically illustrated by the recent acquisitions of Amoco by British Petroleum, Chrysler by Daimler-Benz, AirTouch by Vodafone, Bankers Trust by Deutsche Bank, and Transamerica by AEGON. These mergers have the effect of converting U.S. multinationals to foreign-headquartered companies.

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[1] National Foreign Trade Council, Inc. *International Tax Policy for the 21st Century: A Reconsideration of Subpart F*, March 25, 1999, Washington, D.C.

[2] This statement draws heavily on Chapter 5 and 6 and of the NFTC report.

[3] UNCTAD, *World Investment Report*, 1997.

Bankers Trust by Deutsche Bank, and Transamerica by AEGON. These mergers have the effect of converting U.S. multinationals to foreign-headquartered companies.

Table 1.—The United States and the World Economy: 1960s and 1990s

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 U.S.	126	752
Private portfolio investment in securities:		
U.S. investment abroad	62	1,446
Foreign investment in the U.S.	90	2,240
U.S. Corporate Profits[4]	**1960-69**	**1990-97**
Share from foreign sources	7.5%	17.7%
Rate of return on assets (earnings before interest and taxes)[9]	**1985**	**1995**
Foreign subsidiaries minus domestic corporations	5.1%	2.2%
Gross Domestic Product (GDP)[5]	**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%
Exports[6]	**1960**	**1996**
U.S. share of world total	16.6%	11.9%
Direct Investment Stock[7]	**1967**	**1996**
U.S. share of world outward direct investment stock	50.4%	25.0%
World's 20 Largest Corporations (ranked by sales)[8]	**1960**	**1996**
Number of U.S.-headquartered corporations	18	8

[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.

Ironically, despite the intensified competition in world markets, the U.S. economy is far more dependent on foreign direct investment than ever before. In the 1960s, foreign operations averaged just 7.5 percent of U.S. corporate net income; by contrast, over the 1990–97 period, foreign earnings represented 17.7 percent of all U.S. corporate net income. A recent study of the Standard and Poors' 500 corporations (the 500 largest publicly-traded U.S. corporations) finds that sales by foreign subsidiaries have increased from 25 percent of worldwide sales in 1985 to 34 percent in 1997.[4]

[4]IBES International based on Disclosure data as reported in the *Wall Street Journal,* "U.S. Firms Global Progress is Two-Edged," August 17, 1998.

The U.S. Market

In 1962, U.S. companies focused manufacturing and marketing strategies in the United States, which at the time was the largest consumer market in the world. U.S. companies generally could achieve economies of scale and rapid growth selling exclusively into the domestic market. In the early 1960's, foreign competition in U.S. markets was inconsequential.

The picture is now completely changed. First, 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 six (from $126 billion to $752 billion in 1997), and $20 of every $100 of direct cross-border investment flows into the United States. Foreign companies own approximately 14 percent of all U.S. non-bank corporate assets, and over 27 percent of the U.S. chemical industry.[5] Moreover, imports have tripled as a share of GDP from an average of 3.2 percent in the 1960s to an average of over 9.6 percent over the 1990–97 period (see Table 5–1).

Second, foreign markets frequently offer greater growth opportunities than the domestic market. For example, from 1986 to 1997, foreign sales of S&P 500 companies grew 10 percent a year, compared to domestic sales growth of just 3 percent annually.[6]

From the perspective of the 1960s, there was little apparent reason for U.S. companies to direct resources to penetrating foreign markets. U.S. companies frequently could achieve growth and profit levels that were the envy of their competitors with minimal foreign operations. By contrast, in today's economy, competitive success frequently requires U.S. companies to execute global marketing and manufacturing strategies.

International Trade

Over the last three decades, the U.S. share of the world's export market has declined. In 1960, one of every six dollars of world exports originated from the United States. By 1996, the United States supplied only one of every nine dollars of world export sales. Despite a 30-percent loss in world export market share, the U.S. economy depends on exports to a much greater degree. During the 1960s, only 3.2 percent of national income was attributable to exports, compared to 7.5 percent over the 1990–97 period.

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. U.S. Commerce Department data show that in 1996 U.S. multinational companies were involved in 65 percent of all U.S. merchandise export sales.[7] The importance of foreign operations also is indicated by the fact that U.S. industries with a high percentage of investment abroad are the same industries that export a large percentage of domestic production.[8]

Foreign Portfolio Investment

In 1962, policymakers would scarcely have taken note of cross-border flows of portfolio investment. As recently as 1980, U.S. portfolio investment in foreign private sector securities amounted to only $62 billion—85 percent less than U.S. direct investment abroad. By 1997, U.S. portfolio investment abroad had increased 2,230 percent to over $1.4 trillion—40 percent more than U.S. direct investment abroad. Similarly, foreign portfolio investment in U.S. private securities increased from $90 billion in 1980 to over $2.2 trillion in 1997 (see Table 1).

Institutional changes have greatly facilitated foreign portfolio investments, including the growth in mutual funds that invest in foreign securities and the listing of foreign corporations on U.S. exchanges. According to the New York Stock Exchange, the trading volume in shares of foreign firms totaled $485 billion in 1997, or over eight percent of total NYSE trading volume.[9] Market capitalization of foreign firms listed on the NYSE topped $3 trillion in 1998.[10]

The Administration's 1962 proposal to terminate deferral for U.S. CFCs was motivated in large part by a desire to ensure that foreign direct investment not flow offshore for tax reasons. At the time, U.S. direct investment abroad exceeded private portfolio investment by a factor of 6.5 to 1; thus, it is not surprising that the Admin-

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[5] PricewaterhouseCoopers calculations based on Department of Commerce and IRS data.
[6] Wall Street Journal, Op. cit.
[7] U.S. Bureau of Economic Analysis, *Survey of Current Business*, September 1998.
[8] Robert E. Lipsey, "Outward Direct Investment and the U.S. Economy," in M. Feldstein, J. Hines, Jr., and G. Hubbard (eds.), *The Effects of Taxation on Multinational Corporations, University of Chicago Press, 1995.*
[9] Trading in foreign companies is primarily, but not solely, through depository receipts.
[10] NYSE, *Quick Reference Sheet,* and discussion with NYSE Research, September 1998.

istration focused much of its attention on the taxation of direct investment abroad in 1962.

In the current economic environment, U.S. portfolio investors (e.g., individuals, mutual funds, pension funds, insurance companies, etc.) increasingly allocate capital to foreign-based multinational companies whose foreign investments are not subject U.S. corporate income tax. Under these circumstances, the impact of U.S. multinational corporation tax rules on the global allocation of capital is greatly attenuated.[11]

Market Integration

The explosive pace of economic integration has been aided by governments that have liberalized trade and investment climates. An alphabet soup of regional trade agreements has complemented the original multilateral agreement, GATT. In addition to the formation of the European Union—the world's largest common market—free trade agreements are creating increasingly integrated multinational markets. Examples include the European Economic Area (European Union plus remaining members of the European Free Trade Area), NAFTA (North America), ASEAN (Southeast Asia), ANZCERTA (Australia and New Zealand), and MERCOSUR (Latin America). Almost half of the 153 regional trade agreements notified to the GATT or the WTO have been set up since 1990.[12] Complementing these trade agreements are hundreds of bilateral investment treaties (BITs) which reduce barriers to foreign direct investment flows. UNCTAD reports that there has been a three-fold increase in BITs in the five years to 1997.[13]

A consequence of market integration is that U.S. companies and their foreign competitors increasingly do not view their business as occurring in separate country markets, but rather in regional markets where national boundaries often have little economic significance. In this economic environment, the distinctions in subpart F, between economic activities conducted within and outside a foreign subsidiary's country of incorporation, have in many cases become artificial. When there is a high degree of economic integration between national markets, tax rules that treat these markets separately are as arbitrary as distinctions between a company's transactions with customers in different cities.

Conclusions

In the decades since the enactment of subpart F in 1962, the global economy has grown more rapidly than the U.S. economy. Concomitantly, U.S. companies have confronted both the rise of powerful foreign competitors and the growth of market opportunities abroad. By almost every measure—income, exports, or cross-border investment—the United States today represents a smaller share of the global market. At the same time, U.S. companies have increasingly focused on foreign markets for continued growth and prosperity. Over the last three decades, sales and income from foreign subsidiaries have increased much more rapidly than from domestic operations. To compete successfully both at home and abroad, U.S. companies have adopted global sourcing and distribution channels, as have their competitors.

These developments have a number of potential implications for tax policy. U.S. tax rules that are out of step with those of other major industrial counties are now more likely to hamper the competitiveness of U.S. multinationals in today's global economy than was the case in the 1960s.

The growing economic integration among nations—especially the formation of common markets and free trade areas—raises questions about the appropriateness of U.S. tax rules that treat foreign transactions differently if they cross national borders than if they occur within the same country.

The eclipsing of foreign direct investment by portfolio investment calls into question the ability of tax policy focussed on foreign direct investment to influence the global allocation of capital.

The abandonment of the gold standard has eliminated balance of payment considerations as a rationale for using tax policy to discourage U.S. investment abroad. Indeed, as the world's largest debtor nation, tax policies that discourage U.S. investment abroad are obsolete.

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[11] See Section E of Chapter 6 of the NFTC report for a discussion of this issue.
[12] *The Economist,* October 3, 1998, p. 19.
[13] UNCTAD, *World Investment Report,* 1997.

III. Is Foreign Investment By U.S. Companies Harmful to the Domestic Economy?

While acknowledging the anti-competitive implications of subpart F, opponents of deferral frequently argue that U.S. direct investment abroad comes at the expense of the U.S. economy. From this perspective, subpart F is viewed as protecting the U.S. economy in general—and U.S. workers specifically—from the flow of U.S. investment abroad. Opponents of deferral often oppose free trade agreements because the free flow of goods across national borders, much like the free flow of investment, is perceived as jeopardizing domestic jobs.

The data and economic studies, summarized below, however, support the view that outward investment is beneficial rather than harmful to the home country economy. As noted in a recent report of the Organization for Economic Cooperation and Development (OECD), critics of outward direct investment sometimes fail to look at the broader economic ramifications:

> The effects of direct investment outflows on the source country, particularly on employment are sometimes still regarded with some disquiet. Most concerns regarding the effects of FDI [foreign direct investment] outflows may arise because investment is viewed statically and without due regard to the spillover effects it generates at home and abroad. In fact, however, domestic firms and their employees generally gain from the freedom of businesses to invest overseas. As with trade, FDI generally creates net benefits for host and source countries alike.[14]

Background: Why Do U.S. Corporations Invest Abroad?

Contrary to the image some commentators have that U.S. corporations set up foreign affiliates as substitutes for U.S. operations, the latest UN report on foreign investment finds that "accessing markets will remain the principal motive for investing abroad.[15] Tariff and non-tariff barriers, transportation costs, local content requirements, location of natural resources, location of customer facilities, and other factors frequently make investing abroad the only feasible option for successfully penetrating foreign markets. Moreover, a local presence generally is required for services industries such as finance, retail, legal, and accounting.[16] In addition, multinational customers frequently prefer to deal with suppliers and service providers who have operations in all of the jurisdictions in which they operate. Foreign investment also allows U.S. parent companies to diversify risks; through diversification, a downturn in the home market may be offset by an upturn abroad.

High-income countries provide the most lucrative opportunities for U.S. multinationals. As a result, government data show that the bulk of U.S. direct investment abroad goes to high-wage, high-income countries. In 1996, 81 percent of assets and 68 percent of employment were in high-income developed countries rather than low-wage developing nations.[17] This pattern of investment is consistent with the view that the presence of rich consumer markets is a much more important explanation for U.S. investment abroad than low wages. Low wages typically indicate low productivity, so there is little if any advantage to be obtained from manufacturing in low-wage jurisdictions, particularly where the economic infrastructure (e.g., transportation, communication, electricity and water services) and legal infrastructure are not adequately developed.

Further evidence for the hypothesis that U.S. direct investment abroad is attracted by consumer demand rather than low-cost labor supply is the fact that less than 10 percent of U.S.-controlled foreign corporation sales were exported to the United States. If U.S. investment abroad were motivated by the desire to substitute cheap foreign labor, rather than to serve foreign markets, one would expect a significant amount of U.S. multinational production abroad to be shipped back to the United States.[18] In fact, over half of all foreign affiliates of U.S. companies are en-

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[14] OECD, *Open Markets Matter: The Benefits of Trade and Investment Liberalization,* 1998, p. 49.

[15] UNCTAD, *World Investment Report,* 1997, p. xix.

[16] See, OECD, *Open Markets Matter: The Benefits of Trade and Investment Liberalization,* 1998, p. 50.

[17] Developed countries are defined here as Europe, Canada, Australia, New Zealand, South Africa, Japan, Singapore, and Hong Kong. See, U.S. Department of Commerce, U.S. Direct Investment Abroad (September 1998).

[18] See, Peter Merrill and Carol Dunahoo, "Runaway Plant Legislation: Rhetoric and Reality," Tax Notes (July 8, 1996) pp. 221–226 and Tax Notes International (July 15, 1996) pp. 169–174.

gaged in services and trade, activities that are closely tied to the customers' location.[19]

If U.S. investment abroad were attracted by low wages, as critics contend, foreign employment and production of U.S. multinationals abroad would be rising in comparison to domestic employment and production. In fact, the output and employment of U.S.-controlled foreign corporations has declined as a share of domestic output and employment since the CFC data were first published by the Bureau of Economic Analysis in 1982.[20]

The centrality of the sales expansion function of foreign affiliates suggests that the operations of U.S. parent firms and their foreign affiliates are mutually reinforcing rather than substitutes. Direct investment abroad frequently leads to additional exports of machinery and other inputs into the manufacturing process as well as additional demand at home for headquarters services such as research, engineering, finance, etc. The parent companies of U.S. multinationals purchase over 90 percent of their inputs from U.S.-based suppliers.[21]

Exports

U.S. multinational corporations play a crucial role in U.S. foreign trade. As affiliates establish production and distribution facilities abroad, export data indicate that they source a large quantity of inputs from the United States. U.S. multinationals were responsible for $407 billion of merchandise exports in 1996 representing almost two-thirds of all U.S. merchandise exports.

Academic studies support the hypothesis that U.S. investment abroad promotes U.S. exports. For example, Prof. Robert Lipsey finds a strong positive relationship between manufacturing activity of foreign affiliates of U.S. corporations and the level of exports from the U.S. parent company.[22] Similarly, a recent OECD study of 14 countries found that "each dollar of outward FDI [foreign direct investment] is associated with $2 of additional exports and with a bilateral trade surplus of $1.70.[23] These studies support the conclusion that if U.S. investment abroad were curtailed, U.S. exports would suffer.

Headquarters services

In addition to their role in increasing demand for U.S. exports, foreign affiliates of U.S. corporations also increase the demand for U.S. headquarters services such as management, research and development, technical expertise, finance, and advertising. These support activities expand as U.S. affiliates compete successfully abroad. For example, in 1996, nonbank U.S. multinationals performed 88 percent of their research and development in the United States, even though one-third of their sales were abroad./24/

Headquarters functions, such as R&D, finance, and management, are the types of activities that are prospering in the information-oriented economy. As such, some economists have argued that U.S. tax policy should seek to make the United States an attractive location for multinational corporations to establish their headquarters.[25] Unfortunately, because of subpart F and other aspects of U.S. international tax rules, the United States is one of the least attractive jurisdictions—from a tax perspective—for a multinational corporation's headquarters.[26]

U.S. Investment Abroad and U.S. Employment

Rather than draining jobs and production from the United States, the economic evidence points to the opposite conclusion—U.S. investment abroad increases activity at home. The complementary relationship between the foreign and domestic op-

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[19] Mathew Slaughter, Global Investment, American Returns, Emergency Committee for American Trade, 1998.

[20] The gross product of controlled-foreign corporations (CFCs) has fallen from 6.9 percent of U.S. GDP in 1982 to 6.6 percent in 1996. Similarly, CFC employment as fallen from 5.0 percent of U.S. domestic employment in 1982 to 4.9 percent in 1986.

[21] Mathew Slaughter. Global Investments, American Returns Emergency Committee for American Trade, 1998.

[22] Robert E. Lipsey, "Outward Direct Investment and the U.S. Economy," in M. Feldstein, J. Hines, Jr., and G. Hubbard (eds.), The Effects of Taxation on Multinational Corporations, University of Chicago Press, 1995.

[23] See, OECD, Open Markets Matter: The Benefits of Trade and Investment Liberalization, 1998, p. 50.

[24] U.S. Department of Commerce, *Survey of Current Busines*, (September 1998).

[25] See Gary Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform*, Institute for International Economics, 1992.

[26] See, Price Waterhouse LLP, *Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues*, Financial Executives Research Foundation, 1996.

erations of U.S. multinational corporations means that U.S. workers need not be harmed by U.S. investment abroad.[27] Profs. David Riker and National Economic Council Deputy Director Lael Brainard find that the labor demand of U.S. multinationals at home and abroad are linked, with an increase in one supporting an increase in the other:

Labor demand of U.S. multinationals is linked internationally at the firm level, presumably through trade in intermediate and final goods, and this link results in complementarity rather than competition between employers in industrialized and developing countries.[28]

The foreign operations of U.S. companies also are associated with higher wages of U.S. workers. U.S. companies that invest overseas, on average, pay higher domestic wages than do purely domestic companies in the same industries. Profs. Mark Doms and Bradford Jensen find that U.S. parent companies pay higher wages to their entire workforce, and that the wage premium in percentage terms is greater for lower paid production workers than for higher paid non-production workers.[29] Prof. Slaughter interprets this as evidence that U.S. parent companies promote a more equal distribution of income by paying higher wage premia to traditionally lower paid workers.[30]

Investment abroad by U.S. multinationals not only is essential to facilitating the distribution and servicing of U.S. exports, but failure of U.S. multinationals to invest abroad would create an opportunity for foreign-headquartered competitors to increase their investment in and exports to foreign markets.

Returns to U.S. Investors

U.S. shareholders in U.S. multinationals directly realize the benefits of the high profits and risk diversification offered by international operations. The pre-tax return on assets earned by U.S.-controlled foreign corporations was almost 30 percent higher than the return earned on domestic corporate investment in 1995.[31] These foreign profits totaled $150 billion, and accounted for about 18 percent of all U.S. corporate profits in 1997.[32]

The profits earned abroad by U.S. multinationals are part of national income (GNP) and are reflected in the share valuations. Moreover, much of the income earned abroad by foreign subsidiaries is distributed back to the United States. According to the most recent available IRS data, in 1994, distributions from the largest U.S.-controlled foreign corporations totaled $50 billion, amounting to 67 percent of their after-tax earnings and profits.

Academic research has found a large premium in the returns from foreign investment as compared to domestic investment. Prof. Martin Feldstein concludes that an additional dollar of foreign direct investment by U.S. corporations, in present value, leads to 70 percent more interest and dividend receipts and U.S. tax payments than an additional dollar of domestic investment.[33]

Conclusion

Fears that U.S. investment abroad comes at the expense of output, income, and employment at home are not supported by data or economic research. Rather, the evidence strongly confirms that market access, rather than cheap labor, primarily motivates foreign direct investment. The overwhelming majority of foreign direct investment is in high-wage countries, and very little of the foreign output of U.S. multinationals is shipped back to the United States. Numerous studies have found that foreign investment not only produces higher returns to U.S. investors but also is complementary with economic activity in the United States—leading to increased exports and high-paid research, engineering, and other headquarters jobs in the United States. There is no evidence that U.S. investment abroad has reduced em-

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[27] See, OECD, *Open Markets Matter: The Benefits of Trade and Investment Liberalization*, 1998, pp. 73–76.

[28] David Riker and Lael Brainard, "U.S. Multinationals and competition from Low Wage Countries," NBER Working Paper No. 5959, March 1997.

[29] Mark Doms and Bradford Jensen, "Comparing Wages, Skills, and Productivity Between Domestic and Foreign Owned Manufacturing Establishments in the United States," mimeo., October 1996.

[30] Matthew J. Slaughter, 'Production Transfer Within Multinational Enterprises and American Wages," mimeo., March 1998.

[31] Earnings (excluding capital gains and special charges) before interest and taxes as a percent of assets, as calculated by the U.S. Dept. of Commerce.

[32] U.S. Dept. of Commerce, *Survey of Current Business*, (August 1998).

[33] Martin Feldstein, "Tax Rules and the Effect of Foreign Direct Investment in U.S. National Income," in *Taxing Multinational Corporations*, eds. Martin Feldstein, James Hines, and Glenn Hubbard, 1995.

ployment in the United States; indeed, the data show that companies with investment outside the United States pay better wages than purely domestic companies in the same industries.[34]

Restricting foreign investment in an attempt to protect domestic employment ultimately is a self-defeating policy. Foreign companies will seize these investment opportunities and increase market share at the expense of U.S. multinationals' employment at home and abroad.

Like international trade in goods and services, foreign direct investment benefits both home and host countries; thus, it is in the mutual interest of home and host countries to reduce barriers to the free flow of direct investment. In view of the recent downturn that has struck a number of emerging market economies, it is important to distinguish foreign direct investment from international portfolio investment. Portfolio investment, such as investment in short-term government and private debt obligations, can easily be withdrawn at the first hint of an economic reversal. By contrast, foreign direct investment, particularly in plant and equipment, is long-term in nature, and cannot easily be removed. Barriers to U.S. direct investment abroad not only harm the development of foreign countries, but also deprive the U.S. economy of the increased returns, exports, and wages associated with multinational investment.

IV. Does the Competitiveness of U.S.-Headquartered Companies Matter for U.S. Economic Well-Being?

In a provocative article, former Labor Secretary Robert Reich argues against multinational competitiveness as a goal for U.S. policy.[35] In Reich's view, where corporations happen to be headquartered is "fundamentally unimportant." Reich believes U.S. policymakers should focus primarily on domestic investments (whether by domestic or foreign companies) and less on the strength of American companies.

In response, Prof. Laura Tyson, former Chair of the Council of Economic Advisers and former Director of the National Economic Council, argues that under current conditions, the "competitiveness of the U.S. economy remains tightly linked to the competitiveness of U.S. companies." Tyson offers a number of reasons for this linkage, including:[36]

- U.S. multinationals locate over 70 percent of their assets and employment in the United States;
- U.S. multinationals invest more per employee and pay more per employee at home than abroad in both developed and developing countries;
- U.S. multinationals perform the overwhelming majority of their R&D at home;
- The leadership of U.S. multinationals is overwhelmingly American;
- Trade barriers frequently require U.S. companies to invest abroad in order to sell abroad; and
- U.S. affiliates of foreign firms rely much more heavily on foreign suppliers than on domestic companies.

Tyson believes that American interests will be advanced through multilateral reductions in trade and investment barriers, and through policies that make the U.S. an attractive production location for high-productivity, high-wage, and research-intensive activities.

V. How Does U.S. International Tax Policy Affect the Competitiveness of U.S. Multinational Companies?

If policymakers wish to attract high-end jobs to the United States, they must consider whether the U.S. income tax system makes the United States a desirable location for establishing and maintaining a corporate headquarters. If the U.S. corporate income tax is not competitive, U.S. headquartered companies can be expected to lose world market share with a commensurate loss in the U.S. share of headquarter-type jobs. While the country of incorporation is not necessarily where headquarters functions are located, there is indisputably a very high correlation between legal residence and headquarters operations.

A number of studies have found that, compared to other major industrial countries, the U.S. income tax system places a relatively high burden on cross-border

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[34] For anecdotal evidence from case studies of U.S. multinationals, *see* Mathew Slaughter, *Global Investments, American Returns,* Emergency Committee for American Trade, 1998 (Chapter V).

[35] Robert Reich, "Who is Us?" *Harvard Business Review* (January-February 1990) pp. 53–64.

[36] Laura D'Andrea Tyson, "They are not Us: Why American Ownership Still Matters," *The American Prospect,* Winter, 1991.

corporate investment.[37] The tax burden is relatively high for two main reasons: (1) the U.S. international tax regime, including subpart F, is more restrictive than that of most other countries; and (2) unlike most other major industrial countries, the United States does not relieve the double taxation of corporate dividends.

Over time, countries that place relatively high tax burdens on multinational corporations can expect to see a reduction in investment in domestic headquartered companies. This can occur through a loss in market share and profits that can be reinvested in the business. Alternatively, domestic companies may merge with foreign corporations in transactions that result in a foreign-headquartered company. Recent U.S. examples include the BP-Amoco, Daimler-Chrysler, Vodafone-AirTouch, Deutsche Bank-Bankers Trust, and AEGON-Transamerica mergers. In these examples, future investments outside the United States will most likely not be made by the U.S. merger partner, but instead by the foreign parent, permanently removing such investment from the U.S. corporate income tax net.

Foreign-headquartered companies also can grow at the expense of U.S.-headquartered companies, if U.S. investors buy shares of foreign companies on U.S. or foreign exchanges. The growth in U.S. mutual funds that invest in foreign stocks is an illustration of this trend, as are investments in foreign firms listed on U.S. stock exchanges.

While some have advocated increasing U.S. tax on the foreign earnings of U.S. multinationals as a way to protect U.S. jobs, the most likely consequence of such action will be a loss in the global market share of U.S. headquartered companies. Rather than protecting U.S. jobs, imposing a tax system on U.S. multinationals that is more burdensome than that of their foreign competitors will hamper the growth of U.S. companies, ultimately reducing U.S. exports, research and development, and high-quality American jobs.

SUMMARY OF LARGE U.S. CROSS-BORDER MERGERS AND ACQUISITIONS, 1998

Introduction

in announcing the June 30, 1999 hearing of the Committee on Ways and Means regarding the impact of U.S. tax rules on the international competitiveness of U.S. workers and businesses, Chairman Archer posed the following questions:

> "Is the U.S. tax system contribution to the de-Americanization of U.S. industry? Do our tax laws force U.S. companies to be domiciled in foreign countries? Are we making it a foregone conclusion that mergers of U.S. companies with foreign companies will always leave the resulting new company headquartered overseas?" [1]

As an initial step towards answering these questions, this report summarizes data on all large cross-border mergers and acquisitions involving U.S. companies that were completed in 1998. Based on these data, one can determine whether U.S. companies are more often the acquirer or the target (i.e., the acquired company) in large cross-border mergers and acquisitions.

Methodology

For purposes of this study, PricewaterhouseCooper LLP (PwC) reviewed all mergers and acquisitions completed during 1998 as reported by **Mergers and Acquisitions, a journal that publishes detailed information on all public transactions. From this sample, we selected all transactions that met the following criteria:**

1. The terms of the transaction were in excess of $500 million;
2. The transaction involves the acquisition of all or a remaining interest in the target company;
3. The transaction crosses country borders (i.e., acquirer and target are headquartered in different in different countries); and
4. A U.S.—headquartered company is the acquirer or the target.

Information regarding the selected transactions is summarized in Tables 1–4, including the name and country of incorporation of the acquirer and the target, the target's business, and the terms, type, and completion due of the transaction.

Results

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[37] For an international comparison U.S. multinational tax competitiveness, see: Price Waterhouse LLP, *Taxation of U.S. corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues*, Financial Executives Research Foundation, 1996 (Chapter 10).

[1] U.S. House of Representatives, Committee on Ways and Means, press release no. FC–12, June 15, 1999.

In 1998, there were a total of 51 cross-border mergers and acquisitions involving U.S companies with terms in excess of $500 million. The total dollar value of these transactions exceeded $175 billion.

Foreign acquisitions of U.S. companies far exceeded U.S. acquisitions of foreign companies, both in terms of the number of transactions and the dollar value of these transactions. For cross-border mergers and acquisitions exceeding $500 million in 1998:

- Foreign companies made 34 acquisitions of U.S. companies, while U.S. companies made 17 acquisitions of foreign companies. Thus, the number of transactions that had the effect of moving assets from U.S.-to foreign-headquartered firms exceeded transactions moving assets in the opposite direction by $127 billion, or 529 percent in dollar terms.
- Foreign acquisitions of U.S. companies totaled $151 billion, while U.S. acquisitions of foreign companies totaled $24 billion. Thus, the number of transactions that had the effect of moving assets from U.S.-to foreign-foreign-headquartered firms exceeded transactions moving assets in the opposite direction by $127 billion, or 529 percent in dollar terms.
- Foreign acquisitions of U.S. companies were dominated, in dollar terms, by two mega-mergers—the acquisition of Amoco Corp. by British Petroleum Co. PLC and the acquisition of Chrysler Corp. by Daimler-Benz AG. These two deals together represent the sale of U.S. companies valued at $89 billion to foreign acquirers. However, even excluding these two mega-mergers, transactions which had the effect of moving assets from U.S.-to foreign-headquartered firms exceeded transactions moving assets in the opposite direction by $38 billion, or 58 percent in dollar terms.
- Transactions involving acquisitions of financial services companies accounted for 15 of the 51 ross-border deals, or 29 percent. Foreign acquisions of U.S. financial services companies (12 transactions totaling $11.3 billion) exceeded U.S. acquisitions of foreign financial services companies (3 transactions totaling $3.6 billion) by 300 percent in number, or by 214 percent in dollar terms. It should be noted that some of the other U.s. target companies have large financial services subsidiaries (e.g., Chrysler Corp.), although these are not included in the statistics on financial service mergers and acquisitions.

Conclusions

the structuring of cross-border acquisitions reflects a variety of business reasons including domestic and foreign tax considerations. The role of tax considerations in recent across-border mergers and acquisitions is beyond the scope of this study.

To the extent that U.S. multinational companies are subject to more burdensome international tax rules than their foreign-headquarter multinationals. In particular, one would expect to see this result for target companies in industries where the disparity between U.S. and foreign tax rules is large, such as financial services. The data in this study show that, as a result of cross-border mergers and acquisitions, assets are, on balance moving from U.S.-to foreign-headquartered companies, and this trend is pronounced in the financial services industry (measured by the number of transactions).

While the recent cross-border merger and acquisition data are consistent with the hypothesis that relatively burdensome U.S. tax rules are influencing the movement of assets to foreign-headquartered companies, they cannot be taken as proof of this hypothesis. More research will be necessary to measure the role, if any, of tax considerations.

Table 1 - U.S. Cross-Border Mergers and Acquisitions, Transactions over $500 million, 1998

Foreign Acquisitions of U.S. Companies

Acquirer		Target			Terms (millions of dollars)		
Company	Country	Company	Country	Business	Amount	Type	Date
British Petroleum Co PLC	UK	Amoco Corp	US	Oil & Gas	$48,200	Acquisition	12/31/98
Daimler-Benz AG	Germany	Chrsyler Corp	US	Automobiles	$40,500	Acquisition	11/12/98
Northern Telecom Ltd	Canada	Bay Networks Inc	US	Data Networking	$9,270	Acquisition	8/31/98
Teleglobe Inc	Canada	Excel Communications Inc	US	Tel Voice & Data Comm	$6,400	Acquisition	11/10/98
Alcatel Alsthom CGE	France	DSC Communications Corp	US	Digital Telecomm.	$4,690	Acquisition	9/8/98
Pearson PLC	UK	Simon & Shuster (publishing div)	US	Publish Educ. Materials	$4,600	Divestiture	11/27/98
Schlumberger Ltd	France	Camco International Inc	US	Oil & Gas Field Eqpt	$3,380	Acquisition	8/31/98
Canadian National Rlwy	Canada	Illinois Central Corp	US	Railroad	$2,930	Acquisition	6/5/98
Koninklijke Ahold NV	Netherlands	Giant Food Inc	US	Supermarkets	$2,630	Acquisition	10/28/98
Royal Dutch/Shell Group	UK/Nethlnds	Tejas Gas Corp	US	Natural Gas Pipeline	$2,170	Acquisition	1/12/98
Verenigd Bezit VNU	Netherlands	ITT Corp (ITT World Dir)	US	Intl Tel Directories	$2,100	Divestiture	2/19/98
Swiss Reinsurance Co	Switzerland	Life Re Corp	US	Reinsurance	$1,800	Acquisition	11/30/98
Cable & Wireless PLC	UK	MCI Corp (Wholsale Internet bus.)	US	Telecomm Services	$1,750	Divestiture	9/14/98
Valeo SA	France	ITT Ind Inc (Automotive Electrical)	US	Auto Elec. Systems	$1,700	Divestiture	9/28/98
Newcourt Credit Group	Canada	AT&T Capital Corp	US	Eqpt Leasing & Financing	$1,600	Acquisition	1/12/98
Siemens AG	Germany	CBS Corp (Westinghouse Power)	US	Power Generators	$1,530	Divestiture	8/20/98
Ispat International	Netherlands	Inland Steel Ind (Inland Steel Co)	US	Carbon Steel	$1,430	Divestiture	7/17/98
Reed Elsevier PLC	UK	Times Mirror (Matthew Bender)	US	Legal Information	$1,380	Divestiture	7/31/98
Tommy Hilfiger Holdings	Hong Kong	Pepe Jeans USA Inc	US	Men's Clothing	$1,300	Acquisition	6/10/98
Amvescap PLC	UK	Chancellor LGT Asset Mgmt	US	Securites Brokerage	$1,300	Acquisition	6/1/98
National Australia Bank	Australia	Homeside Inc	US	Res. Mortgage Banking	$1,230	Acquisition	2/10/98
Bayer AG	Germany	Chiron Corp (Chiron Diagnostics)	US	Medical Diag. Apparatus	$1,100	Divestiture	11/30/98
Randstad Holding NV	Netherlands	AccuStaff Inc (Strategix Soltns Inc)	US	Staffing Services	$850	Divestiture	10/1/98
Elan Corp	Ireland	Neurex Corp	US	Biopharmaceutical	$825	Acquisition	8/14/98
Partner Re Holdings Ltd	Bermuda	Winterthur Reinsurance Corp	US	Insurance	$780	Acquisition	12/23/98
Guardian Royal Exchange	UK	ING Groep NV (Nethlnds Ins Co)	US	Insurance	$775	Divestiture	9/1/98
Royal Bank of Scotland	UK	Citizens Financial Group, Inc	US	Savings Bank	$753	Acquisition	9/4/98
Gerling Konzern Vers. Bet.	Germany	Constitution Re Corp	US	Insurance	$700	Acquisition	10/27/98
Granaria Holdings	Netherlands	Eagle-Pitcher Industries	US	Auto & Truck Parts	$700	Acquisition	2/25/98
Fairfax Financial Holdings	Canada	Xerox Corp (Crum & Foster Hdgs)	US	Insurance	$680	Divestiture	8/13/98
Fortis BV	Netherlands	John Alden Financial Corp	US	Life & Health Insurance	$583	Acquisition	8/31/98
Robeco NV	Netherlands	Weiss Peck & Greer	US	Investment Firm	$575	Acquisition	5/7/98
Societe Generale SA	France	Cowen & Co	US	Merchant Banking	$540	Acquisition	6/30/98
Micro Focus Group PLC	UK	Intersolv Inc	US	Application Dev. Software	$532	Acquisition	9/24/98

Source: *Mergers & Acquisitions*; calculations by PricewaterhouseCoopers, LLP

Table 2 - U.S. Cross-Border Mergers and Acquisitions, Transactions over $500 million, 1998

U.S. Acquisitions of Foreign Companies

Acquirer		Target			Terms (millions of dollars)		
Company	Country	Company	Country	Business	Amount	Type	Date
Du Pont Co	US	Imperial Chemical Ind	UK	Industrial Chemicals	$3,000	Divestiture	2/2/98
Bowater Inc	US	Avenor Inc	Canada	Pulp & Paper Products	$2,330	Acquisition	7/24/98
Enron Corp	US	Wessex Water PLC	UK	Water Utility	$2,230	Acquisition	9/21/98
Marsh & McLennan Cos	US	Sedgwick Group PLC	UK	Insurance Agency	$2,100	Acquisition	11/3/98
Boston Scientific Corp	US	Pfizer Inc (Schneider Worldwide)	Switzerland	Catheters	$2,100	Divestiture	9/10/98
Bacardi Corp	US	Diageo PLC (Dewar's & Bombay)	UK	Scotch, Whiskey, & Gin	$1,940	Divestiture	6/16/98
Du Pont Co	US	Hoechst AG (Herberta)	Germany	Auto Paints	$1,890	Divestiture	10/29/98
Caterpillar Inc	US	LucasVarity (Perkins Engines)	UK	Diesel Engines	$1,330	Divestiture	2/27/98
American Elec. Power Co	US	Entergy Corp (Citipower Ltd)	Australia	Electric Utility	$1,100	Divestiture	12/31/98
NTL Inc	US	Comcast UK Cable Partners Ltd	Bermuda	Cable Television Services	$998	Acquisition	10/29/98
NTL Inc	US	ComTel Ltd; Telecential Comm	UK	Cable Television Services	$908	Divestiture	9/22/98
Devon Energy Corp	US	Northstar Energy Corp	Canada	Oil & Gas	$896	Acquisition	12/11/98
Blackstone Group	US	Savoy Hotel PLC	UK	Hotels	$883	Acquisition	5/26/98
Merrill Lynch Inc	US	Midland Walwyn Inc	Canada	Security Brokerage	$806	Acquisition	8/27/98
Goldman Sachs & Co	US	Financial Sector Rest. Authority	Thailand	Loan Services	$645	Divestiture	12/18/98
Weyerhaeuser Co	US	Bowater Inc (Dryden mill)	Canada	Paper and Pulp	$520	Divestiture	9/30/98
Autodesk Inc	US	Discreet Logic Inc	Canada	Image Process. Software	$505	Acquisition	8/21/98

Source: *Mergers & Acquisitions*; calculations by PricewaterhouseCoopers, LLP

Table 3 - Total U.S. Cross-Border Mergers and Acquisitions, Transactions over $500 million, 1998

[dollar amounts in millions]

Item	Firms	Transactions Total
Foreign Acquistions of U.S. Companies	34	$151,283
U.S. Acquisitions of Foreign Companies	17	$24,181

Source: *Mergers & Acquisitions*; calculations by PricewaterhouseCoopers, LLP

Table 4 - Subtotal for Mergers and Acquisitions involving Financial Service Company Targets, 1998

[dollar amounts in millions]

Item	Firms	Transactions Total
Foreign Acquistions of U.S. Financial Service Companies	12	$11,316
U.S. Acquisitions of Foreign Financial Service Companies	3	$3,551

Source: *Mergers & Acquisitions*; calculations by PricewaterhouseCoopers, LLP

Chairman ARCHER. Thank you, Mr. Merrill.

Our last witness on this panel is Mr. Bouma. Welcome, you may proceed.

STATEMENT OF HERMANN B. BOUMA, INTERNATIONAL TAX ATTORNEY, H.B. BOUMA

Mr. BOUMA. Thank you. Thank you very much, Mr. Chairman. My name is Herm Bouma and I am an international tax attorney engaged in private practice in Washington, D.C. I appreciate very much the opportunity to appear before the Committee this morning, almost afternoon now. And I commend the Committee for fo-

cusing its time and energy on the international provisions of the Code.

In my testimony, I would like to take a look at the forest, rather than the trees, and focus on the basic foundations of our international tax rules. I believe those foundations are not tied into reality and that this accounts for much of the arbitrariness and complexity of the current system.

Specifically, I would like to focus on three fundamental issues: taxation of business entities in general, the taxation of U.S. versus foreign corporations, and the rules for sourcing income.

With respect to the taxation of business entities, under the current Code, business entities are divided into two basic types: corporations and partnerships. As used here, the term partnership also includes a sole proprietorship. Radically different tax rules apply to corporations and to partnerships. Certain business entities are treated as per se corporations, while other business entities are permitted to choose whether they wish to be treated as a corporation or as a partnership. There is no logical reason why per se corporations are treated as such.

Certainly, this treatment cannot be justified on the grounds that they provide limited liability to their interest holders or that they are so-called separate entities. Many business entities that are entitled to choose their classification also have these same characteristics. When it comes to the taxation of business entities, all business entities should be subject to only one layer of taxation and they should be taxed on a territorial basis.

Assuming the Code continues to classify business entities as either corporations or partnerships, the next fundamental issue I would like to address is whether there should be any difference between the taxation of U.S. corporations on the one hand and foreign corporations on the other.

Under present law, a corporation is considered a U.S. corporation, simply by being organized under the laws of the United States or some political subdivision thereof, such as Delaware. I would like to emphasize whether the company has its headquarters in the United States or does any business here is completely irrelevant to whether or not it is a U.S. corporation for purposes of the Internal Revenue Code.

Incorporation in the United States does not in any way justify taxing a corporation on a worldwide basis. Thus, the United States should adopt a territorial system for corporations. Every corporation, whether U.S. or foreign, should be taxed by the United States only on its income from operations in the United States.

The third fundamental issue I would like to address involves the rules for sourcing income as either U.S.-source or foreign-source income. The current Code and regulations have come up with a complex, arbitrary, and arcane set of rules for sourcing all kinds of income. Replacing these rules with an approach focused on permanent establishments would be a major step toward rationalizing and simplifying the international provisions.

Under this approach, the 30 percent gross basis tax would apply to certain payments made by U.S. permanent establishments and the foreign tax credit limitation, assuming such was still necessary, would focus on income that is effectively connected with a tax-

payer's foreign permanent establishment or that is received by the taxpayer from someone's foreign permanent establishment. Thus, the arbitrary and complex sourcing rules of the current Code could be replaced with a much more logical and clear-cut approach.

Because of the arbitrariness and complexity of the current international provisions, it is critical that they be revised from the ground up so that they are tied into reality, rationalized and simplified, thereby eliminating the major burden they currently impose on the international competitiveness of U.S. corporations.

Thank you, Mr. Chairman, and I would be happy to answer any questions the Committee might have.

[The prepared statement follows:]

Statement of Hermann B. Bouma, International Tax Attorney, H.B. Bauma

Mr. Chairman and distinguished Members of the Committee on Ways and Means:

My name is Herm Bouma and I appreciate very much the opportunity to appear before the Committee this morning to speak on the international provisions of the Internal Revenue Code. I commend the Committee for focusing its time and energy on this very important topic. I appear before the Committee on my own behalf and not on behalf of any client.

I have been an international tax attorney now for almost 20 years, ever since I graduated from law school. Upon graduating from law school, I went to work with the Office of Chief Counsel at the Internal Revenue Service, where I worked in the International Branch of the Legislation and Regulations Division. My principal project there involved the final foreign tax credit regulations under sections 901 and 903. After fulfilling my four-year commitment there, I went into private practice with the Washington tax firm known as McClure & Trotter. I was a partner there for eight years and then left to establish my own practice, continuing to focus on international taxation. The rationalization and simplification of the international tax provisions is a subject I have thought about for a long time now.

REALITY AND THE INTERNATIONAL PROVISIONS

We international tax practitioners have a tendency to get bogged down among the trees (of which there are many) and seldom step back to view the forest as a whole. In my testimony I would like to look at the forest and focus on the basic foundational principles on which our international tax regime should be constructed.

Judge Learned Hand once wrote:

> . . . In my own case the words of such an act as the Income Tax . . . merely dance before my eyes in a meaningless procession . . . couched in abstract terms that offer no handle to seize hold of . . . [A]t times I cannot help recalling a saying of William James about certain passages of Hegel: that they were no doubt written with a passion of rationality; but that one cannot help wondering whether to the reader they have significance save that the words are strung together with syntactical correctness.

Learned Hand, Thomas Walter Swan, 57 Yale L.J. 167, 169 (1947). Why is it that people find the Code so hard to understand? There are a number of reasons but one explanation is that often it is not tied in to reality. I believe this is the case with the international provisions of the Code.

There is a huge gap between reality and those provisions. If the international provisions can be based on certain fundamental principles that are grounded in reality and that make sense conceptually, then the provisions will be far less arbitrary and far less complex. They will be easier to learn, both for practitioners and the IRS, and easier to apply. Even where a certain amount of complexity is still required, the complexity will be based on sound fundamental principles, and thus much easier to understand. Moreover, if the international provisions are tied in to reality and make sense, then, when one encounters a situation that is not directly addressed by the provisions, it will be much easier to determine what the answer should be.

When the foundation of a structure is wealc and rickety, adding more to the top will not strengthen it; it will simply add more weight so that eventually the whole structure may collapse of its own weight. That is the point we are reaching now with the international provisions of the Code, where the structure has become so huge and so heavy, and yet the foundation is extremely weak and rickety. The

whole thing is in danger of collapsing, collapsing in the sense that it is moving beyond the capacity of the IRS to administer and enforce it.

"A Brief Description of Reality"

In order to tie the international provisions in to reality, we first need to have a clear view of reality. Describing reality in somewhat broad-brush strokes, reality consists of God, people, and the world (which includes such things as rocks and trees and squirrels). People have rights and obligations, including financial rights and obligations, which are often referred to as assets and liabilities. People can hold assets and liabilities directly or through arrangements. Some arrangements for assets and liabilities are intended to generate income. An income-generating arrangement normally consists of a set of rules which governs the management of the assets and liabilities and the distribution of assets either to persons who hold interests in the arrangement or to others. Income-generating arrangements are of three basic types: business entities, trusts, and non-profit organizations.

In focusing on the basic foundational principles on which our international tax regime should be constructed, I would like to consider three "big-ticket" items: the taxation of business entities, the taxation of U.S. versus foreign corporations, and the rules for sourcing income as either U.S.-source or foreign-source.

Taxation of Business Entities

Obviously, the taxation of business entities is not an issue that is limited to the international area. However, it does have major ramifications for the international area and thus is a foundational issue for an international tax regime.

Worldwide there is a great variety of business entities—they come in all different shapes and sizes. However, they have one thing in common—they are attempting to generate income for their interest holders. Under the current Code, this great variety of business entities is divided into two basic types, corporations and partnerships (including, for this purpose, sole proprietorships), and radically different tax regimes apply to each. With respect to corporations, there are two layers of taxation; with respect to partnerships, only one.

Under current IRS regulations, certain business entities, including certain foreign business entities, are treated as per se corporations. All other business entities are permitted to choose whether they wish to be treated as a corporation or as a partnership for U.S. tax purposes. There is no logical reason why certain business entities are treated as per se corporations, and thus subject to an additional layer of tax.

It is sometimes said that it is appropriate to treat certain corporations as per se corporations because they provide limited liability to their interest holders. However, what logical connection is there between the two? Why should two layers of tax apply just because the entity provides limited liability to its interest holders? When an interest holder receives a distribution of profits from an entity, the interest holder benefits to the same extent, whether or not it has limited liability. Moreover, many business entities that are entitled to choose whether to be treated as a corporation or a partnership do provide limited liability to their interest holders. Thus, there is nothing in the nature of limited liability that requires an additional layer of tax.

An extra layer of tax is sometimes justified for per se corporations on the grounds that they are "separate entities." However, the concept of "separate entity" is never defined and in fact there does not appear to be any definition that would apply only to per se corporations and not to other types of business entities also. Certainly, under typical business law concepts, a traditional partnership under state law, which may be treated as a partnership for U.S. tax purposes, is as much a "separate entity" as is a corporation under state law that is treated as a per se corporation for U.S. tax purposes. Such a partnership can sue and be sued, it can operate under its own name, and it can hold property in its own name, including real estate. Thus, it would appear to be as much of a "separate entity" as is a per se corporation. There is, therefore, absolutely no justification for taxing certain business entities as per se corporations, while permitting other business entities to choose how they are taxed. Until this can be remedied, we have a Code that at its very foundation makes no sense.

Except as noted below with respect to publicly-traded business entities, all business entities should be taxed in the same way. Ideally, there should be only one layer of tax and it should be imposed on the business entity on a territorial basis. Requiring the business entity to pay the tax (rather than the interest holders as is currently the case under the Code with respect to the taxation of partnership income) would promote efficiency and reduce the reporting burden on the interest

holders. If an interest holder sold its interest in the business entity, the business entity would be responsible for paying the tax on the gain (which would be withheld from the proceeds due to the interest holder), and adjustments to the entity's asset bases would be made in a manner similar to that provided in section 743 of the current Code. If the business entity were publicly-traded and an interest holder with a less than 10% interest sold its interest, then the interest holder would pay tax on the gain and there would be no adjustment to the asset bases of the business entity.

Suppose, for example, a business entity (such as a large law firrn) has 1,000 interest holders and conducts business in five countries. Under the current Code, if one of those countries is the United States and the business entity is treated as a partnership for U.S. tax purposes, then each of the 1,000 interest holders is required to file a U.S. tax return because the business entity is engaged in the conduct of a trade or business in the United States. However, the tax obligation should be imposed on the business entity, not the interest holders. Thus, instead of 5,000 returns being required (assuming the other four countries also required a return from each interest holder), only five returns would be necessary (assuming all five countries adopted the approach of imposing the tax obligation on the business entity).

An alternative approach would be to treat all non-publicly-traded business entities as partnerships are treated under the current Code. Thus, there would be only one layer of tax but the income would be taxed through to the interest holders. If a business entity were publicly-traded, it would be taxed as discussed above under the ideal approach. Thus, there would be only one layer of tax, but it would be imposed on the business entity (except in the case of gain on the sale of an interest by a less than 10% interest holder).

Thus, when it comes to the taxation of business entities, the only distinguishing characteristic should be whether or not they are publicly-traded, not whether or not they provide limited liability or are "separate entities".

TAXATION OF U.S. VS. FOREIGN CORPORATIONS

If the Code continues to characterize business entities as either corporations or partnerships and continues to subject them to different tax regimes, the next "big-ticket" item is whether there should be any difference between the taxation of U. S. corporations as opposed to foreign corporations. Under present law, a U.S. corporation is taxed by the United States on its worldwide income, whereas a foreign corporation is taxed by the United States only on certain U.S.-source income and on income that is effectively connected with the conduct of a trade or business in the United States.

It is important to understand what makes a corporation a U.S. corporation or a foreign corporation for this purpose. What makes the difference is a simple piece of paper, a paper indicating whether the corporation has been organized under the laws of the United States or a political subdivision thereof, such as Delaware, or under the laws of a foreign jurisdiction, such as the Cayman Islands. The location of the corporation's headquarters, of most of its business operations, of most of its property, where it first started business, and the residency of most of its shareholders are all completely irrelevant for this purpose. What matters is a simple piece of paper. Thus, a corporation can be a U.S. corporation even if it has no operations or property in the United States, and no shareholders that are residents of the United States. Similarly, a corporation can be a foreign corporation even if it:s headquarters and most of its operations and property are in the United States, and all of its shareholders are residents of the United States.

Incorporation in the United States does not provide any benefits that justify taxing a U.S. corporation on a worldwide basis. In fact, given the many rules and regulations that apply to U.S. corporations outside the tax area, one could argue that incorporation in the United States is actually a detriment, particularly when there are many other locations in the world that have favorable corporate laws. Thus, incorporation in the United States does not in any way justify taxing a corporation on a worldwide basis. A corporation primarily benefits from the countries in which it earns income, not from the country in which it happens to be incorporated.

On March 11, 1999, Mr. Robert Perlman, Vice President for Tax, Licensing & Customs for Intel Corporation, testified before the Senate linance Committee concerning the international provisions of the Code. Mr. Perlman stated that if Intel had it to do all over again, it would incorporate as a foreign corporation, not as a U.S. corporation. Some members ofthe Committee took offense at this statement and considered it unpatriotic. In addition, they pointed out all of the benefits of doing business in the United States, including an educated labor force, little regulation, and a stable government, and they expressed skepticism that a company would

move its operations offshore in order to secure better tax benefits. However, this reaction to Mr. Perlman's statement reflected a basic misunderstanding of what it means, under the Code, to be a U.S. corporation or a foreign corporation.

Mr. Perlman said that if Intel had it to do all over again, it would incorporate in the Cayman Islands rather than the United States. All that this would mean is that Intel would have a piece of paper saying it was incorporated under the laws of the Cayman Islands. Everything else about Intel's operations, including its U.S. operations, would be exactly the same. Intel would still have its headquarters in the United States, and it would have just as many factories in the United States, just as much research in the United States, and just as many salesmen in the United States. The only difference is that Intel would have a piece of paper saying it was incorporated in the Cayman Islands and this would make all the diSerence in the world taxwise. It would not be subject to the infamous Subpart F regime, and in fact all of its income from foreign operations would be completely free of U.S. tax.

Start-up companies are now being wisely advised to incorporate in a foreign jurisdiction in order to avoid the onerous rules of the U.S. tax regime, including worldwide taxation and Subpart F. However, many companies which incorporated as U. S. corporations many years ago are stuck with the onerous U.S. tax regime because the "toll charge" under section 367(a) precludes a foreign reincorporation. It is simply unfair for a corporation to now suffer inordinately under the U.S. tax regime just because it made the unfortunate decision, 50 or 100 years ago, to be incorporated in the United States.

In a recent article, Professor Reuven S. Avi-Yonah, an assistant professor at Harvard Law School, stated that "it does not seem to make sense to rely so much on formalities such as which country an entity is incorporated in." Reuven S. Avi-Yonah, Tax Competition and Multinational Competitiveness: The New Balance of Subpart F, Tax Notes International, April 19, 1999, p. 1575, fn 45. Although Professor Avi-Yonah made this statement in reference to controlled foreign corporations, it certainly applies to the taxation of U.S. corporations also. It is ironic that, while the IRS struggles to tax transactions based on their substance and not their forrn, in this major way the Code elevates form over substance.

It is extremely important, therefore, that all corporations be treated the same, whether they are incorporated in the United States or outside the United States. This means that the United States should adopt a territorial system with respect to the taxation of corporations; every corporation, whether U.S. or foreign, should be taxed only on its income from operations in the United States.

THE SOURCING RULES

The third "big-ticket" item that I would like to address involves the sourcing rules. The current Code operates on the assumption that every item of income is either U.S.-source or foreign-source. The use of the term "source" is misleading because it gives the impression that there is a quarry of income in each country and one simply determines whether an item of income came from a quarry in the United States or from a quarry in a foreign country. However, the matter is not that simple. Income, which is an increase in value, is not a physical object, and thus, by its very nature, does not have a geographical location. Therefore, one cannot source income simply by determining the geographical location from which it came.

Given this conundrum, the Code and regulations have come up with a complex, arbitrary, and arcane set of rules for sourcing all kinds of income. Depending on the type of income that is involved, these rules look at such factors as the residence, citizenship, place of incorporation, or place of business of the payor, the residence, citizenship, place of incorporation, or place of business of the payee, and the place where services were performed, where negotiations took place, where property was at the time title to the property passed, where property is used, where property is manufactured using certain manufacturing intangibles, and where property is marketed using certain marketing intangibles.

Supposedly, the intent of these rules is to identify the country whose economy is most closely connected with the particular item of income. However, in fact the result has been a hodge-podge of extremely arbitrary rules that in many cases make no sense. For example, income from the performance of services is sourced to the country where the services were performed. Thus, if I hire Tom Clancy to write a novel and he spends three weeks on a beach in France writing it, the amount I pay him will be foreign-source income, even though it is extremely difficult to see how this income might have its "source" in France.

Given the arbitrariness and complexity of these rules, one is led to ask the question, are these rules really necessary? In fact they are not, and eliminating them

would be a major step towards rationalizing and simplifying the international provisions of the Code.

Under the Code, the sourcing rules are generally used for three purposes: (1) to deterrnine the effectively-connected income of a foreign person that is engaged in the conduct of a trade or business in the United States; (2) to determine the income of a foreign person that is subject to a U.S. tax of 30% on a gross basis (certain "U.S.-source" income that is not effectively connected with the conduct of a trade or business in the United States); and (3) to detertnine "foreign-source" income for purposes of the limitation on the foreign tax credit for U. S. persons.

With respect to the determination of the effectively-connected income of a foreign person, such income can be determined by focusing direcl.ly on the business activities being carried on in the United States and by determining what income those activities give rise to. Although this determination would not always be easy, the approach would be much more direct and much easier to understand. There certainly is no need to first "source" income before determining whether a particular business activity has given rise to it.

With respect to the determination of the income of a foreign person that is subject to a U.S. tax of 30% on a gross basis, the sourcing rules are not needed for this purpose either. Such income could be defined as income paid by a perrnanent establishment in the United States to a foreign person, provided the income is not effectively connected with the conduct of a trade or business by the foreign person in the United States. This approach would also be more direct and easier to understand.

With respect to the deterrnination of the foreign tax credit limitation for U.S persons, clearly the sourcing rules would not be necessary if no foreign tax credit were given. Such would be the case with respect to business entities if the United States taxed every business entity, whether U.S. or foreign, only on the portion of its worldwide income that is allocable to a permanent establishment (or establishments) that the business entity has in the United States. Since income that is allocable to foreign permanent establishments would not be taxed by the United States, there would be no need to provide a foreign tax credit. If the United States had a 30% gross basis tax for payments made by U.S. permanent establishments to foreign persons, then the United States would need to allow a foreign tax credit with respect to payments received by a U.S. permanent establishment from a foreign permanent establishment (since, in the eyes of the United States, those payments could rightfully be subject to a gross basis tax by the country of the foreign permanent establishment).

Even if the United States did not adopt a territorial system, it still would not be necessary to retain the current sourcing rules in order to determine the foreign tax credit limitation of a U.S. person. The limitation could be determined by adding together all the income of a U.S. person that is allocable to foreign permanent establishments of the U.S. person or that is received by the U.S. person from foreign permanent establishments (whether or not belonging to the U.S. person). This approach would not only be easier to apply but would also make sense conceptually because the foreign tax credit limitation would be based on the income of a U.S. person that foreign countries would tax if they applied the rules of the United States for taxing foreign persons. Under the current Code, there is often a disconnect between the amount of a U.S. person's foreign-source income for purposes of the foreign tax credit limitation and the amount of income foreign countries would tax if they applied to the U.S. person the rules applied by the United States to foreign persons.

Thus, the arbitrary and complex sourcing rules of the current Code could be replaced with much more clear-cut, logical approach.

CONCLUSION

There is a fundamental disconnect between reality and the international provisions of the current Code, and this disconnect accounts for the arbitrariness and complexity of those provisions. Because ofthis arbitrariness and complexity, U.S. corporations are subject to both a much higher tax burden and a much higher compliance burden than are many of their foreign competitors. It is critical that the international provisions be revised from the ground up, so that they are tied in to reality, rationalized, and simplified, thereby eliminating the current burden on the international competitiveness of U.S. corporations.

Chairman ARCHER. Thank you, Mr. Bouma.

Does any member wish to inquire of this panel?

[No response.]

If not, we appreciate your testimony, and we thank you for the opportunity to consider it as we move ahead in developing this tax package.

The Committee will stand in recess until one o'clock so everybody can get some lunch, and then we will hear from our last panel.

[Whereupon, the Committee recessed to reconvene at 1 p.m., the same day.]

Chairman ARCHER. The Chair apologizes to our next panel of witnesses for keeping you waiting for an extra 20 minutes. We will be pleased to receive your testimony. Mr. Conway, if you would lead off, please, sir.

STATEMENT OF KEVIN CONWAY, VICE PRESIDENT, TAXES, UNITED TECHNOLOGIES CORPORATION, HARTFORD, CONNECTICUT, AND VICE CHAIRMAN, SUBCOMMITTEE ON INTERNATIONAL TAXATION, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. CONWAY. Thank you, Mr. Chairman. Members of the Committee, my name is Kevin Conway. I am the vice president of taxes at United Technologies Corp. I am here today on behalf of the National Association of Manufacturers.

NAM is the oldest and largest multi-industry trade association in the U.S. NAM's 14,000 members include 10,000 small and medium-sized companies and over 300 member associations who represent manufacturers in every State. NAM has long advocated international tax simplification to improve the international competitiveness of U.S. companies. NAM strongly supports the provisions of H.R. 2018.

I will focus my testimony on four areas of particular concern. At United Technologies, the Otis Elevator Co. competes in the global marketplace in the elevator service industry. There are approximately 6 million elevators in the world that are available to service. Over 5 million of those are located outside the United States. So what this means is that 80 percent of that market is outside the United States.

In order for us to compete in that marketplace, we often have to operate through corporate joint ventures. In order to penetrate markets or expand in existing markets, we are required to have partners and joint ventures. Very often, our partners will want to retain at least a 50 percent ownership in that venture. The result is that we often find ourselves in the 10/50 basket. What that means is that if the local income tax rate is greater than the 35 percent U.S. rate, if we have dividends from that 10/50 company, we will have excess credits that we will never use.

In the same year, we have 10/50 company operations in countries where the local rate is below the 35-percent rate. In that case, when we take dividends back, we have excess limitation that we will never use. Clearly, we think the 10/50 rule results in us being non-competitive and it is time that it be repealed. The 1997 Act recognized that and it repealed the 10/50 basket. Unfortunately, there was a complex transition rule which delayed the effective

date of the repeal. And NAM urges that the effective date be accelerated to the current time.

The second area I want to talk about is the provision which applies in the case of a taxpayer who is subject to the AMT, the alternative minimum tax regime. That provision essentially says that if you have foreign tax credits, you are subject to a 90 percent limitation. You can use the foreign tax credits, but you can only reduce your liability up to 90 percent. We don't believe that the AMT tax regime makes any sense. We think it makes even less sense to have this 90 percent limitation. So we urge that the rules be changed and that AMT taxpayers, just like regular taxpayers, be permitted to use their foreign tax credits to offset their tax liability.

The third area I would like to talk about is exports. Exports are critical to the growth of U.S. jobs, U.S. companies, and the U.S. economy. In 1998, United Technologies had export sales of more than $4 billion. Those were products that were manufactured in the United States and sold abroad. We have two important provisions in the Internal Revenue Code dealing with exports. The first provision is the foreign sales corporation provision. We also have the export source rule under section 863. They are both important export incentives and should be maintained.

However, the FSC rules have a provision which essentially provides that the FSC benefit is reduced by 50 percent in the case of export sales of military or Defense products. This provision was enacted back in 1976 on the theory that military products weren't subject to competition. We know that is not the case today. The competition from Europe is stiff on these types of products and there is no reason why military products should be treated differently than commercial products. So that limitation should be repealed.

Finally, I would like to urge the Committee and Congress to act on the legislation which would continue to ensure the confidentiality of financial information which is submitted or generated as part of an advance pricing agreement. The APA program, I think, is one example we can all point to of a program that has really worked well for the IRS, for taxpayers, and foreign countries. It has enabled us to resolve intercompany pricing issues to avoid audits and tax controversies. And the issue we have before us is if this information is not treated as confidential and it becomes disclosed, there will be a significant chilling effect on the use of the APA program, and we don't think that that is appropriate.

I would like to thank the chairman and the Committee for the progress that you have made in the international tax area and urge that H.R. 2018 be adopted. Thank you.

[The prepared statement follows:]

Statement of Kevin Conway, Vice President, Taxes, United Technologies Corporation, Hartford, Connecticut, and Vice Chairman, Subcommittee on International Taxation, National Association of Manufacturers

I. INTRODUCTION

Chairman Archer, members of the committee, my name is Kevin Conway. I am the vice president of taxes for United Technologies Corporation. I thank you for this opportunity to testify on behalf of the National Association of Manufacturers (NAM). The National Association of Manufacturers—"18 million people who make things in

America''—is the nation's largest and oldest multi-industry trade association. The NAM represents 14,000 members (including 10,000 small and mid-sized companies) and 350 member associations serving manufacturers and employees in every industrial sector and all 50 states. Headquartered in Washington, D.C., the NAM has 11 additional offices across the country.

The NAM has long advocated international tax simplification, which would greatly improve the international competitiveness of U.S. manufacturers and the U.S. economy overall. There are many opportunities to improve the international provisions of the Internal Revenue Code (IRC), and the NAM strongly supports H.R. 2018, the ''International Tax Simplification for American Competitiveness Act of 1999,'' by Representatives Houghton (R–31st NY) and Levin (D–12th MI). However, due to time constraints and more extensive coverage of several important issues by other members of this panel, I will confine my remarks to four particular areas of concern: (1) look-through for 10/50 companies; (2) the 90 percent limitation on foreign tax credits applicable to companies in AMT status; (3) advance pricing agreement (APA) disclosure; and (4) the 50 percent limitation on foreign sales corporation (FSC) benefits applicable to defense exports.

II. Look-Through for 10/50 Companies

Until 1997, a separate foreign tax credit (FTC) limitation (i.e., a separate ''basket'') computation was required for dividends received from each ''noncontrolled Section 902 corporation.'' A ''noncontrolled Section 902 corporation'' is a foreign corporation that satisfies the stock ownership requirements of IRC section 902(a), yet is not a controlled foreign corporation (CFC) under IRC section 957(a). More simply stated, these are companies in which U.S. shareholders own at least 10, but no more than 50, percent of the foreign corporation, hence the name ''10/50 company.''

This rule imposed a tremendous compliance burden on multinationals by requiring extensive, separate bookkeeping. Additionally, it severely constrained the ability of U.S.-based multinationals to use their FTCs in the most efficient manner to alleviate double taxation. Only foreign taxes directly associated with a 10/50 company's dividends could be credited against the U.S. tax on that 10/50 company's income, i.e., excess FTCs from other sources could not offset FTC shortfalls of 10/50 companies, and excess FTCs generated by 10/50 companies could not offset shortages incurred by other companies, even other 10/50 companies. This is a deviation from the general rules, which allow ''look-through'' treatment, as in the case of CFC dividends. Furthermore, there is no tax accounting or policy reason for differentiating between income earned by noncontrolled corporations versus CFCs.

Look-through rules allow dividend income to be re-characterized in accordance with the underlying sources of the payor corporation's income. Thus, dividends associated with overall limitation income would be eligible for inclusion in the overall limitation income basket. Under the rules in place before 1998, however, taxpayers were not allowed to ''look-through'' dividends received from 10/50 companies, even though 10/50 company dividends are generally derived from overall limitation income and would otherwise be eligible for inclusion in the overall limitation income basket under the look-through rules.

The 1997 Tax Relief Act corrected this inequity by eliminating separate baskets for 10/50 companies. Instead, 10/50 companies are treated just like CFCs, and taxpayers can utilize look-through rules for re-characterizing dividend income in accordance with the underlying sources of the payor corporation's income. The 1997 act, however, did not make the change effective for such dividends unless they were received after the year 2003 and, even then, required two sets of rules to apply for dividends from earnings and profits (E&P) generated before the year 2003, and dividends from E&P accumulated after the year 2002.

The ongoing requirement to use two sets of rules on dividends before the year 2003 has been a concern of taxpayers, members of Congress, and the Administration. Thus, to address the complexity created by this much-delayed effective date, the Administration has, as part of both its FY1999 and FY2000 budget proposals, recommended accelerating the effective date of the 1997 Tax Act change. The proposal would apply the look-through rules to all dividends received in tax years after 1998, no matter when the E&P constituting the makeup of the dividend was accumulated.

This change would result in a tremendous reduction in complexity and compliance burdens for U.S. multinationals doing business overseas through foreign joint ventures. It would also reduce the competitive bias against U.S. participation in such ventures by placing U.S. companies on a much more level playing field from a corporate tax standpoint. Finally, this proposal epitomizes the favored policy goal of

simplicity in the tax laws and will go a long way toward helping the U.S. economy by strengthening the competitive position of U.S.-based multinationals.

III. Foreign Tax Credit Limitations on AMT Companies

A multinational corporation with a U.S. parent and foreign subsidiaries can be double taxed on income earned by its foreign subsidiaries when the income is repatriated to the U.S. parent as a dividend. The U.S. government, recognizing that these multiple levels of tax hurt the competitiveness of U.S. corporations, alleviates this multiple tax burden by allowing the U.S. company foreign tax credits (FTCs) for the income taxes paid to foreign governments. These credits are allowed for taxes paid by subsidiaries on dividends which are distributed to the U.S. parent. Foreign tax credits are dollar-for-dollar credits that offset U.S. tax liability. However, the number of these credits that can actually be used to offset the U.S. parent tax liability is determined by whether the parent corporation has regular tax liability or alternative minimum tax (AMT) liability.

Under a regular tax computation, the U.S. parent company can use foreign tax credits to offset 100 percent of its U.S. tax liability on the dividends it receives from the foreign subsidiary. However, a similar company in AMT status would not be permitted to alleviate all of its double taxation. The resulting multiple taxation occurs because of a provision added to the tax code as part of the Tax Reform Act of 1986, providing that only 90 percent of the amount of AMT liability can be offset by foreign tax credits.

The intent of this limitation was to ensure that a U.S. corporation that earned U.S.-source income and was profitable on its U.S. operations from a book perspective would incur a minimum amount of U.S. taxes. In operation, however, U.S. corporations that have a substantial amount of foreign source income relative to their U.S.-source income or that have taxable losses on their U.S. operations are forced to pay U.S. taxes on income already heavily taxed outside the United States. This result contravenes the very purpose for which foreign tax credits were created.

AMT liability by its very nature actually represents a prepaid double taxation. Because AMT is a prepayment of taxes, the law allows corporations to accumulate credits for AMT taxes that have been paid.

Theoretically, these credits can ultimately be used when the corporation is no longer in AMT status and has fully utilized all other available credits such as foreign tax credits and research and development credits. In reality, a corporation that has substantial U.S.-source losses over a number of years or that has substantially more foreign source income than U.S. source income may never actually recover the taxes it prepaid. In this regard, the provision operates in a punitive manner not anticipated when the provision was enacted.

IV. Advance Pricing Agreement (APA) Disclosure

The Advance Pricing Agreement (APA) program of the Internal Revenue Service (IRS) began in 1991 as an innovative way for taxpayers, the IRS, and foreign tax agencies to avoid costly litigation and uncertainty over international transfer pricing—i.e., the appropriate arm's length price for sales, services, licenses and other transactions between related parties. The program has been extremely successful and is often cited as a model for how the IRS should interact with taxpayers. From the beginning of the program, the IRS assured taxpayers, Congress, and foreign governments that any information "received or generated" by the IRS during the APA process was "subject to the confidentiality requirements of §6103." (See Rev. Proc. 91–22 and Rev. Proc. 96–53). Indeed, written assurances of confidentiality have often been included in the APA itself. However, in January of this year, as a concession in a lawsuit seeking public disclosure brought by the Bureau of National Affairs (BNA), the IRS unexpectedly reversed its long-standing policy and notified taxpayers that APAs are subject to disclosure under IRC §6110—which requires disclosure of any IRS "written determination." Regardless of the outcome of the pending lawsuit, the IRS is proceeding with redaction and release of APAs (now scheduled for October 1999) in contravention of both its own prior assurances of confidentiality to taxpayers and the express intent of Congress (in 1993) that §6103 protects APAs from disclosure.

First of all, APAs are not "written determinations" under IRC §6110. In 1976, when Congress enacted §6110 to allow disclosure of written determinations, negotiated taxpayer agreements, such as closing agreements, were specifically excluded because "a negotiated settlement . . . as such, does not necessarily represent the IRS view of the law." (S. Rep. No. 938, 94th Cong. 2d Sess. 306–7 (1976); H.R. Rep. No. 658, 94th Cong., 2d Sess. 316 (1976)). APAs are not written determinations (such as private letter rulings) that are unilaterally issued to the taxpayer by the

IRS and consist of facts, law and the application of the law to the facts. Rather, APAs are customized, binding, written contracts that determine specific tax results and are carefully negotiated between the taxpayer and the IRS, like closing agreements, which are not subject to disclosure (Id). APAs are highly factual in nature, making a fact-intensive economic determination, not a legal one.

Second, APAs are protected return information under IRC §6103. In 1993, when Congress amended §6103 to add §6103(l)(14), which permits disclosure of certain return information to the Customs Service, the Congress expressly exempted APAs from such disclosure. This was done because APAs were viewed as return information in the first instance. The legislative history states: "The effectiveness of the APA program relies on voluntary disclosure of sensitive information to the Internal Revenue Service; accordingly, information submitted or generated in the APA negotiating process should remain confidential." See H.R. Report. No. 103–361, Vol. I, at 104 (1993). Treasury regulations implementing this provision also expressly describe APAs as "return information." See Treas. Reg. 301.6103(l)(14)–1(d). Public disclosure of APAs is contrary to congressional intent and Treasury's own regulations.

Third, redaction of APAs under IRC §6110 will strain IRS and taxpayer resources. Prior to release of any APAs under §6110, the IRS will be required to redact any identifying taxpayer information. In addition, the "background files" will be subject to disclosure under IRC §6110(b)(2). These background files are voluminous and contain highly sensitive proprietary data that will have to be reviewed and redacted. Redaction, especially of these background files, will strain the resources of the IRS and be yet another cost, and likely deterrent, for taxpayers participating in the APA program

Ironically, release and redaction of APAs under IRC §6110 will create costly disputes and litigation. The APA program was instituted specifically to curtail audit disputes and litigation over transfer pricing, but the redaction process required under IRC §6110 allows taxpayers and third parties to challenge proposed redactions in court, creating a significant risk of even more disputes and litigation. Disputes will arise not only between the taxpayer and the IRS over what should be redacted, but also between the taxpayer and third parties seeking disclosure, and over what is or is not a background file. Release and/or redaction of APAs and the background files would be disastrous for both the IRS and the taxpayer, as well as for our treaty partners.

Furthermore, confidentiality is essential to protect taxpayer privacy and to assure continuation of the APA program. The APA program has worked because taxpayers have trusted the IRS and agreed to voluntarily submit sensitive pricing information to the IRS in advance of an audit—based on a promise of confidentiality. Release and redaction of APAs and background files would be a betrayal of taxpayers who voluntarily submitted sensitive information in the past and a significant deterrent to taxpayers contemplating participation in the APA program in the future. In addition, an increasing number of APAs are bilateral or multi-lateral involving foreign tax authorities and making confidentiality even more important. Our treaty partners are very concerned about possible breach of the promise of confidentiality in the APA program. If taxpayers cannot obtain bilateral APAs because foreign tax authorities refuse to participate, many taxpayers may decide not to pursue an APA at all. IRS's concession has jeopardized the APA program, which has been such a successful tool in helping the IRS and taxpayers resolve difficult factual issues without litigation.

Finally, disclosure of APAs could jeopardize the confidentiality of competent authority proceedings and U.S. relationships with foreign governments. When a taxpayer's income is potentially subject to tax by both the United States and a foreign jurisdiction, the IRS can enter into a negotiation with the foreign "competent authority" to determine how much tax should be paid to each jurisdiction. These Competent Authority proceedings are confidential under our tax treaties. Although these proceedings involve the elimination of any type of double taxation, they often resolve double taxation problems arising from transfer pricing disputes—just like bilateral APAs. If APAs are subject to disclosure, there is a real risk Competent Authority proceedings could also be disclosed. Any suggestion that Competent Authority proceedings should be subject to disclosure would be viewed with tremendous concern by our treaty partners and could seriously impair our ability to resolve claims regarding double taxation in the future.

Congress should promptly confirm that APAs are protected taxpayer information under IRC §6103 and not subject to disclosure under IRC §6110. Congressional action is needed to prevent the IRS from breaching its solemn assurances to taxpayers, the Congress, and foreign governments that these agreements are confiden-

tial taxpayer information. Failure to take immediate action in this regard will severely cripple, if not destroy, the APA program.

V. Foreign Sales Corporation (FSC) Benefits for Defense Exports

The Internal Revenue Code allows U.S. companies to establish foreign sales corporations (FSCs), 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 (VATs) 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 that pay less tax.

In 1976, Congress reduced the Domestic International Sales Corporation (DISC) tax benefits for defense products to 50 percent, while retaining the full benefit for all other products. The limitation on military sales, currently contained in IRC § 923(a)(5), was continued when Congress enacted the FSC (which replaced the DISC) in 1984. The rationale for this discriminatory treatment—that U.S. defense exporters faced little competition—no longer exists. Regardless of the veracity of that premise 25 years ago, today military exports are subject to fierce international competition in every area. In the mid–1970s, 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 15 years, the U.S. defense industry has experienced spending 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 during the Korean War in the early 1950s and gradually dropping to 6–7 percent in the late 1980s. That figure has now sunk to 3 percent of GDP and is projected 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. This is additionally evidenced by massive consolidation and job loss in the defense industry. Of the top 20 defense contractors in 1990, two-thirds of the companies have merged, been sold or spun off, and hundreds of thousands of jobs have been eliminated in the industry.

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. However, this expense is justified by both overriding policy concerns and sound tax policy. With the sharp decline in the defense budget over the past 15 years, exports of defense products have become ever more critical to maintaining a viable U.S. defense industrial base. Key U.S. defense programs rely on international sales to keep production lines open and to reduce unit costs. Repeal will benefit not only the large manufacturers of military hardware, but also the smaller munitions manufacturers, whose products are particularly sensitive to price fluctuations.

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. Since the Congress transferred export control jurisdiction to the State Department, the identical sat-

ellites, manufactured in the same facility, by the same hard-working employees, no longer receive the same tax benefit. Because these satellites are now classified as munitions, their FSC benefit has been cut in half. 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 the same under the FSC.

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 be able to take advantage of the FSC only after the U.S. Government has determined that a sale is in the national interest.

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

VI. CONCLUSION

In conclusion, the NAM has long advocated overhaul of the overly complex and arcane international tax provisions in the Internal Revenue Code and complete repeal of the punitive alternative minimum tax (AMT). While the opportunities for improvement in the code are numerous, the NAM strongly endorses H.R. 2018, the "International Tax Simplification for American Competitiveness Act of 1999," and the simplification provisions therein as a significant step toward improving the competitiveness of U.S.-based manufacturers. However, we would also urge the committee to address the impending disclosure by IRS of advance pricing agreements (APAs) by clarifying their status as return information under I.R.C. § 6103.

With only about four percent of the world's population residing in the United States, international trade is no longer a luxury but necessary to the survival and growth of U.S.-based manufacturers. While U.S. negotiators have actively pursued an increasing number of trade agreements to improve access to overseas markets, a major impediment to trade sits in our own backyard, namely the U.S. tax code. The NAM thanks the Committee on Ways and Means for recognizing the barriers our tax code imposes and the decreased competitiveness that results. Hearings such as this one are the first step to achieving significant reform. Thank you for scheduling this hearing to address these important issues and for allowing me to testify today on the NAM's behalf.

Chairman ARCHER. Thank you, Mr. Conway. Mr. Mogenson, you may proceed.

STATEMENT OF HARVEY B. MOGENSON, MANAGING DIRECTOR, MORGAN STANLEY DEAN WITTER & CO.; ON BEHALF OF THE COALITION OF SERVICE INDUSTRIES

Mr. MOGENSON. Mr. Chairman, Members of the Committee, my name is Harvey Mogenson. I am a managing director at Morgan Stanley Dean Witter responsible for international tax matters for the company. Morgan Stanley Dean Witter is a global financial services firm and a market leader in securities, asset management, and credit and transaction services. We have offices in New York, London, Tokyo, Hong Kong, and all of the other principal financial centers around the world.

However, today I am testifying on behalf of the Coalition of Services Industries, CSI. CSI was established in 1982 to create greater

awareness of the major role services industry play in our national economy, to promote the expansion of business opportunities abroad for U.S. services, and to encourage the U.S. leadership in attaining a fair and competitive global marketplace. CSI represents a broad array of U.S. service industries, including financial, telecommunications, professional, travel, transportation, information, and information technology sectors.

I would like to thank you, Mr. Chairman, for holding this important meeting today regarding the U.S. tax rules and their impact on the competitiveness of U.S. corporations doing business abroad. I also want to thank Mr. Houghton and Mr. Levin and other Members of the Ways and Means Committee and members who have joined them in introducing H.R. 2018, the International Tax Simplification For American Competitiveness Act of 1999. And also I would like to thank Mr. McCrery and Mr. Neal for the work that they are doing in this area.

Although my limited grey hair belies the fact, I have been practicing international tax for 18 years. I can personally attest that the U.S. international tax laws are complex, cumbersome, and can stifle competitiveness of U.S. companies doing business abroad. Because of this, international tax reform is a critical element of an effective U.S. tax and trade policy.

While U.S. trade policy has concentrated on opening world markets to U.S. companies, particularly in the service sector, the U.S. tax policy has not always moved in the same direction. As trade policy moves into the 21st century, it seems our international tax policy still reflects the business environment of the sixties, as elaborated on by the previous panel in citing the statistics regarding the segments of our economy at that time. That is why we strongly support the provisions of the Houghton-Levin Simplification bill. Further, as part of that bill, CSI believes that the active financing exception to subpart F for financial services companies active business foreign earnings should be extended with other expiring provisions for as long as possible.

To understand how important the U.S. tax laws are to companies operating abroad, perhaps I will elaborate on why U.S. firms and financial service companies in particular go overseas in the first place. As the world economy has been increasingly global in nature, the need to secure new markets for U.S. corporations has intensified. As those companies, who are our clients, expand overseas, the financial services firms have had to go and do the same thing in order to support the global expansion of those companies. In essence, financial services companies are in the foreign markets initially because that is where our customers are. Thus, as our customers have become global, we have had to also become global rather than lose that business to our global competitors.

Also, the U.S. financial markets are mature and it is anticipated that much of the growth in the financial services industry will come in foreign marketplaces as they open up to the type of development that we have seen in the U.S. financial services marketplace.

Many financial service companies have also had a local presence abroad because we are heavily regulated and required to conduct business through local companies. For example, insurance and re-

insurance companies, like securities dealers—my company—are required to maintain significant levels of capital with minimum solvency thresholds in order to be licensed to operate in the foreign jurisdiction. In addition, these regulated companies are subject to stringent regulation that constrains the movement of capital, regardless of whether such income has or has not been subject to U.S. taxation.

Most global services firms, therefore, including Morgan Stanley Dean Witter, have operated through locally incorporated and regulated affiliates in the major commercial centers.

As a way of background to the legislative approach to active financing exception, I would just like to say that in 1986, Congress repealed the active financing exception because of the concerns over active and passive income. In 1997 and 1998, those concerns were revisited and a compromise was crafted to focus on the active activities of financial services firms that do conduct substantial activities in the home country. Active financial services, as we have heard, is recognized by our major trading partners as active 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 all of our major competitors operating outside the United States.

Also, because the active financing exception is currently temporary, it denies U.S. companies of a certainty their foreign competitors have. I will conclude my remarks there.

[The prepared statement follows:]

Statement of Harvey B. Mogenson, Managing Director, Morgan Stanley Dean Witter & Co.; on behalf of the Coalition of Service Industries

INTRODUCTION

Mr. Chairman and distinguished Members of the Committee:

My name is Harvey Mogenson, I am a Managing Director at Morgan Stanley Dean Witter & Co. (MSDW). MSDW is a global financial services firm and a market leader in securities, asset management, and credit and transaction services. The Firm has offices in New York, London, Tokyo, Hong Kong and other principal financial centers around the world and has 456 securities branch offices throughout the United States. I am testifying today on behalf of the Coalition of Services Industries (CSI). CSI was established in 1982 to create greater awareness of the major role services industries play in our national economy; promote the expansion of business opportunities abroad for U.S. services, and encourage U.S. leadership in attaining a fair and competitive global marketplace. CSI represents a broad array of U.S. service industries including the financial, telecommunications, professional, travel, transportation, information and information technology sectors.

I want to thank you, Mr. Chairman for holding this important hearing on the impact U.S. tax rules have on the competitiveness of U.S. corporations doing business abroad. I also want to thank Mssrs. Houghton and Levin and the other Ways & Means Committee Members who have joined them in introducing H.R. 2018, the International Tax Simplification for American Competitiveness Act of 1999.

U.S. international tax laws are complex, cumbersome, and can stifle the competitiveness of U.S. companies doing business overseas. Because of this, international tax reform is a critical element of an effective U.S. trade policy. While U.S. trade policy has concentrated on opening world markets to U.S. companies, our tax policy has not always moved in the same direction. As trade policy moves into the 21st Century, it seems our international tax policy still reflects the business environment of the '60s. That is why we strongly support the provisions in the Houghton-Levin Simplification bill. And, as part of that bill, CSI believes that the active financing exception to subpart F for financial services companies' active business foreign earnings should be extended with the other expiring provisions for as long as possible.

WHY FINANCIAL SERVICES COMPANIES OPERATE OVERSEAS

To understand how important U.S. international tax laws are to companies operating abroad, it may be useful to elaborate on why U.S. firms, and financial services companies in particular, go overseas in the first place.

As the world economy has become increasingly global in nature, the need to secure new markets for U.S. corporations has intensified. As those companies expand overseas, financial services firms have had to do the same in order to support that global expansion and to stake out new markets for themselves. In essence, financial services companies are in foreign markets because that is where our customers are (both domestic and foreign). Thus, as our customers have become more global, we have also become global rather than lose the business to our global competitors. Also, the U.S. financial markets are mature and much of the growth in the industry will come in foreign markets as they open up to the type of development we have seen in the US financial services market-place.

You will hear today from manufacturing companies such as United Technologies, which owns Otis Elevator Company. Otis maintains a presence overseas in order to service and maintain the elevators they sell around the world. In much the same way financial services companies, be they banks, securities, finance or insurance companies, need to have a local presence to market, service and maintain financial services to their customers. As with other non-financial companies that need to be close to their customers because of the proximity to raw materials and other inputs, financial services companies need access to the local debt and financial markets to facilitate their lending and securities activities. In most cases, such access provides us with lower cost of funds and protection against currency fluctuations.

Many financial services companies also have a local presence because they are heavily regulated businesses and foreign rules dictate that they conduct business through local companies. In the case of insurance and reinsurance companies, they are required to maintain significant levels of capital with minimum solvency thresholds in order to be licensed in a foreign jurisdiction. In addition, insurers are subject to stringent regulation that constrain the movement of capital.

Most global securities firms, including Morgan Stanley Dean Witter, have locally incorporated and regulated affiliates in the major commercial centers within Europe (London, Frankfurt, Paris, Milan) and Asia (Tokyo, Hong Kong, Singapore, Sydney). Because each jurisdiction asserts full regulatory control for activities within its country, local subsidiaries are used to avoid overlapping regulatory supervision.

LEGISLATIVE BACKGROUND ON ACTIVE FINANCING EXCEPTION

When subpart F was first enacted in 1962, the original intent was to provide deferral for foreign operating income, and 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 were specifically excluded from current taxation if such income was earned from activities with unrelated parties.

In 1986, Congress repealed deferral of controlled foreign corporation's active financial services business income in response to concerns about the difficulty in distinguishing between active and passive income. In 1997, the 1986 rules were revisited, and an exception to the subpart F rules was added for the active income of U.S. based financial services companies, along with rules to ensure that the exception would not be available for passive income. The active financing income provision was revised in 1998, in the context of extending the provision for the 1999 tax year, and changes were made to focus the provision on active overseas financial services businesses that perform substantial activities in their home country.

Active financial services income is recognized by our major trading partners 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-á-vis all their 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. financial services institutions need to know the tax consequences of their business operations, especially since many client transactions may be multiple year commitments or arrangements.

A comparative review of current U.S. law with the laws of foreign countries conducted by the National Foreign Trade Council, Inc.[1] shows that the United States imposes a stricter anti-deferral policy on U.S.-based financial services companies than Canada, France, Germany, Japan and The Netherlands. None of the countries listed eliminates deferral for active financial services income. For example, "German law merely requires that the income must be earned by a bank with a commercially viable office established in the CFC's jurisdiction and that the income results from transactions with customers. Germany does not require that the CFC conduct the activities generating the income or that the income come from transactions with customers solely in the CFC's country of incorporation. The United Kingdom has an even less restrictive deferral regime than Germany. The United Kingdom does not impose current taxation on CFC income as long as the CFC is engaged primarily in legitimate business activities primarily with unrelated parties. In sum, current U.S. treatment of CFC active financing income is more restrictive than the treatment afforded such CFC income by many of the United States' competitors."[2]

THE ACTIVE FINANCING EXCEPTION IS ESSENTIAL TO THE COMPETITIVE POSITION OF AMERICAN FINANCIAL SERVICES INDUSTRIES IN THE GLOBAL MARKETPLACE

The financial services sector is one of the fast growing components of the U.S. trade in services surplus (which is expected to exceed $80 billion this year). It is therefore in the economic interest of the United States that the Congress act to maintain a tax structure that does not hinder the competitive efforts of the U.S. financial services industry. While the economic research is continuing, there seems to be a growing awareness of the benefits to the U.S. economy of strong U.S.-based global companies. And, certainly in the case of a financial services company like MSDW, our global reach has allowed us to be a stronger competitor and more successful within the U.S.

The growing interdependence of world financial markets has highlighted the urgent need to rationalize U.S. tax rules that undermine the ability of American financial services industries to compete in the international arena. From a tax policy perspective, financial services businesses should be eligible for the same U.S. tax treatment of worldwide income as that of manufacturing and other non-financial businesses. The inequitable treatment of financial services industries under prior law jeopardizes the international expansion and competitiveness of U.S.-based financial services companies, including finance and credit entities, commercial banks, securities firms, insurance, and reinsurance companies.

This active financing provision is particularly important today as the U.S. financial services industry is the global leader and plays a pivotal role in maintaining confidence in the international marketplace. Also, recently concluded trade negotiations have opened new foreign markets for this industry, and it is essential that our tax laws complement this trade liberalization effort. We hope the Congress will not allow the tax code to revert to penalizing U.S.-based companies upon the expiration of the temporary provision this year.

THE ACTIVE FINANCING EXCEPTION SHOULD BE EXTENDED FOR AS LONG AS POSSIBLE

According to the floor statement of Mr. Houghton during the debate on the Conference Report of the Tax Act of 1997, the fact that the original active financing exception would sunset after one year was "a function of revenue concerns, not doubts as to its substantive merit."[3] Indeed, even in the course of subjecting this provision to a presidential line-item veto, the Clinton Administration acknowledged, and continues to acknowledge that the "primary purpose of the provision was proper."[4]

Understanding that revenue constraints can impact U.S. tax policy considerations, extending the provision for as long as possible would greatly enhance the competitive position of the U.S. financial services industry as they compete in the global marketplace. Otherwise, the international growth of American finance and credit companies, banks, securities firms, insurance and reinsurance companies will continue to be impaired by an on-again, off-again system of annual extensions that does not allow for certainty.

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[1] *The NFTC Foreign Income Project: International Tax Policy For The 21st Century* A Report and Analysis Prepared by the National Foreign Trade Council, Inc.

[2] *The NFTC Foreign Income Project. International Tax Policy For The 21st Century* p 4–11.

[3] Congressional Record, July 31, 1997.

[4] White House Statement, August 11, 1997.

CONCLUSION

On behalf of the entire U.S. financial services industry and the Coalition of Services Industries, I want to thank you Mr. Chairman and Members of the Committee for your efforts to improve the international rules that affect not only the financial services industry but all U.S. corporations operating overseas. We urge the Committee to support H.R. 2018 which would provide a more consistent, equitable and stable international tax regime for the U.S. financial services industry.

Chairman ARCHER. Thank you, Mr. Mogenson. I am sure all the witnesses hear those buzzers, which mean that we are being summoned to vote on the floor of the House. We have 10 more minutes before we have to be over there. We will proceed for at least one more witness and then we will have to recess and vote. Two votes will be taken so it will be a while before we get back. Mr. Chip, you may proceed.

STATEMENT OF WILLIAM W. CHIP, CHAIRMAN, TAX COMMITTEE, EUROPEAN-AMERICAN BUSINESS COUNCIL, AND PRINCIPAL, DELOITTE & TOUCHE LLP

Mr. CHIP. Thank you, Mr. Chairman. I am an international tax lawyer. I have been practicing for 20 years. I am testifying today for the European-American Business Council. The Council is an alliance of U.S. companies that have operations in Europe and European companies that have operations in the United States. Our membership has a lot of experience in the relative impact of the U.S. tax rules compared to foreign tax rules.

Mr. Chairman, I would agree with you that—what you said this morning—that if we were to replace our income tax system with a sales tax system that raised the same amount of revenue, that would almost certainly confer a significant competitive advantage on the United States. One reason it would is because most of our competitors have income tax systems that, while more competitive than ours, are not completely competitive.

Understanding what makes a competitive tax system and why ours is not is actually not that hard. I think in an ideal system, each country would tax the business income locally generated at a rate sufficient to pay for roads and education and other things needed to make that a desirable place to do business. And the income would not be taxed again until it was distributed to the individual owners of the enterprise to pay for things that their resident country needed to make it a safe and pleasant place to live.

The reason the U.S. tax system is uncompetitive is very simple. Between the time the income is earned overseas and distributed to the U.S. owners or the foreign owners, we impose an extra level of tax at the U.S. corporate level when that income is brought back to the United States to be distributed to shareholders or invested in the United States. For example, if we pay a lower rate of tax in Ireland on operations there, the United States will impose a tax in the United States equal to the difference between the United States and the foreign tax rate.

What if a foreign operation had lower electricity charges? What if we imposed a charge at the U.S. level on the difference between U.S. electricity rates and foreign electricity rates and the difference

between U.S. labor rates. It is not that hard to understand why the income tax system makes U.S. companies uncompetitive.

This innate uncompetitive feature of the U.S. tax law has been with us from the beginning and has been exacerbated, rather than created, by Subpart F, which requires that this extra level of corporate tax be imposed in many cases even if the income has not been brought back to the United States.

In particular, I would like to focus on the foreign base company rules, which provide that if a foreign subsidiary of a U.S. company conducts sales and services activities outside the country where it is incorporated, the income from that activity is immediately taxed by the United States at whatever the U.S. rate is over the local rate. This is a problem for U.S. companies everywhere, but it is particularly a problem for us in the European Union.

The European Union is a single marketplace. You can be a successful global business without having an operation in Nigeria or Thailand, but you cannot be a global competitor unless you have a substantial, profitable, cutting-edge operation in the European Union. U.S. companies are fiercely competing with European companies to reorganize themselves and structure themselves to take advantage of the common market there. The Subpart F rules which treat an operation that is incorporated in one EU country, but takes place in another EU country, as, in effect, tax-shelter income that must immediately be taxed by the United States, is a very serious impediment to the rationalization of U.S. business in the European Union.

That is why we are, of course, very grateful that Mr. Houghton and Mr. Levin in their bill have asked for a study to identify the consequences of this and to propose solutions. I would say that the business community, almost since Subpart F was enacted, have been complaining and pointing out to the Congress the tremendous competitive disadvantage they suffer in structuring their European operations and taking advantage of European economic integration that this rule has imposed upon them.

So, in closing, I would like to thank the chairman for calling these hearings. This is a very important subject. I am also very interested in the United States staying on top and I hate to see our rules pushing us in any other direction.

[The prepared statement follows:]

Statement of William W. Chip, Chairman, Tax Committee, European-American Business Council, and Principal, Deloitte & Touche LLP

My name is Bill Chip. I am a principal in Deloitte & Touche, an international tax, accounting, and business consulting firm. I have been engaged in international tax practice for 20 years.

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 members is attached. Because the EABC membership includes both US companies with European operations and European companies with U.S. operations, the EABC brings a unique but practical perspective on how the U.S. international tax rules impact the competitiveness of U.S. companies operating in the European Union (EU)—the world's largest marketplace.

The points I would like to make today may be summarized as follows:

1. U.S. international tax rules foster tax neutrality between U.S. companies, but not between U.S. companies and foreign companies.

2. In order for U.S.-parented companies to be truly competitive in a globalized economy, the U.S. should not impose a corporate income tax on income from foreign operations.

3. The enhanced power of the IRS to police transfer pricing has eliminated the most important rationale for the subpart F rules, which should therefore be relaxed.

4. The anticompetitive flaws in the U.S. system cannot be fully corrected without attending to other problems, such as the taxation of dividends with no credit for corporate-level taxes.

5. Certain changes are urgently needed pending more fundamental reforms: (1) the EU should be treated as a single country under the subpart F rules; (2) the U.S. should agree to binding arbitration of transfer pricing disputes; and (3) the rules for allocating interest between U.S. and foreign income should be made economically realistic.

6. Many problems faced by U.S. companies operating internationally cannot be resolved by U.S. tax policy alone, and the U.S. should take the lead in erecting an international tax system that does not impede cross-border business activity.

The EABC welcomes the Chairman's interest in reforming this country's international tax rules. Those rules have always had a negative impact on the ability of U.S. companies to compete overseas. However, this anticompetitive impact has been masked during most of this century by several U.S. business advantages, including the world's largest domestic economy as a base, a commanding technological lead in many industries, and sanctuary from the destruction of two world wars. However, 50 years of peace and the rapid spread of new technologies have leveled these advantages and exposed the anticompetitive thrust of our international tax regime.

I would go so far as to say that the U.S. rules with respect to income produced overseas were written without any regard whatsoever for their impact on competitiveness. Their goal instead was to ensure that any income controlled by a U.S. person was eventually subject to U.S. tax. Thus, income of foreign subsidiaries is taxed at the full U.S. corporate rate when distributed to the U.S. parent (with a credit for any foreign income taxes) and then taxed again (with no credit for either U.S. or foreign income taxes) when distributed to the U.S. shareholders. The imposition of U.S. tax is accelerated when foreign earnings are redeployed from one foreign subsidiary to another and also, under subpart F, when the foreign income is one of the many types that Congress feared could otherwise be "sheltered" in a "tax haven."

These rules do have the effect of neutralizing the impact of foreign taxes on competition between U.S. companies. Because all foreign earnings must eventually bear the full U.S. tax rate, a U.S. company that produces in a low-tax foreign jurisdiction enjoys at most a temporary tax advantage over one that produces in the U.S.. Likewise, because all earnings of U.S. companies eventually bear the same U.S. corporate tax rate, the presence or absence of a shareholder-level credit for corporate taxes is immaterial in a shareholder's decision to invest in one U.S. company rather than in another.

In contrast, the U.S. tax system does not neutralize the impact of taxes on competition between U.S. and foreign companies. At the shareholder level, the absence of a credit for corporate-level taxes favors investments in low-taxed foreign companies over their U.S. equivalents. At the corporate level, if the costs of producing a product, including tax costs, are lower in a foreign country such as Ireland than they are in the U.S., our free trade rules will likely result in U.S. customers purchasing the Irish product rather than the equivalent U.S. product. However, if a U.S. owner of an Irish enterprise must also pay the excess of U.S. over the Irish tax rate, then the Irish enterprise will likely end up being owned by a foreign company whose home country does not tax the Irish earnings, taxes them later, or provides a more liberal foreign tax credit.

These competitive disadvantages are aggravated by business globalization. Owing to the internationalization of capital markets, an ever-larger percentage of U.S. shareholders are able and willing to invest in foreign corporations and mutual funds, impairing the ability of U.S. companies to raise capital for their overseas operations even in the U.S. capital markets. The electronic revolution in communications and computing has also globalized the economic production process. Economic output is increasingly the consequence of coordinated activity in a number of different countries, expanding the range of products impacted by anticompetitive tax rules. If the Irish enterprise in the foregoing example is an integral part of a global activity, U.S. companies may lose the opportunity to sell, not only the Irish product, but also any integral U.S. products.

The U.S. system leads to very anomalous results. Consider a U.S. company with a German and Irish subsidiary, then consider three identical companies, except that

the U.S. and Irish companies are subsidiaries of the German company. The U.S. would never dream of trying to tax the income of the Irish subsidiary in the second case, but in the first case insists on taxing it when the income is repatriated, if not sooner. There is no reason why this should be so. Most countries, like the U.S., have a progressive income tax for individuals and, above a certain level, a virtually flat income tax for corporations. That being the case, there is a reason for imposing shareholder-level taxes on dividends received from local and foreign corporations (although there should be a credit for taxes paid at the corporate level). There is no reason for imposing a local corporate tax on foreign earnings as they make their way from the foreign subsidiary to the ultimate individual shareholders.

Nowhere is the anti-competitive burden imposed by U.S. tax rules more evident and damaging than in the application of the U.S. "subpart F" rules to U.S.-owned enterprises in the EU. The subpart F rules were intended to prevent U.S. companies from avoiding U.S. 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 U.S. 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 U.S. corporate rate. (If the U.S. corporate tax rate when subpart F was enacted were the benchmark, the U.S. today would itself be considered 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 U.S.-controlled foreign corporations from sales or services to related companies in other jurisdictions. Consider the impact of this rule on a U.S. 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 U.S.-owned or EU-owned, will favor those locations that impose the lowest EU tax burden on the activity. However, if the enterprise is U.S.-owned, the subpart F rules may eliminate any locational tax efficiency by immediately imposing an income tax effectively equal to the excess of the U.S. tax rate over the local tax rate. Thus, U.S. 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 U.S. taxes collected when the earnings are repatriated). It makes as little sense for the U.S. to penalize its companies in this way as it would for the EU to impose a special tax on European companies that based their U.S. sales and service activities in the U.S. States that imposed the least tax on those activities.

The subpart F rules were enacted mostly out of concern that certain types of income could readily be shifted into "tax havens." However, the term tax haven is misleading. Taxes are only one of many costs that enter into the production process and into the decision where to conduct a particular activity. Some countries have low taxes, but others have low labor or energy costs or a favorable climate or location. If an enterprise is actually conducted in a low-tax jurisdiction, it is anticompetitive for the U.S. to impose (let alone accelerate) corporate taxes on the income properly attributable to that enterprise, just as it would be anticompetitive to impose a charge equal to any excess of U.S. over foreign labor or energy costs. The imposition of taxes or other charges that offset the competitive advantage of the foreign enterprise will simply cause the enterprise to be owned by a non-U.S. competitor that does not have subpart F rules.

When subpart F was enacted, Congress seemed to be concerned that U.S. companies might arbitrarily attribute excessive amounts of income to their low-taxed foreign operations. Whether or not such concern was warranted then, it is not warranted now. Since 1994 U.S. companies have been subject to draconian penalties on any substantial failure to price their international transactions at arm's length. Moreover, most of our competitors, and even less developed countries such as Mexico and Brazil, have followed suit and greatly enhanced their enforcement of the arm's length standard. Having endowed the IRS with "weapons of mass destruction" in the field of transfer pricing, Congress can now afford to retire much of the obsolete subpart F armory.

I would be remiss not to acknowledge that the globalization of business poses important challenges to tax administrators in the U.S. and elsewhere. Ever greater shares of the nation's income derives from cross-border activity, while ever increasing integration of cross-border activity makes it harder to determining the source of business income. The IRS and most foreign tax authorities are well aware of

these challenges and are working to surmount them. Indeed, the enhanced attention to transfer pricing is one of the more important and obvious responses to the globalization challenge.

The efforts of the U.S. and other countries to ensure receipt of their "fair share" of global tax revenues through transfer pricing enforcement points also to a need for increased international cooperation. For example, each country is likely to view arm's length transfer pricing as the pricing that maximizes the amount of local income. Hence the need for international mechanisms which ensure that the calculation of national incomes under national transfer pricing policies does not add up to more than 100% of a company's global income. Unfortunately, although all tax treaties provide a mechanism for reaching agreement on transfer pricing, very few require that the countries actually reach agreement, meaning there is no guarantee against double taxation. Even more unfortunately, the U.S. is opposing such requirements. For example, while the EU countries have entered into a convention that requires arbitration of international transfer pricing disputes, the U.S. has declined to exchange the notes that would effectuate the arbitration clauses of the few U.S. tax treaties that have them. For that reason the EABC strongly recommends that the U.S. enter into negotiations with the EU members states to extend the principles of the EU convention to transfer pricing disputes between the U.S. and EU members.

International cooperation does not mean that tax rates should be harmonized or even that the calculation of taxable income should be harmonized. In fact, unharmonized tax rates are a good thing, because tax competition is a useful counterweight to the many pressures on government to increase taxes and spending. For that reason the EABC shares many of the concerns outlined in the response of the Business and Industry Advisory Committee (BIAC) to the report on "Harmful Tax Competition" by the Organization for Economic Cooperation and Development (OECD). There is genuine alarm within the business community that some OECD members are responding in an anticompetitive way to the challenges of globalization. Rather than working cooperatively to construct an international tax system that ensures income is properly attributed to the jurisdiction where it originates and not taxed more than once, some countries seem more interested in maximizing the reach of their tax jurisdiction and capturing any income under the control of companies that are headquartered locally. The efforts of the present U.S. Administration to expand the scope of subpart F by regulation and legislation reflect such an approach and should be rejected by the Congress.

I am worried about a deep and growing divide between the business community and the tax authorities in many industrialized countries on how to manage the fiscal challenges of business globalization. At the EABC's recent Transatlantic Tax Conference, officials of the U.S., EU, and OECD discussed "harmful tax competition" and other current issues with tax leaders from BIAC and from leading U.S. and EU business organizations. EU business was as frustrated with the inability of the EU member states to eliminate obstacles to cross-border business integration and dividend/royalty payments as was U.S. business with IRS Notices 98–11 and 98–35. All business representatives were concerned that the OECD seemed less intent on eliminating tax obstacles to an efficient international economy than on attempting to freeze in place existing revenue sources.

The EABC welcomes attention by the U.S. Congress to how the U.S. tax system impacts business decisionmaking and is ready to work with your Committee to identify urgently needed reforms.

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VNU Business Information Svcs., Inc.
Volkswagen
Volvo Corporation
White Consolidated, Inc.
Xerox Corporation
Zeneca Inc.

Chairman ARCHER. Thank you, Mr. Chip. With the indulgence of the other witnesses, we are going to have to go across the street and vote. There will also be another 5-minute vote. It will probably be somewhere between 10 and 15 minutes before we get back. The Committee will stand in recess until then.

[Recess.]

Chairman ARCHER. The Committee will come to order. Mr. Laitinen, would you give us your testimony?

STATEMENT OF WILLIAM H. LAITINEN, ASSISTANT GENERAL TAX COUNSEL, GENERAL MOTORS CORPORATION, DETROIT, MICHIGAN

Mr. LAITINEN. Thank you, Mr. Chairman. My name is Bill Laitinen. I am Assistant General Tax Counsel for General Motors Corporation.

I am testifying today on behalf of a coalition of U.S. multinational companies that are severely penalized by a particular aspect of the U.S. tax law affecting international operations, that is, the rules regarding the allocation of interest expense between U.S. source and foreign source income for purposes of determining the foreign tax credits a U.S. taxpayer may claim for taxes it pays to a foreign country.

I would like to express our appreciation to the Chairman and the Members of the Committee for holding this hearing and for the opportunity to testify on the vitally important issue of the impact of U.S. tax rules on the international competitiveness of U.S. workers and businesses. Also, I would like to commend Representative Houghton and Representative Levin on the introduction of their important international simplification bill.

My testimony today will focus exclusively on the distortive and anti-competitive impact of the current interest allocation rules and the pressing need to reform these rules.

The United States taxes U.S. persons on their worldwide income, but allows a credit against U.S. tax for foreign taxes paid on income earned abroad. In order to determine the foreign tax credits that may be claimed, taxpayers must allocate expenses between U.S. source and foreign source income. Special rules enacted in the Tax Reform Act of 1986 require that U.S. interest expense be allocated to a U.S. multinational group's investment and its foreign subsidiaries. Although the rules purport to reflect a principle of fungibility of money, in fact, they ignore the interest expense actually incurred by the foreign subsidiaries. This one-way street approach to fungibility is a gross economic distortion.

The interest allocation rules cause a disproportionate amount of U.S. interest expense to be allocated to foreign source income. This overallocation of U.S. interest expense reduces the group's capacity to claim foreign tax credits for the taxes it pays to foreign countries. Of course, the U.S. interest expense so allocated is not deductible for foreign tax purposes and, therefore, does not result in any reduction in the foreign taxes a multinational group actually pays. Thus, the ultimate distortion caused by the interest allocation rules is the double-taxation of foreign income earned by the U.S. multinational group.

This double-taxation represents a significant cost for U.S. multinationals, a cost not borne by their foreign competitors. This increased cost makes it more difficult for U.S. multinationals to compete in the global marketplace. When a U.S. multinational considers a foreign expansion or acquisition, it must factor into its projections the double taxation caused by the interest allocation rules. A foreign competitor considering the same expansion or acquisition can do so without this added cost.

Not only do the interest allocation rules impose a cost that makes it more difficult for U.S. multinationals to compete in overseas markets, the rules actually put U.S. multinationals at a competitive disadvantage in making U.S. investments. When a U.S. multinational incurs debt to make an additional investment in the United States, a portion of the interest expense on that debt is allocated to foreign source income. In effect, the U.S. multinational is denied a current deduction for that portion of the interest expense.

A foreign corporation that makes the same investment in the United States will not be impacted by these interest allocation rules. Thus the foreign corporation making an investment in the United States will face lower costs than a U.S. multinational making the same investment in this country. Under the interest allocation rules, U.S. multinationals can't even compete on a level playingfield when they are the home team.

There is no tax policy rationale that supports the distortion caused by the current rules. The interest allocation rules must be reformed to eliminate these distortions. First, the interest allocation rules should take into account all the interest expense incurred by the multinational group, that is, both United States and foreign interest expense. Second, debt incurred by a subsidiary member of the group based on its own credit should be allocated separately, taking into account only the assets of that member and its subsidiaries. Finally, financial services entities, which borrow

on their own credit rather than that of the group, should be treated as a separate group.

These important reforms to the interest allocation rules are embodied in H.R. 2270, which was introduced recently by Representative Portman and Representative Matsui. The interest allocation rules reflected in H.R. 2270 eliminate the distortions caused by the current rules, thereby allowing the foreign tax credit to achieve its fundamental purpose, which is to eliminate double taxation of income earned abroad.

In closing, I respectfully urge the Committee to enact the reforms reflected in H.R. 2270. Reform of the interest allocation rules is critical to ensuring the ability of U.S. multinationals to compete with their foreign counterparts, both abroad and in the United States. Thank you.

[The prepared statement follows:]

Statement of William H. Laitinen, Assistant General Tax Counsel, General Motors Corporation, Detroit, Michigan

I. Introduction

General Motors Corporation appreciates the opportunity to testify before the House Ways and Means Committee on competitiveness issues raised by the international provisions of the U.S. tax laws. Our testimony is submitted on behalf of a coalition of U.S.-based multinational companies that are severely penalized by a particular aspect of the international provisions of the U.S. tax laws: the rules regarding the allocation of interest expense between U.S.-source and foreign-source income for purposes of determining the foreign tax credit a U.S. taxpayer may claim for foreign taxes it pays. Our testimony specifically focuses on the distortive and anti-competitive impact of the present-law interest allocation rules, which were enacted with the Tax Reform Act of 1986, and the pressing need for reform of these rules.

The present-law interest allocation rules penalize U.S. multinationals by artificially restricting the foreign tax credits they may claim. By improperly denying a credit for foreign taxes paid by U.S. multinationals on the income they earn abroad, the rules result in double taxation of such income. This double taxation is contrary to fundamental principles of international taxation and imposes on U.S.-based multinationals a significant cost that is not borne by their competitors.

We respectfully urge the Ways and Means Committee to consider legislation to reform the interest allocation rules. Such reforms are embodied in H.R. 2270, which was introduced recently by Representative Portman and Representative Matsui. As we explain in this testimony, interest allocation reform is necessary in order to reflect the fundamental tax policy goal of avoiding double taxation and to eliminate the competitive disadvantage at which the present-law interest allocation rules place U.S.-based multinationals.

II. Present-Law Interest Allocation Rules

The United States taxes its corporations, citizens and residents on their worldwide income, without regard to whether such income is earned in the United States or abroad. In order to avoid having the same dollar of income subjected to tax both by the United States and by the country in which it is earned, the United States allows U.S. persons to claim a credit against U.S. taxes for the foreign taxes paid with respect to foreign-source income. The U.S. tax laws have allowed such a foreign tax credit since the Revenue Act of 1918.

The purpose of preventing double taxation requires allowing foreign taxes paid by a U.S. person as a credit against the potential U.S. tax liability with respect to the income earned by such person abroad. However, foreign taxes are not allowed as a credit against the U.S. tax liability with respect to income earned in the United States. Accordingly, the foreign tax credit limitation applies to limit the use of such credits to offset only the U.S. tax on foreign-source income and not the U.S. tax on U.S.-source income.

In order to compute the foreign tax credit limitation, the U.S. taxpayer must determine its taxable income from foreign sources. This determination requires the allocation and apportionment of expenses and other deductions between U.S.-source

gross income and foreign-source gross income. Deductions that are allocated to foreign-source income for U.S. tax purposes have the effect of reducing the taxpayer's foreign tax credit limitation, thus reducing the amount of foreign taxes that may be used to offset the taxpayer's potential U.S. tax on income earned from foreign sources.

Special rules enacted with the Tax Reform Act of 1986 apply for purposes of determining the allocation of interest expense between U.S.-source income and foreign-source income. Interest expense generally is allocated based on the relative amounts of U.S. assets and foreign assets. The rules enacted with the 1986 Act generally require that interest expense be allocated by treating all the U.S. members of an affiliated group of corporations as a single corporation. Accordingly, the interest allocation computation is done by taking into account all the interest expense incurred by all the U.S. members of the group on a group-wide basis. Moreover, such interest expense is allocated based on the aggregate amounts of U.S. and foreign assets of all such U.S. members of the affiliated group on a group-wide basis.

Under the 1986 Act provisions, the group for interest allocation purposes includes only the U.S. corporations in a multinational group of corporations and does not include foreign corporations that are part of the same multinational group. Under this approach, the interest expense incurred by the foreign subsidiaries in the multinational group is not taken into account in the allocation determination. Moreover, the assets of the foreign subsidiaries are not taken into account in determining the aggregate U.S. and foreign assets of the group. Rather, the stock of the foreign subsidiaries is treated as a foreign asset held by the group for purposes of allocating the interest expense of the U.S. members of the group between U.S. and foreign assets.

Special rules apply to certain banks that are members of the affiliated group. Under these rules, banks are not included in the group for interest allocation purposes. Instead, such banks are treated as a separate group and the interest allocation rules are applied separately to such group.

In addition, the regulations apply more specific tracing rules to allocate interest expense in certain situations. A tracing approach applies to the allocation of interest expense incurred with respect to certain nonrecourse indebtedness. Such an approach also applies to the allocation of interest expense incurred in connection with certain integrated financial transactions.

III. Impact of the Present-Law Interest Allocation Rules

The present-law interest allocation rules purport to reflect a principle of fungibility of money, with interest expense treated as attributable to all the activities and assets of the U.S. members of a group regardless of the specific purpose for which the debt is incurred. However, the approach adopted with the 1986 Act does not truly reflect the fungibility principle because it applies fungibility only in one direction. Under this approach, the interest expense incurred by the U.S. members of an affiliated group is treated as funding all the activities and assets of such group, including the activities and assets of the foreign corporations in the same multinational group. However, in this calculation, the interest expense actually incurred by the foreign corporations in the group is ignored. Thus, under the present-law interest allocation rules, the interest expense incurred by the foreign corporations in a multinational group is not recognized as funding either the foreign corporation's own activities and assets or any of the activities and assets of other group members. This one-way street approach to fungibility is a gross economic distortion.

The distortive impact of the present-law interest allocation rules can be illustrated with a simple example. Consider a U.S. parent with a single foreign subsidiary. The two corporations are of equal size and are equally leveraged. Thus, the total assets of the two corporations are equal and the interest expense incurred by the two corporations is equal. The U.S. parent's assets (other than the stock of the foreign subsidiary) are all U.S. assets and the foreign subsidiary's assets are all foreign assets. Under the present-law interest allocation rules, only the interest expense of the U.S. parent would be taken into account. This interest expense is allocated based on only the U.S. parent's assets, taking into account the stock of the foreign subsidiary as a foreign asset of the U.S. parent. Thus, in this case, one-half of the U.S. parent's assets are U.S. assets and one-half are foreign assets. Accordingly, one-half of the U.S. parent's interest expense is allocated to the foreign assets (i.e., the stock of the foreign subsidiary). However, the foreign subsidiary itself has incurred interest expense equal to that of the U.S. parent and representing a leverage ratio equal to that of the U.S. parent. From an economic perspective, none of the U.S. parent's interest expense in this example should be treated as supporting the activities or assets of the foreign subsidiary. The allocation of a portion of the

U.S. parent's interest expense to foreign assets represents a double-counting of the interest expense that is treated as relating to foreign assets. Indeed, in this case, three-quarters of the group's interest expense (i.e., one-half of the U.S. parent's interest expense plus all of the foreign subsidiary's interest expense which is disregarded under the interest allocation rules) effectively is treated as relating to the foreign subsidiary, even though its assets represent only one-half of the group's assets. There is absolutely no economic basis for this result -it is an obvious distortion.

By disregarding the interest expense of the foreign members of a multinational group, the approach reflected in the present-law interest allocation rules causes a disproportionate amount of U.S. interest expense to be allocated to the foreign assets of the group. This over-allocation of U.S. interest expense to foreign assets has the effect of reducing the amount of the multinational group's income that is treated as foreign-source income for U.S. tax purposes, which in turn reduces the group's foreign tax credit limitation. This reduction in the foreign tax credit limitation has the effect of reducing the amount of the group's foreign taxes that can be used to offset its potential U.S. tax liability on its foreign-source income. Of course, the U.S. interest expense that is allocated to foreign assets under the interest allocation rules is not deductible for foreign tax purposes and therefore such allocation does not result in any reduction in the foreign taxes the multinational group actually pays. The allocation merely reduces the amount of such taxes paid that may be used as a credit against the potential U.S. tax liability with respect to the same foreign-source income. Thus, the ultimate result of the distortion caused by the present-law interest allocation rules is double taxation of the foreign income earned by the U.S. multinational group.

The double taxation that results from the present-law interest allocation rules represents a significant cost for U.S.-based multinationals, a cost not borne by their foreign competitors. This increased cost makes it more difficult for U.S. multinationals to compete in the global marketplace. When a U.S. multinational considers a foreign expansion or acquisition, it must factor into its projections the fact that the additional foreign asset will result in an additional allocation to foreign-source income of the interest expense incurred by the multinational group in the United States. An additional allocation will result as the expansion or acquisition generates earnings even if the expansion or acquisition is fully supported by borrowing incurred outside the United States. The resulting additional allocation of U.S. interest expense will exacerbate the double taxation to which the U.S.-based multinational is subject. A foreign-based corporation considering the same expansion or acquisition can do so without this cost that arises from the distortion in the U.S. tax rules.

Not only do the interest allocation rules impose a cost that makes it more difficult for U.S. multinationals to compete with their foreign counterparts with respect to foreign operations, the rules actually operate to put U.S. multinationals at a competitive disadvantage with respect to investments in the United States. This impact of the interest allocation rules is especially troubling. When a U.S.-based multinational makes an additional investment in the United States and finances that investment with debt, a portion of the interest expense incurred with respect to that debt is treated as relating to its foreign subsidiaries, even if the foreign subsidiaries are themselves leveraged to the same extent as the U.S. members of the group. Thus, the U.S. multinational effectively is denied a deduction for a portion of the interest expense on the additional debt incurred to fund the U.S. acquisition. A foreign corporation that makes the same acquisition in the United States and finances it with the same amount of debt will not be impacted by these interest allocation rules and will be entitled to a deduction for U.S. tax purposes for the full amount of the interest expense related to the acquisition. Thus, the foreign corporation considering an investment in the United States will face lower costs than a U.S.-based multinational considering the same investment in the United States.

IV. Proposed Reform of the Interest Allocation Rules

The interest allocation rules enacted with the Tax Reform Act of 1986 were intended to eliminate the potential for manipulation that arose under the then-applicable separate company approach to interest allocation. The 1986 Act rules requiring interest to be allocated on a group basis addressed that concern. However, by drawing the line for interest allocation at the water's-edge and ignoring the interest expense incurred by the foreign members of a U.S. multinational group, the present-law rules create a fundamental distortion. There is no tax policy rationale that supports the distortion caused by the present-law rules. The interest allocation rules must be reformed to eliminate these distortions and to reflect a defensible result

from a tax policy perspective. Eliminating such distortions will remove a significant barrier to the competitiveness of U.S. multinationals in the global marketplace.

First, interest expense should be allocated consistent with the actual economics of the debt structure of the U.S. multinational group. In order to accurately reflect the principle of fungibility, such principle must be applied on a worldwide basis. Under a worldwide fungibility approach, the foreign-source income of the U.S. multinational group generally would be determined by allocating all interest expense of the worldwide affiliated group on a group-wide basis. The interest allocation computation would take into account both the interest expense of the foreign members of the affiliated group and the assets of such members. Interest expense incurred by a foreign subsidiary thus would reduce the amount of the U.S. interest expense that would be allocated to foreign-source income. This approach would eliminate the double-counting of the amount of interest expense treated as the cost of holding the assets of a foreign subsidiary that occurs under the present-law rules.

Moreover, interest expense should be more specifically allocated where the debt does not fund the entire multinational group. In other words, the principle of fungibility should be applied to a smaller group of companies in cases where the debt is incurred by (and based on the credit of) a member other than the common parent. While debt incurred by one lower-tier member of an affiliated group may be viewed as funding the assets and activities of that corporation and its subsidiaries, such debt does not fund the assets and activities of other members of the group (such as the parent or sister corporations of the borrowing corporation). Thus, it is appropriate to permit the interest expense associated with such debt to be allocated based solely on the assets of the subgroup of corporations that consists of the borrower and its subsidiaries.

Finally, it is appropriate to separate financial services entities -which tend to have debt structures that are very different from the other members of an affiliated group -for purposes of the allocation of interest. This treatment of financial services entities as a separate subgroup is consistent with the present-law rule treating banks as a separate subgroup. However, this expansion of the present-law bank rule recognizes that such treatment should encompass all financial services entities rather than only entities regulated as banks.

These important reforms to the interest allocation rules are embodied in H.R. 2270, the Interest Allocation Reform Act, which was introduced recently by Representative Portman and Representative Matsui. The interest allocation rules reflected in H.R. 2270 eliminate the distortions caused by the present-law rules, facilitating the operation of the foreign tax credit to eliminate double taxation of income earned abroad. Enactment of the reforms reflected in H.R. 2270 is critical to ensuring the ability of U.S.-based multinationals to compete with their foreign counterparts, both with respect to operations abroad and with respect to operations in the United States.

V. Technical Explanation of H.R. 2270

A detailed technical explanation of the provisions of H.R. 2270 is set forth below.

In General

H.R. 2270 would modify the present-law interest allocation rules of section 864(e) that were enacted by the Tax Reform Act of 1986. Under the bill's modifications, interest expense generally would be allocated by applying the principle of fungibility to the taxpayer's worldwide affiliated group (rather than to just the U.S. affiliated group). In addition, under special rules, interest expense incurred by a lower-tier U.S. member of an affiliated group could be allocated by applying the principle of fungibility to the subgroup consisting of the borrower and its direct and indirect subsidiaries. H.R. 2270 also would allow members engaged in the active conduct of a financial services business to be treated as a separate group. Finally, the bill would provide specific regulatory authority for the direct allocation of interest expense in other circumstances where such tracing is appropriate.

Under H.R. 2270, a taxpayer would be able to make a one-time election to apply the modified rules reflected in the bill rather than the interest allocation rules of present law. Such election would be required to be made for the taxpayer's first taxable year to which the bill is applicable and for which it is a member of an affiliated group, and could be revoked only with IRS consent. Such election, if made, would apply to all the members of the affiliated group.

H.R. 2270 generally is not intended to modify the interpretive guidance contained in the regulations under the present-law interest allocation rules that is relevant to the rules reflected in the bill, and such guidance is intended to continue to be applicable.

Worldwide Fungibility

Under H.R. 2270, the taxable income of an affiliated group from sources outside the United States generally would be determined by allocating and apportioning all interest expense of the worldwide affiliated group on a group-wide basis. For this purpose, the worldwide affiliated group would include not only the U.S. members of the affiliated group, but also the foreign corporations that would be eligible to be included in a consolidated return if they were not foreign. Both the interest expense and the assets of all members of the worldwide affiliated group would be taken into account for purposes of the allocation and apportionment of interest expense. Accordingly, interest expense incurred by a foreign subsidiary would be taken into account in determining the initial allocation and apportionment of interest expense to foreign-source income. The interest expense incurred by the foreign subsidiaries would not be deductible on the U.S. consolidated return. Accordingly, the amount of interest expense allocated to foreign-source income on the U.S. consolidated return would be reduced (but not below zero) by the amount of interest expense incurred by the foreign members of the worldwide group, to the extent that such interest would be allocated to foreign sources if these rules were applied separately to a group consisting of just the foreign members of the worldwide affiliated group. As under the present-law rules for affiliated groups, debt between members of the worldwide affiliated group, and stockholdings in group members, would be eliminated for purposes of determining total interest expense of the worldwide affiliated group, computing asset ratios, and computing the reduction in the allocation to foreign-source income for interest expense incurred by a foreign member.

As under the present-law rules, taxpayers would be required to allocate and apportion interest expense on the basis of assets (rather than gross income). Because foreign members would be included in the worldwide affiliated group, the computation would take into account the assets of such foreign members (rather than the stock in such foreign members). For purposes of applying this asset method, as under the present-law rules, if members of the worldwide affiliated group hold at least 10 percent (by vote) of the stock of a corporation (U.S. or foreign) that is not a member of such group, the adjusted basis in such stock would be increased by the earnings and profits that are attributable to such stock and that are accumulated during the period that the members hold such stock. Similarly, the adjusted basis in such stock would be reduced by any deficit in earnings and profits that is attributable to such stock and that arose during such period. However, unlike under the present-law rules, these basis adjustment rules would not be applicable to the stock of the foreign members of the expanded affiliated group (because such members would be included in the group for interest allocation purposes).

Under H.R. 2270, interest expense would be allocated and apportioned based on the assets of the expanded affiliated group. For interest allocation purposes, the affiliated group would be determined under section 1504 but would include life insurance companies without regard to whether such companies are covered by an election under section 1504(c)(2) to include them in the affiliated group under section 1504. This definition of affiliated group would be the starting point for the expanded affiliated group. In addition, the expanded affiliated group would include section 936 companies (which are included in the group for interest allocation purposes under present law). The expanded affiliated group also would include foreign corporations that would be included in the affiliated group under section 1504 if they were domestic corporations; consistent with the present-law exclusion of DISCs from the affiliated group, FSCs would not be included in the expanded affiliated group.

Subgroup Election

H.R. 2270 also provides a special method for the allocation and apportionment of interest expense with respect to certain debt incurred by members of an affiliated group below the top tier. Under this method, interest expense attributable to qualified debt incurred by a U.S. member of an affiliated group could be allocated and apportioned by looking just to the subgroup consisting of the borrower and its direct and indirect subsidiaries (including foreign subsidiaries). Debt would qualify for this purpose if it is a borrowing from an unrelated person that is not guaranteed or otherwise directly supported by any other corporation within the worldwide affiliated group (other than another member of such subgroup). Debt that does not qualify because of such a guarantee (or other direct support) would be treated as debt of the guarantor (or, if the guarantor is not in the same chain of corporations as the borrower, as debt of the common parent of the guarantor and the borrower). If this subgroup method is elected by any member of an affiliated group, it would be required to be applied to the interest expense attributable to all qualified debt of all U.S. members of the group.

When this subgroup method is used, certain transfers from one U.S. member of the affiliated group to another would be treated as reducing the amount of qualified debt. If a U.S. member with qualified debt makes dividend or other distributions in a taxable year to another member of the affiliated group that exceed the greater of its average annual dividend (as a percentage of current earnings and profits) during the five preceding years or 25 percent of its average annual earnings and profits for such period, an amount of its qualified debt equal to such excess would be recharacterized as nonqualified. A similar rule would apply to the extent that a U.S. member with qualified debt deals with a related party on a basis that is not arm's length. Interest attributable to any debt that is recharacterized as nonqualified would be allocated and apportioned by looking to the entire worldwide affiliated group (rather than to the subgroup).

If this subgroup method is used, an equalization rule would apply to the allocation and apportionment of interest expense of members of the affiliated group that is attributable to nonqualified debt. Such interest expense would be allocated and apportioned first to foreign sources to the extent necessary to achieve (to the extent possible) the allocation and apportionment that would have resulted had the subgroup method not been applied.

Financial Services Group Election

Under H.R. 2270, a modified and expanded version of the special bank group rule of present law would apply. Under this election, the allocation and apportionment of interest expense could be determined separately for the subgroup of the expanded affiliated group that consists solely of members that are predominantly engaged in the active conduct of a banking, insurance, financing or similar business. For this purpose, the determination of whether a member is predominantly so engaged would be made under rules similar to the rules of section 904(d)(2)(C) and the regulations thereunder (relating to the determination of income in the financial services basket for foreign tax credit purposes). Accordingly, a member would be considered to be predominantly engaged in the active conduct of a banking, insurance, financing, or similar business if at least 80 percent of its gross income is active financing income as described in Treas. Reg. sec. 1. 904–4(e)(2). As under the subgroup rule, certain transfers of funds from a U.S. member of the financial services group to another member of the affiliated group that is not a member of the financial services group would reduce the interest expense that is allocated and apportioned based on the financial services group. Also as under the subgroup rule, if elected, this rule would apply to all members that are considered to be predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.

IV. CONCLUSION

The present-law interest allocation rules operate to deny U.S. multinationals foreign tax credits for the taxes they pay to foreign jurisdictions. The rules thus subject U.S. multinationals to double taxation of their income earned abroad. This double taxation represents a burden on U.S.-based multinationals that hinders their ability to compete against their foreign counterparts. Indeed, the distortions caused by the interest allocation rules impose a substantial cost that affects the ability of U.S.-based multinationals to compete against foreign companies both with respect to foreign operations and with respect to their operations in the United States.

H.R. 2270 would reform the interest allocation rules to eliminate these rules. The interest allocation rules reflected in H.R. 2270 represent sound tax policy and are consistent with the goal of eliminating double taxation. Such rules would allow the foreign tax credit limitation to operate properly. We respectfully urge the Congress to enact the reforms reflected in H.R. 2270 in order to eliminate the unfair, anticompetitive, and indefensible burden that the present-law interest allocation rules have imposed on U.S. multinationals for the last thirteen years.

Chairman ARCHER. Thank you, Mr. Laitinen. Mr. Hamod, you may proceed.

STATEMENT OF DAVID HAMOD, EXECUTIVE DIRECTOR, SECTION 911 COALITION

Mr. HAMOD. Thank you, Mr. Chairman, for the opportunity to testify today. My name is David Hamod, and I serve as the Executive Director of the section 911 Coalition. Our Coalition consists of business organizations, non-profit entities, and companies that have come together in recent years to call attention to the importance of the Section 911 foreign earned income exclusion. The Coalition has some 75 members, including representatives of the more than 75 American chambers of commerce around the world and nearly 550 American and international schools abroad.

On a personal note, Mr. Chairman, Americans around the world want to thank you for your consistent support for American communities overseas. No one in Congress during the past two decades has been a more outspoken advocate for, or more tenacious defender of, the foreign earned income exclusion and the jobs that it helps to create here in the United States.

Mr. Chairman, if I were to take this 23-page testimony and boil it down to just a few words, they would be these: Americans abroad = U.S. exports = U.S. jobs. Any businessowner will tell you that to generate business, you have got to put your sales people into the field. Experience shows that Americans abroad are the best salesmen and best saleswomen for U.S. goods and services overseas. They drive U.S. exports, which, in turn, generate U.S. jobs. We know that Americans abroad *buy* American, *sell* American, *specify* American, *hire* American, and *create other business opportunities* for Americans overseas.

Despite the obvious importance of employing Americans overseas, U.S. tax policy puts American workers abroad and their employers at a significant competitive disadvantage. The United States is the only major industrial country in the world that taxes on the basis of citizenship rather than residence. Because this U.S. tax policy is out of step with the rest of the world, American workers are significantly more expensive to hire than are comparably qualified foreign nationals. As a result, the trend worldwide is to replace American workers with less expensive third-country nationals, particularly Europeans.

In the continuing battle for international market share, Section 911 has proved to be one of the most important weapons in America's trade arsenal because this exclusion: (1) makes U.S. citizens working overseas more competitive with foreign nationals, who pay no tax on their overseas earned income; (2) makes American companies more competitive in their bids on overseas projects; and, (3) helps to put Americans into the field overseas where they promote U.S. goods and services and create hundreds of thousands of jobs here in the United States.

In 1995, the section 911 Coalition commissioned two independent studies that reinforced the long-held view that section 911 is especially important to the little guy overseas: small and medium-sized companies, American educators, clergy, NGOs and others. Summaries of these studies are attached to this testimony, but two key points bear repeating this afternoon. First, nearly two-thirds of small and large companies said their competitive advantage would

improve if the exclusion were increased from $70,000 to at least $100,000 back in 1995.

Second, without Section 911, there would be a decline in U.S. exports of almost 2 percent. This translates into $8.7 billion in lost exports and a loss of upward of 150,000 direct U.S.-based jobs. These figures do not include service-related jobs or indirect employment, which would probably double the number of jobs lost.

Mr. Chairman, I have good news and I have bad news. First, the good news is that 2 years ago, under your leadership, the Ways and Means Committee and Congress helped to temporarily shore up Section 911 through the Taxpayer Relief Act of 1997.

The *bad* news, as this chart illustrates, is that the Section 911 exclusion continues to lose ground. According to Pricewaterhouse-Coopers, the 1999 exclusion amount in real dollars is 45 percent below its level in 1983, when the exclusion topped out at $80,000. The real value of the exclusion is projected to continue falling after 1999 and is expected to stabilize in the year 2007 at approximately $65,150 in 1999 dollars.

Looked at from a purchasing power point of view, the value of the exclusion will have plummeted in real dollars from $134,197 back in 1983 to $65,150 in 2007, a devastating loss of nearly $70,000 in 1999 dollars. The exclusion was $80,000 in 1983; it will again be $80,000 in 2008, 25 years later. And as we all know, Mr. Chairman, $80,000 today doesn't buy what it did a quarter-century ago.

In the long-run, Congress should remove the limitation on the Section 911 exclusion. But in the short-term, the Coalition is proposing an interim step designed to restore value to the exclusion that has been eroded over the years as a result of inflation. We recommend that the foreign earned income exclusion be adjusted, beginning in calendar year 2000, to compensate for the effects of inflation since 1983, when the exclusion was frozen at $80,000. This indexation would help to stop the deterioration of Section 911 and it would also be consistent with the inflation adjustments made in many other dollar amounts in the individual income tax system.

In conclusion, Mr. Chairman, as you yourself have said, our work is not yet done. We hope that the Committee will look favorably upon our proposal. It represents a small investment that we believe will position the United States to compete in the 21st century and yield billions of dollars worth of dividends to the U.S. economy in the years ahead. Thank you, Mr. Chairman, for the opportunity to testify today.

[The prepared statement follows:]

Statement of David Hamod, Executive Director, Section 911 Coalition

Thank you, Mr. Chairman, for the opportunity to testify today. My name is David Hamod, and I serve as Executive Director of the Section 911 Coalition. Our coalition consists of business organizations, non-profit entities, and companies that have come together in recent years to call attention to the importance of the Section 911 foreign earned income exclusion. The Coalition has some 75 members, including representatives of more than 75 American chambers of commerce overseas and nearly 550 American and international schools abroad. (A list of Section 911 Coalition members is attached to this testimony as Appendix A.)

In recent years, the stock market notwithstanding, exports have been the most impressive engine of growth for America's economy. It goes without saying that exports don't just happen by themselves. Independent studies and raw statistical data show a direct correlation between the number of Americans working overseas and

the level of U.S. exports. Any business owner will tell you that to generate business, you've got to put your sales people in the field. Experience shows that Americans abroad are the best salesmen and saleswomen for U.S. goods and services overseas. The bottom line, Mr. Chairman, is this:

Americans Abroad = U.S. Exports = U.S. Jobs.

In the ongoing battle for international market share, the Section 911 exclusion has proved to be one of the most important weapons in America's trade arsenal. By helping to maintain U.S. citizens "in the field" around the world, where they promote America's national interests on a daily basis, Section 911 has had a direct impact on the competitiveness of American workers and U.S. companies operating in foreign markets.

Two years ago, the Ways and Means Committee responded very positively to an initiative by Americans worldwide to increase the foreign earned income exclusion. Under your leadership, Mr. Chairman, the Committee (and ultimately, Congress) increased Section 911 by $2,000 per year, leveling off at $80,000 in calendar year 2002. Beginning in calendar year 2008, the $80,000 exclusion will also be adjusted for inflation for 2008 and subsequent years.

We are very grateful for this increase, which has helped to shore up temporarily the backsliding that the foreign earned income exclusion has experienced for more than a decade. But as you have said yourself, Mr. Chairman, our work is not yet done. The changes of two years ago represent an important step in the right direction, but U.S. companies overseas and American workers abroad must continue to make their case to Congress to level the international business playing field for the United States.

Even with the positive changes enacted under the Taxpayer Relief Act of 1997, the Section 911 exclusion continues to lose ground. According to PricewaterhouseCoopers LLP, the 1999 exclusion amount, in real dollars, is 45 percent below its level in 1983 ($80,000 in nominal dollars and $134,197 in 1999 dollars), following passage of the Economic Recovery Tax Act of 1981. The real value of the exclusion is projected to continue falling after 1999 and is expected to stabilize in the year 2007 at approximately $65,150 in 1999 dollars. Looked at from a "purchasing power" point of view, the value of the exclusion will have plummeted in real dollars from $134,197 (1983) to $65,150 (2007), a devastating loss of nearly $70,000 in 1999 dollars. Under these circumstances, Mr. Chairman, the Section 911 Coalition is very concerned about "locking in" indexation of the exclusion at an unacceptable level from the year 2008 onwards. (A copy of the June 28, 1999 report by PricewaterhouseCoopers LLP—*The Effect of Inflation on the Foreign Earned Income Exclusion Amount*—is attached to this testimony as Appendix B.)

Ideally, Congress should remove the limitations on the Section 911 exclusion in order to give American workers an equal footing in the global marketplace. None of America's major trade competitors tax foreign earned income, and the U.S. should also move to an unlimited exclusion. (The only countries that tax on the basis of citizenship rather than residence, like the United States, appear to be Bulgaria, Gabon, Honduras, Indonesia, Jamaica, Kenya, Korea, Philippines, Senegal, and Zambia.) Reinstating the unlimited exclusion today would be a forward-looking measure and would do more to move the United States toward a consistent foreign trade surplus than would many other proposals under consideration by Congress.

We realize, however, that removing the cap on the foreign earned income exclusion may not be possible at a time when Congress is grappling with so many major budgetary considerations. This is especially true because under the current revenue estimating procedure, the unlimited exclusion, in the short-term, would somewhat curtail tax revenues. Our Coalition would argue, however, that in the medium-term and long-term, net revenue gains would be substantial and would more than compensate for short-term losses.

With this in mind, Mr. Chairman, the Section 911 Coalition proposes an interim measure for the Committee's consideration. This step is designed to restore value to the exclusion that has been eroded over the years as a result of inflation.

We propose that the foreign earned income exclusion be adjusted, beginning in calendar year 2000, to compensate for the effects of inflation since 1983, when the Deficit Reduction Act of 1984 froze the exclusion at $80,000. This indexation would help to stop the deterioration of Section 911, and it would also be consistent with the inflation adjustments made in many other dollar amounts in the individual income tax system—the standard deduction, personal exemption, tax bracket amounts, earned income credit, phase-out of itemized deductions and personal exemptions, and so on.

Enactment of this measure would represent an important step forward for U.S. companies and American workers overseas. Our Coalition believes that by making

American workers more affordable in the global marketplace, Congress would pave the way for more U.S. citizens overseas to buy American, sell American, specify American, hire American, and create opportunities for other Americans abroad. In short, this measure represents a relatively small investment that will position the United States to compete in the twenty-first century and yield billions of dollars worth of dividends to the U.S. economy in the years ahead.

1. SECTION 911: THE BIG PICTURE

Section 911 provides for a foreign earned income exclusion of up to $74,000 annually to Americans working overseas, thereby assisting them to compete against comparably qualified non-Americans (who pay no taxes on income earned abroad). A U.S. citizen or resident alien whose tax home is outside the United States and who is a bona fide resident of a foreign country or who is present in a foreign country for 11 months out of 12 (330 days in any 365 day period) may exclude from gross income up to $74,000 per year of foreign earned income, plus a housing cost amount.

The foreign earned income exclusion has been part of the Internal Revenue Code since 1926, when it was unlimited for bona fide residents of a foreign country. (For a short history of the foreign earned income exclusion, see Appendix C.) Congress enacted the exclusion more than 70 years ago in an effort to "encourage citizens to go abroad and to place them in an equal position with citizens of other countries going abroad who are not taxed by their own countries." (Senate Report No. 781, 82nd Congress, 1st Session, 1951, pp. 52–53.)

America's trade competitors realized long ago that encouraging their citizens to work overseas has a pronounced, salutary impact on their domestic economies. Sending their workers abroad has become an integral part of these nations' export strategies. To facilitate this "export" of their citizens (and thus the export of products and services), other governments do not tax their citizens on the money they make while working abroad. This makes these citizens extremely competitive in foreign markets.

U.S. Government tax policies, by contrast, have generally discouraged Americans from working abroad. Alone among the world's industrialized nations, the United States still taxes its citizens on the basis of citizenship rather than residence. Further, overseas Americans must also pay U.S. income tax on benefits, allowances, and overseas adjustments. The practical effects of this tax policy are clear: Americans overseas are at a significant competitive disadvantage and are being priced out of foreign markets because prospective employers must provide more income to compensate American workers for these additional tax burdens.

Overseas employers are faced with a choice: They must pay an American worker more than they would pay other comparably qualified nationals (so that the American may keep a comparable after-tax income) or they must utilize a tax equalization program to keep the employee whole for his or her additional tax burden. Both approaches involve additional costs to the employer—a burden that many employers are unwilling to accept even if the American worker is more productive and has better professional qualifications than the competition.

For those companies that have a tax equalization program in place, where the company pays any actual taxes for its overseas employees, the Section 911 exclusion helps to mitigate the tax burden mentioned above—thereby cutting company costs and enabling it to be more competitive abroad. For companies that do not utilize a tax equalization program—and most small and medium-sized companies working overseas fall into this category—the Section 911 exclusion is most helpful to the employee, who is responsible for paying his own taxes. The current exclusion helps to make a difference in both cases, but the difference may still not be substantial enough to enable an American worker overseas to defend his or her job against foreign nationals.

The cost of hiring or maintaining an American worker is inordinately high because non-salary, quality-of-life items must be included in the worker's taxable income, often adding as much as 50 – 100 percent of base pay. Such "income" includes reimbursement for the cost of children's schooling, cost-of-living allowances, home leave, emergency travel, and other necessary and often expensive aspects of living overseas. Because so many overseas contracts today are decided on the basis of cost, and when companies' profit margins grow tighter and tighter, many employers (including American employers) simply aren't prepared to cover the additional tax burden to "Hire American."

A Section 911 Coalition member offered this case in point:

> A large American company recently won a multi-billion dollar, multi-year overseas contract to supply telecommunications equipment and services. The U.S.-based company would prefer to have Americans heading its overseas oper-

ations but, because the U.S. tax system effectively prices Americans out of the international job market, the company tends to hire Europeans instead. The President of this company's international operations is British, and his Vice President is Dutch. Not surprisingly, the Human Resources Director, who answers to the Vice President, is also from Holland. He has hired approximately 2,000 technical employees for this project, most of whom are Dutch. In addition, Volvos were purchased instead of U.S.-made vehicles because they are considered "more suitable" for the technical employees. If the U.S. tax system were more like those of America's trade competitors, who maintain an unlimited foreign earned income exclusion, most of these 2,000+ jobs would have gone to Americans rather than Europeans, and a large number of American cars would have been exported and purchased instead of Volvos.

Section 911 is important because it makes a substantial difference in our nation's efforts to compete on the international business playing field. Without this exclusion, there is good reason to believe that many thousands of Americans currently overseas would be priced out of the global marketplace. This would be a devastating blow to America's national interests because Americans abroad:

- Direct business and jobs to the United States;
- Carry America's culture and business ethic to other nations;
- Specify and purchase U.S. goods and services for overseas projects;
- Set standards and shape ideas that guide future policies in the development of infrastructures and economies overseas.

In addition, for U.S. companies to continue expanding their market share worldwide, they must think and act globally. To stay competitive internationally, American managers need the kind of "hands on" experience that can only be gained by living and working abroad. In recent years, for example, two of the traditional Big Three automobile companies promoted their CEOs directly from European positions to corporate headquarters. This clearly demonstrates recognition by these companies of the role that international experience plays in their economic futures.

In short, Mr. Chairman, Section 911 helps to protect against replacement of Americans abroad by third country nationals who pay no taxes at all on their overseas income. Given the tens of thousands of overseas business opportunities that are of interest to U.S. companies and U.S.-based institutions each year, increasing the Section 911 exclusion stands to make a substantial difference for American influence abroad, U.S. exports, U.S. jobs, and overall American competitiveness.

2. WHO BENEFITS FROM SECTION 911?

The loss of U.S. market share and the cutback in American jobs overseas represent a setback for American competitiveness. However, this tells only part of the story. The other part, of more immediate concern here at home, is the impact felt in communities all across the United States as jobs created or sustained by exports would disappear.

All Americans abroad, whatever their background, are helping to fuel the economy in the United States. By securing employment overseas, they free up jobs for other Americans back home, thereby reducing unemployment. They also support the American economy by repatriating much of their overseas earnings back to the United States. Most important of all, perhaps, Americans working overseas serve as the front-line marketing and sales force for U.S. exports. Unless all Americans support competitiveness through exports, our nation's trade deficit will surely continue. I noted earlier that exports are the engine of growth for the U.S. economy, and it is generally accepted that small and medium-sized companies provide the fuel for this engine. When the engine of growth is stalled out by constrictive U.S. tax laws that are no longer appropriate, Americans everywhere pay the price.

For years, supporters of Section 911 have emphasized that the exclusion is especially important to small and medium-sized companies operating in overseas markets. "Real world" experience has borne out that:

(1) Small companies, when trying to gain a foothold overseas, are more likely than large companies (many with an established overseas presence already) to draw on U.S.-based personnel to penetrate foreign markets.

(2) Small and medium-sized companies, because they lack the world-class name recognition that might provide them with open access to foreign customers, traditionally rely very heavily on Americans overseas to specify and purchase their products.

(3) Small and medium-sized companies are, by necessity, much more sensitive to individual cost elements and the financial bottom line. Without the $74,000 Section 911 exclusion to help make overseas Americans more competitive with foreign na-

tionals, relatively few of these small and medium-sized companies would be able to hire Americans to fill overseas slots.

In 1995, the Section 911 Coalition commissioned two independent studies to look at the impact of the foreign earned income exclusion on U.S. business. (A one-page summary of each study is attached to this testimony as Appendices D and E.) One study was conducted by Price Waterhouse LLP (Economic Analysis of the Foreign Earned Income Exclusion), while the other was undertaken by professors at The Johns Hopkins University School of Advanced International Studies—SAIS (The Importance of Section 911 for U.S. International Competitiveness). Both studies reinforced the long-held view that Section 911 is especially important to the "little guy" trying to do business overseas. (This also applies to American schools abroad, whose efforts to provide educational services overseas have played an instrumental role in promoting an American lifestyle and U.S. products.) The studies indicated that:

- For small and medium-sized companies (0–500 employees), elimination of the Section 911 exclusion would have a significant impact on the ability of American workers abroad to keep their jobs. In a survey conducted by the SAIS professors for the Section 911 Coalition, nearly two-thirds (64 percent) of small and medium-sized respondents said elimination of Section 911 would result in a "moderate" change (6 to 25 percent) or a "major" change (above 25 percent) in their ability to retain American employees overseas. (In the same survey, 70 percent of large companies said elimination of Section 911 would result in some job loss change, and 38 percent said this change would be a moderate or major change.)
- For small and medium-sized companies, elimination of Section 911 would have an even greater impact on prospective U.S. citizen hires that would be lost or substituted with foreign nationals. Eighty-five percent of these companies said elimination of Section 911 would result in a moderate or major change in their future hiring practices. (For small and medium-sized companies responding to the survey, 32 percent of their total overseas employees are U.S. nationals.) Fifty-four percent of the large companies said elimination of Section 911 would result in a moderate or major change in their future hiring practices.
- For small and medium-sized companies, elimination of Section 911 would have a substantial impact on these companies' abilities to secure projects or compete abroad. Eighty-two percent of these companies said the loss of this exclusion would result in a moderate or major change in their ability to secure projects or compete abroad. (The equivalent number for large companies was 64 percent.)
- For small and large companies alike, there was widespread agreement that increasing the exclusion from $70,000 (in 1995) to $100,000 would have a substantive impact on their ability to secure projects. Sixty-five percent of respondents said their competitive advantage would improve, with 38 percent stating that the improvement would be moderate or major.
- For small and medium-sized companies, U.S. nationals employed abroad are far more likely to source their imports of goods and services from the United States. Eighty-nine percent of these companies said there is a tendency to source American, with 76 percent stating that this is a "large tendency." (The equivalent number for large companies was 77 percent and 46 percent, respectively. This is especially meaningful because U.S. multinational corporations accounted in 1995 for 58 percent of U.S. exports and that almost half of that trade was between parent companies and affiliates, according to the March 1995 "Survey of Current Business.") Seventy-seven percent of all respondents (small and large) made it clear that U.S. citizens abroad "Buy American" and that more than two-thirds of these found a "large tendency" to source U.S. goods and services.
- With regard to compensation levels, the benefits of Section 911 are more important for lower-paid Americans abroad (such as employees of small companies, educators, NGOs and non-profit organizations) than for higher-paid Americans abroad. If Section 911 had been eliminated in 1993, employers would have needed to increase compensation by 12.7 percent to protect the after-tax income of U.S. expatriates at the lower end of the income scale (base pay of $12,720 per year). At the other end of the scale, for those with a base pay of $152,640 per year, compensation would have needed to increase by an average of only 6.8 percent.

This latter finding reinforces a 1993 U.S. Treasury Department study which noted that Section 911 is an important mechanism for mitigating the tax liability of lower income taxpayers working abroad. (U.S. Department of the Treasury, Taxation of Americans Working Overseas—Operation of the Foreign Earned Income Exclusion in 1987, January 1993.) These facts do not support the negative "spin" that some would put on the foreign earned income exclusion—the wrongheaded suggestion that the exclusion benefits only the so-called corporate "fat cats."

It is also important to note, however, that more senior (and consequently more expensive) managers working overseas tend to be best positioned to benefit the U.S.

economy most. The senior managers are more likely to influence the buying and hiring decisions of their company, and they are also more likely to assist other U.S. companies trying to do business abroad. In addition, they are the ones most apt to gain the international experience required by future senior executives for American companies looking to compete successfully in the increasingly global economy.

Nevertheless, it is often very difficult to persuade key employees to adjust their career paths and family situations by leaving corporate headquarters and the United States. And from the companies' perspective, despite the many advantages of hiring American peak performers to head overseas offices, current tax policies tend to make this option prohibitively expensive.

3. Nuts and Bolts: How Section 911 Works

The cost of hiring an American varies widely around the world depending on such factors as local housing costs, local standards of living, availability of schools and recreation facilities, remoteness and hardships, and so forth. Nevertheless, it may be instructive to look at a typical example of how the foreign earned income exclusion works. The American Business Council of the Gulf Countries, an Executive Committee member of the Section 911 Coalition, provided the following example.

> The cost for a grade school student to attend the American School in Dubai is approximately $10,000 per year—not for an exclusive private school, but for the only American curriculum school there. If an employer reimburses this cost for two children, the employee has an additional $20,000 of imputed taxable "income." This places an additional tax burden on the individual of up to $8,000.
>
> If the employer chooses to make the reimbursement of this schooling cost tax-neutral to the employee, the total reimbursement cost to the company could exceed $33,000 (including the compounding effect of tax reimbursements, which are also considered taxable "income" to the employee). This represents a $13,000 (65 percent) additional cost to the company to provide education for the American employee's children (compared to providing the same education for children of a comparable European employee)—simply because of U.S. tax policy.
>
> If the employer provides an annual trip back to the United States for home leave for the employee and family (spouse and two children), the employee has an additional $10,000 or more of taxable "income." Emergency and sympathy travel generate taxable income; cost of living adjustments are considered taxable income; hardship allowances are taxable income; tax reimbursement is taxable income.

In other words, as this typical example shows, taxable compensation that does not represent either "perks" or disposable income to the employee typically absorbs a very large part of the current $74,000 exclusion. This is a burden borne solely by Americans, significantly hampering their ability to compete in the international arena.

The National Constructors Association, another member of the Coalition's Executive Committee, asked one of its member companies in recent years to compare the annual costs of employing an engineer with and without the benefit of Section 911. The results of this comparison are striking:

	Hong Kong	United Kingdom	Saudi Arabia	Chile
Engineer's Base Pay	$112,800	$100,000	$121,824	$100,000
Tax Cost to Company with 911 Exclusion	$11,743	$34,275	$11,433	$4,843
Tax Cost to Company without 911 Exclusion	$103,513	$51,151	$66,019	$27,413
Increased Tax Cost to Company	$91,770	$16,876*	$54,586	$22,570*

*In high tax countries, these savings may not be typical but may be realized in certain dual-contract situations. It should also be noted that the tax burden shown above includes taxes on allowances.

While the Section 911 exclusion is particularly helpful in low-tax foreign jurisdictions like Saudi Arabia and Hong Kong, it can also make a very substantial difference in those nations with relatively high levels of individual income tax. Filings of Internal Revenue Service Form 2555 provide an adequate measure of those Americans abroad utilizing the Section 911 exclusion. According to IRS figures, nearly two-thirds (61.8 percent) of Forms 2555 filed in 1987 were submitted by Americans in just 15 nations. (Internal Revenue Service, SOI Bulletin, Winter 1992–93, p. 86.)

The vast majority of these nations—led by Germany and the United Kingdom, with Canada and Japan not far behind—are considered relatively high-tax jurisdictions. This was consistent with the 1995 Price Waterhouse LLP findings which note that, absent Section 911, required compensation would increase by an average of 8.6 percent in Australia, 8.0 percent in Japan, 5.4 percent in Switzerland, 4.5 percent in France, 3.3 percent in Canada, and 3.1 percent in Germany (In Economic Analysis of the Foreign Earned Income Exclusion, Price Waterhouse LLP calculated the average change in compensation required if Section 911 were repealed for all expatriates at all income levels in each of the 15 nations.)

According to the Price Waterhouse LLP study, Section 911 can be beneficial in high-tax countries for a number of often overlooked reasons, including:

- Countries with very high statutory rates may have generous deductions and exclusions that result in relatively low tax liability, particularly for taxpayers at modest income levels;
- International assignments often begin or end at mid-year, resulting in little foreign income tax liability in the year of assignment and/or return;
- Unlike the foreign tax credit, Section 911 may cause U.S. source income of Americans working abroad to be taxed in lower U.S. income tax brackets.

In short, no matter where in the world U.S. companies and American citizens work, the Section 911 exclusion can make a substantial difference for U.S. competitiveness.

4. Voices from Abroad: Americans Speak Out on Section 911

By their very presence overseas, U.S. citizens help to promote America's national interests. This is true of all Americans abroad—whether they are representatives of major U.S. corporations, cultural or religious institutions, service providers, educators, entrepreneurs, heads of charitable organizations, or homemakers. Americans abroad foster a positive image of the United States throughout the world while also contributing to our nation's economic and cultural well-being at home.

Based on 1995 survey feedback received by professors at The Johns Hopkins University (SAIS), Americans who use the foreign earned income exclusion come from all walks of life and can be found in all parts of the globe. From these expatriates' comments, a sampling of which are provided below, it is also clear that Section 911 makes a substantial difference in the lives of Americans abroad.

> "When I first arrived here, Americans from our firm in the U.S. totaled 90 percent of our professional staff. As time progressed, because of the high cost of the tax equalization program, we first changed to hiring local Americans [those not recruited from the United States] and some foreign nationals. Each year as the cost of Americans increased (the reduction to $70,000 exclusion really hurt) we have slowly reduced our American percentage to today's 28 percent. These professionals not only 'buy American' for our company needs, but as consultants to local businesses also recommend American products to foreign companies. Without U.S. taxes overseas, we would double the number of Americans employed."
>
> "In 1988 when I joined [Company X] our U.S. imports were 0. Since starting our major import program in 1991 we are now (1994) importing over 120 containers of U.S. product annually plus air freight delivery of U.S. produce and beef on a weekly basis."
>
> "Without the tax exclusion, we would not be able to attract U.S. citizens to work at our school and they would be replaced by locally hired Mexican nationals. U.S. textbooks and supplies would probably be discontinued and Spanish materials would be used in their place."
>
> "It becomes very obvious to me around October of each year when the physicians submit their budget requests to me how nationality affects one's thinking. The American (or American trained) physicians will request U.S. manufactured supplies, equipment and pharmaceutical items. Likewise the Germans, British and French physicians request those that they are more familiar with."
>
> "As we are strictly tuition based, an increase in personnel costs is directly reflected in the cost of tuition. In the past we have chosen to hire less expensive teachers from other countries. If we raise tuition, many companies will not send families to Korea. American businesses need a high quality school in Seoul in order to convince their best people to come. Were we to lose our Section 911 it would have a serious impact on the competitiveness of other American businesses in Korea."

"If the exclusion is lost, the company will probably lose the American management it prides itself on and turn to Saudis or British nationals. If this happens, the odds of Americans ever working for this company again will be nil."

"Under [President] Carter, the tax exclusion was eliminated, U.S. companies pulled out of many foreign locations (or greatly reduced their expatriate contingent) and U.S. overseas schools suffered tremendous enrollment/revenue losses. The losses were compensated by increasing host country populations in the schools, an effect which is still felt today, particularly in Latin America."

"We constantly hear it clearly stated by business people here that they would not be here if they did not have access to an American educational program. During the last draw down of the exclusion in the late seventies, the availability of teachers willing to come overseas to work dropped significantly. They saw no advantage to being overseas."

"Elimination of the Section 911 exclusion and even the current limitation dictates that we recruit on a cost-effective basis; i.e., lower cost nationalities due to tax advantages. This will be particularly true for our smelter project in [country X] which requires an expatriate staff of about 185. Projections are that between 60–80 percent will be TCNs [third-country nationals]."

"Administering an overseas school in 1980 in Bangladesh when the foreign earned income exclusion was taken away, I observed first hand the impact on American business, especially on the construction industry. I was building a new school at the time for $4,000,000, half of which was financed by the U.S. government. There were 2 bidders: a U.S. company and a Korean company. The Americans lost the contract on price, and the difference was the tax on U.S. personnel! . . . It was proven back then that abolishing the 911 exemption cost money: it didn't gain a dime. Have we learned nothing from experience?"

The Section 911 Coalition believes that having Americans overseas is not just helpful, it is essential. In effect, taxation of foreign earned income amounts to a shortsighted, indirect tax on U.S. exports and American culture. This is a debilitating and entirely self-inflicted wound—a policy which discriminates against America's companies, U.S. workers, and American educational institutions abroad.

5. Tax Policy Implications of Section 911

The concept of a foreign earned income exclusion has been part of U.S. tax law for more than 70 years. During that time, the exclusion has undergone a number of configurations. The debate over whether to increase Section 911, decrease Section 911, or maintain it at current levels centers on an evaluation of basic tax policy rationale for and implications of such an exclusion.

The results of the 1995 Price Waterhouse LLP study suggest that the traditional standards for evaluating income tax provisions—fairness and economic efficiency—justify exclusion of the portion of foreign earned income attributable to the additional costs of living abroad. The Section 911 exclusion is an approximate method for meeting the equity and efficiency standards and also satisfies a third tax policy objective: simplicity.

Fairness—Price Waterhouse LLP noted that the concept of "ability to pay" taxes is inherently subjective, but that it has generally been recognized that an individual's costs associated with earning income reduce the ability to pay taxes and should be deducted. By this logic, individuals on international assignment should not be taxed on that part of their compensation which reasonably reflects the added costs of working abroad (extra housing costs, the education of children, home leave, cost-of-living adjustments, etc.).

Economic Efficiency—This standard dictates that the tax law not interfere with the efficient allocation of resources. Economic efficiency suggests that in foreign markets, American workers should be allowed to compete according to prevailing rules. Absent Section 911, Price Waterhouse LLP found, the tax law would frequently discourage U.S. companies from hiring Americans in overseas positions, causing foreign nationals to be hired even where Americans would, but for taxes, be preferred.

Simplicity—By all accounts, the Section 911 exclusion simplifies deductions revolving around doing business overseas, especially when compared to the 1978 rules that the current exclusion replaced.

Three additional tax policy standards are often used to evaluate U.S. tax provisions that affect international income: competitiveness, harmonization, and protection of the U.S. tax base. Once again, Price Waterhouse LLP found that the Section 911 exclusion clearly meets these standards.

International competitiveness—This standard requires that U.S. capital and labor employed in foreign markets bear the same tax burden as foreign capital and labor in those markets. Price Waterhouse LLP noted that for Americans abroad,

> "the competitiveness standard would be achieved if the United States excluded all foreign earned income without the $70,000 limitation in present law. In this way, Americans working abroad would be subject only to foreign income taxes on their foreign earned income in exactly the same manner as foreign workers are taxed."

Harmonization—Price Waterhouse LLP pointed out that Section 911 provides a "glaring example of the failure on the part of the United States to harmonize with international tax practice. As noted by the General Accounting Office, the United States is the only major industrial power that taxes its individuals on the basis of citizenship rather than residence. In today's global economy . . . the failure of the United States to harmonize the tax treatment of expatriate workers means that U.S. citizens are more expensive to employ abroad than citizens of many other industrial nations. In summary, the principle of tax harmonization strongly argues for complete exclusion of foreign earned income" as was the case in the United States during the period 1926–1952.

Protecting the U.S. Tax Base—This standard is intended to prevent U.S. source income from escaping the income tax net. The Section 911 exclusion does not undermine the U.S. tax base because the exclusion has been carefully designed to prevent U.S. source income from escaping U.S. taxation.

In summary, according to the Price Waterhouse LLP study, "an unlimited foreign earned income exclusion would be consistent with the international tax policy standards of competitiveness, preservation of the U.S. tax base, and harmonization. Thus it would be appropriate to lift the . . . cap on the foreign earned income exclusion to better achieve these tax policy objectives."

6. CONCLUSION: INCREASING SECTION 911 = INCREASING BUSINESS AND JOBS

As I noted at the outset of my remarks today, Americans Abroad = U.S. Exports = U.S. Jobs. Perhaps more than any other provision of law, Section 911 helps to put U.S. citizens "in the field" around the world where they buy American, sell American, specify American, hire American, and create opportunities for other Americans. As such, Section 911 has a direct impact on the competitiveness of American workers and U.S. companies operating in foreign markets—a substantial growth area for the United States as we move into the twenty-first century.

To help place America on a more level footing with our trade competitors, the Section 911 Coalition encourages Congress to adjust the foreign earned income exclusion, beginning in calendar year 2000, to compensate for the effects of inflation since 1983, when the exclusion was frozen at $80,000. This will not make American workers and companies as competitive as an unlimited exclusion would, but it is certainly an important step in the right direction. U.S.-based jobs are on the line, especially for small and medium-sized businesses, and we look forward to an opportunity to work with the Ways and Means Committee to strengthen Section 911 -an unheralded but vital part of the U.S. tax code.

Thank you, Mr. Chairman, for the opportunity to testify today. I would be pleased to answer any questions that you or the Committee might have.

APPENDIX A

Section 911 Coalition Members

American Business Council of the Gulf Countries
American Citizens Abroad
American Consulting Engineers Council
American Express
American Institute of Architects
American International School of Budapest
Asia Pacific Council of American Chambers of Commerce
Ass'n of American Chambers of Commerce in Latin America
Association of Americans Resident Overseas
BDM International, Inc.
Baker Hughes, Inc.
Bechtel Group, Inc.
Booz-Allen & Hamilton Arabia
Brown and Root/ Halliburton
COLSA International
CRSS—Metcalf & Eddy Joint Venture
Caltex Petroleum Corporation
Caterpillar, Inc.
Chicago Bridge & Iron Company

Chrysler Technologies Corp.—Middle East Ltd.
Coalition for Employment through Exports, Inc.
Coopers & Lybrand L.L.P.
Culligan Italiana SpA
Cummins Engine Company, Inc.
Deloitte & Touche LLP
Democrats Abroad
Dillingham Construction International, Inc.
Dresser Industries, Inc.
Economic Strategy Institute Employee Relocation Council
European Council of American Chambers of Commerce
FMC Arabia Ltd.
Federated League of Americans Around the Globe
Federation of American Women's Clubs Overseas
Fluor Corporation
Foster Wheeler
Hoechst Celanese Corporation
Hughes Saudi Arabia Ltd.
Intercom International Consultants
Int'l Engineering & Construction Industries Council
International School of Islamabad
International School of Tanganyika
International Schools Services
J.A. Jones Construction
John Brown Constructors
Juraid & Company
Lockheed Middle East Services
Loral Corporation
M.W. Kellogg Company
Mansour General Dynamics Ltd.
McDonnell Douglas Middle East Ltd.
Middle East Policy Council
National Constructors Association
Occidental Petroleum Corporation
Oracle Corporation
Parsons Brinckerhoff
Parsons Corporation
Republicans Abroad
Saudi American Bank
Saudi Arabian International School—Dhahran
Saudi Arabian International School—Riyadh
Science Applications International Corporation
Small Business Exporters Association
Sogerep, Ltd.
Stafford & Paulsworth
Stone & Webster, Inc.
U.S. Chamber of Commerce
United Technologies
Unocal Corporation
Verdala International Schools
Vinnell Corporation—Saudi Arabia
Vinnell Corporation—U.S.A.
Westinghouse Electric Corporation
World Federation of Americans Abroad

APPENDIX B

The Effect of Inflation on the Foreign Earned Income Exclusion Amount

INTRODUCTION

This report updates information on the effect of inflation on the real value of the foreign earned income exclusion amount, which was originally included in an October 1995 report (entitled Economic Analysis of the Foreign Earned Income Exclusion) prepared by Price Waterhouse LLP for The Section 911 Coalition.

Under the provisions of Section 911 of the Internal Revenue Code, a U.S. citizen or resident alien whose tax home is outside the United States, and who meets a foreign residence or foreign presence test, may exclude from gross income in 1999 up to $74,000 per year of foreign earned income plus a housing cost amount. Historically, the principal rationale for the exclusion has been to make the tax treatment of Americans working abroad more competitive with that of foreign nationals and, thereby, to promote exports of U.S. goods and services.

HISTORY OF THE FOREIGN EARNED INCOME EXCLUSION

The foreign earned income exclusion originally was enacted in 1926 to help promote U.S. exports. From 1926 to 1952, the exclusion was unlimited, corresponding to the present day practice of other major industrial countries. From 1953 to 1977, the exclusion was limited to $20,000 per year; however, for Americans working abroad for more than three years, the exclusion was increased to $35,000 from 1962 to 1964 and subsequently reduced to $25,000 from 1965 to 1977.

In 1978, the Foreign Earned Income Act replaced the Section 911 exclusion with Section 913, a series of deductions for certain excess costs of living abroad.

The Economic Recovery Tax Act of 1981 restored Section 911 and increased the exclusion to $75,000 in 1982 with scheduled increases to $95,000 in 1986. The legislative history indicates that Congress was concerned that the rules enacted in 1978 made it more expensive to hire Americans abroad compared to foreign nationals, reduced U.S. exports, rendered the United States less competitive abroad, and due to

the complexity, the new rules required many Americans employed abroad to use professional tax preparers.

Among a number of other deficit reduction measures, the Deficit Reduction Act of 1984 delayed the scheduled increases in the foreign earned income exclusion, freezing the benefit at $80,000 through 1987. The Tax Reform Act of 1986 reduced the exclusion to $70,000 beginning in 1987. The exclusion remained at this level through 1997.

PRESENT LAW

The Taxpayer Relief Act of 1997 increased the $70,000 exclusion to $80,000 in increments of $2,000 beginning in 1998. The following table shows the exclusion amounts specified by the Act.

Table 1.—Present Law Section 911 Exclusion Amounts

Calendar Year	Exclusion Amount
1998	$72,000
1999	$74,000
2000	$76,000
2001	$78,000
2002–2007	$80,000
2008 and thereafter	$80,000 adjusted for inflation

As noted in the table, beginning in 2008 the $80,000 exclusion for foreign earned income will be adjusted for inflation. Thus, for any calendar year after 2007, the exclusion amount will be equal to $80,000 times the cost-of-living adjustment for that calendar year. The cost-of-living adjustment will be calculated using the methodology that adjusts the income brackets in the tax rate schedules (Section 1(f)(3) of the Internal Revenue Code). The Consumer Price Index for all urban consumers (CPI-U) that is published by the Department of Labor will be used to determine the adjustment. Specifically, the cost-of-living adjustment for a calendar year will equal the CPI-U for the preceding calendar year divided by the CPI-U for calendar year 2006 (the base year). The Internal Revenue Code further specifies that, in making this calculation, the CPI-U for a calendar year is to be calculated as the average of the CPI-U as of the close of the 12-month period ending on August 31 of such calendar year. Finally, the Taxpayer Relief Act of 1997 stipulates that if the adjusted exclusion amount is not a multiple of $100, then it is to be rounded to the next lowest multiple of $100.

For this report, we have estimated the inflation-adjusted exclusion amounts for 2008 and 2009 to be $82,000 and $84,200, respectively. These estimates assume that the CPI-U will increase by 2.6 percent annually beginning in calendar year 2000. This assumption is based on the Congressional Budget Office's (CBO) most recent published economic projections (The Economic and Budget Outlook: Fiscal Years 2000–2009, January 1999, Table 1.4).

EFFECT OF INFLATION

Figure 1 shows the exclusion amount in both nominal and real (1999) dollars. The nominal dollar line shows the exclusion amounts specified by legislation. The effect of the Taxpayer Relief Act of 1997 is shown starting in 1998 when the exclusion amount begins to increase in $2,000 increments from the $70,000 amount established by the Tax Reform Act of 1986. In 2002, the exclusion amount reaches $80,000 and remains at that level until 2008 when the exclusion amount begins to be adjusted for inflation.

As illustrated in Figure 1, the real value of the exclusion has dropped substantially. In real 1999 dollars, the 1999 exclusion amount of $74,000 is 45 percent below its level in 1983 ($134,197 in 1999 dollars) when the nominal dollar amount of the exclusion ($80,000) reached its highest level after the 1981 Act.

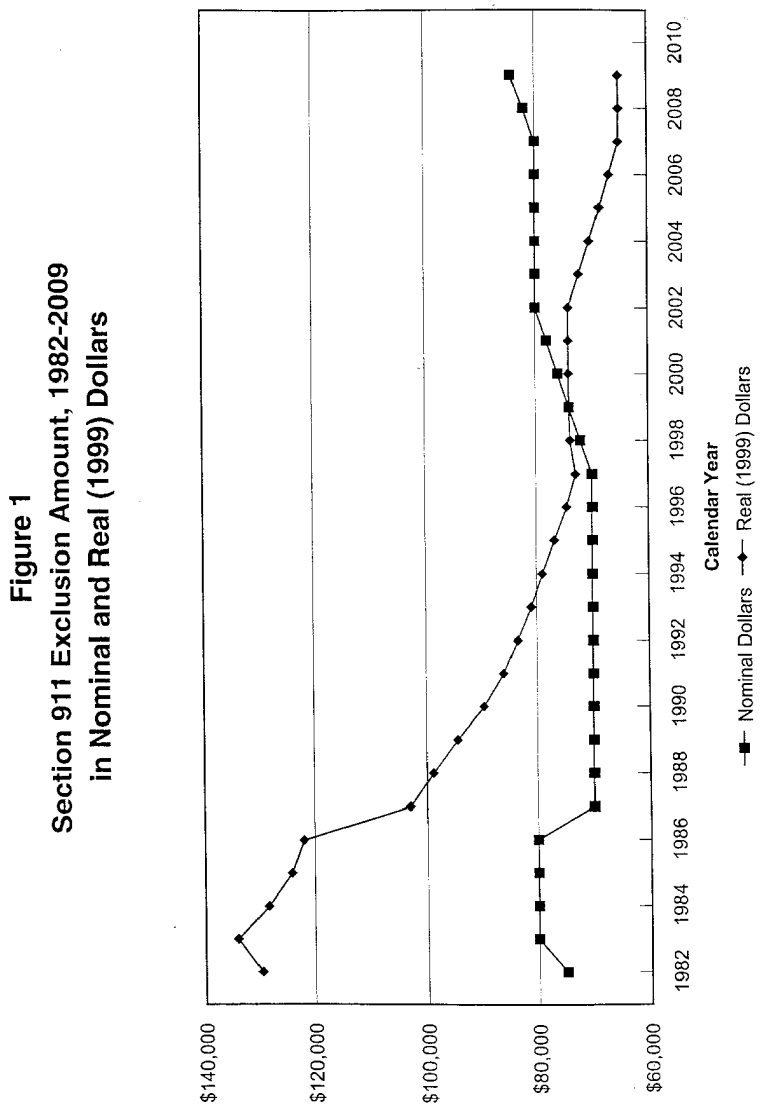
Figure 1 also shows that the real value of the exemption is projected to continue to fall after 1999, even though the Taxpayer Relief Act of 1997 eventually will raise the exclusion amount to $80,000.

The provision to adjust the exclusion amount for inflation will stabilize the real value of the exclusion amount beginning in 2008. Based on the CBO's projection that consumer prices will be 2.5 percent higher in 1999 than they were in 1998 and that annual price increases will amount to 2.6 percent thereafter, the value of the exclusion amount will stabilize at approximately $65,150 in 1999 dollars—an

amount that is 12 percent below the current exclusion amount in real terms and 51 percent below the 1983 peak as measured in 1999 dollars.

CONCLUSION

Since the Section 911 exclusion amount has not been automatically indexed for inflation in the way that the Internal Revenue Code adjusts the income tax tables and other dollar amounts, the real value of the exclusion has dropped substantially. If the $80,000 exclusion that was in effect in 1983 had been continually adjusted for inflation, the exclusion would be approximately $134,000 in 1999. Based on current CBO projections of inflation, the exclusion amount in the year 2000 would be nearly $138,000.



APPENDIX C

The Foreign Earned Income Exclusion

A SHORT HISTORY

The foreign earned income exclusion has been part of the Internal Revenue Code since 1926, when it was unlimited for bona fide residents of a foreign country. Congress enacted the exclusion more than 70 years ago in an effort to "encourage citizens to go abroad and to place them in an equal position with citizens of other countries going abroad who are not taxed by their own countries." (Senate Report No. 781, 82nd Congress, 1st Session, 1951, pp. 52–53.)

Limiting the foreign earned income exclusion is a concept that goes back to 1953, when Congress first capped the exclusion. In the immediate aftermath of World War II, there may have been a good reason for limiting the exclusion. However, times have changed dramatically since the 1950s, when the U.S. economy was a global colossus with no serious competition, and U.S. tax policy has not kept pace with the changing times.

In 1978, the Foreign Earned Income Act replaced the exclusion with a series of deductions for certain expenses associated with living abroad (former Section 913). American workers and U.S. companies in overseas markets were hit hard by the 1978 amendments and lost considerable overseas market share as a result. Recognizing this, Congress in 1981 restored the flat earned income exclusion (Section 911) at $75,000 per year for 1982 with scheduled increases to $95,000 in 1986. Noting that the rules enacted in 1978 reduced exports, Congress in 1981 "was concerned with the increasing competitive pressures that American businesses faced abroad. The Congress decided that in view of the nation's continuing trade deficits, it is important to allow Americans working overseas to contribute to the effort to keep American business competitive" through Section 911. (Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, JCS–71–81, December 29, 1981, p. 43.)

The exclusion was revisited in 1984 and 1986. The Deficit Reduction Act of 1984 delayed the scheduled increases in the exclusion, freezing the benefit at $80,000 (the 1983 benefit level) through 1987. The Tax Reform Act of 1986 reduced the exclusion to $70,000, and it remained at that level through 1997. The Taxpayer Relief Act of 1997 increased the $70,000 exclusion to $80,000 in increments of $2,000 per year, beginning in 1998. In addition, beginning in the year 2008, the $80,000 exclusion will be adjusted for inflation.

Because the exclusion has not been adjusted for inflation over the years, its real value has dropped substantially. According to a June 28, 1999 report by PricewaterhouseCoopers LLP, the 1999 exclusion amount, in real dollars, is 45 percent below its level in 1983, following passage of the Economic Recovery Tax Act of 1981. (The exclusion in 1983 was $80,000 in nominal dollars and $134,197 in 1999 dollars.) If the $80,000 exclusion that was in effect in 1983 had been continually adjusted for inflation, the exclusion would be approximately $134,000 in 1999, rising to nearly $138,000 in the year 2000.

The real value of the exclusion is projected to continue falling after 1999 and is expected to stabilize in the year 2007 at approximately $65,150 in 1999 dollars. Looked at from a "purchasing power" point of view, the value of the exclusion will have plummeted in real dollars from $134,197 (1983) to $65,150 (2007)—a devastating loss of nearly $70,000 in 1999 dollars.

* * * * *

Many Members of Congress serving today were not witness to the extensive Congressional debates which resulted in the enactment of the exclusion in 1981. As a result, this short history should provide some insights into why the exclusion came about, why it provides a return to the U.S. economy that far exceeds its estimated revenue losses, and why the Section 911 exclusion has such an impact on U.S. business competitiveness overseas.

In the 1970s, in an effort to move away from the foreign earned income exclusion, Congress took steps that proved to be disastrous. The Tax Reform Act of 1976 generally reduced the exclusion to $15,000 per year. While this cut in the exclusion did not take effect in the end, it nevertheless had a "chilling" effect on U.S. companies' efforts to send American workers abroad. A 1978 General Accounting Office (GAO) survey of 183 U.S. companies found that more than 80 percent of these companies felt that reducing the exclusion along the lines of the 1976 Act would result in a

reduction of U.S. exports by at least five percent. (U.S. GAO, Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas, ID–78–13, February 21, 1978.)

Two years after the 1976 Act, the situation went from bad to worse. The Foreign Earned Income Act of 1978 repealed the foreign earned income exclusion and put in its place Section 913, composed of five factors: (1) A cost-of-living deduction based on the differential between U.S. and overseas costs of living; (2) A housing deduction; (3) A deduction for schooling expenses where a U.S.-type school was not within a reasonable commuting distance; (4) A travel expense deduction for an annual round-trip visit to the United States; 5) A deduction for work in a hardship area.

The 1978 Act, compared to prior law, represented a 23 percent reduction in the tax benefit of the exclusion. To determine the impact of this reduction, the GAO conducted a survey in 1980 of 33 key firms in four industries. The GAO found that additional costs attributable to the 1978 Act was a primary reason why these firms had decreased their employment of Americans abroad. The numbers decreased absolutely from 1979 to 1980 in three of the industries and, during the period 1976 to 1980, the relative number of Americans abroad dropped compared to third country nationals. (U.S. GAO, American Employment Abroad Discouraged by U.S. Income Tax Laws, ID–81–29, February 27, 1981.)

As a result of these findings, the 1981 GAO report produced the following recommendation:

> "We believe that the Congress should consider placing Americans working abroad on an income tax basis comparable with that of citizens of competitor countries who generally are not taxed on their foreign earned income."

The GAO went on to say that "complete exclusion or a limited but generous exclusion of foreign earned income for qualifying taxpayers . . . would establish a basis of taxation comparable with that of competitor countries and, at the same time, be relatively simple to administer."

Findings in a 1980 report by Chase Econometrics provided more evidence of the dangers for U.S. competitiveness of restricting the foreign earned income exclusion. As a result of the changes in 1976 and 1978, Chase noted, a significant number of Americans working overseas would be forced to return home. Chase determined that a ten percent drop in Americans overseas would lead to a five percent drop in U.S. exports. The study went on to say that the "drop in U.S. income due to a five percent drop in real exports will raise domestic unemployment by 80,000 [persons] and reduce federal receipts on personal and corporate income taxes by more than $6 billion, many times the value of increased taxes on overseas workers." (Chase Econometrics, Economic Impact of Changing Taxation of U.S. Workers Overseas, June 1980, p. 2.)

The U.S. & Overseas Tax Fairness Committee, an ad hoc group established in the late 1970s to defend the foreign earned income exclusion, noted in 1980 that "of all the current U.S. disincentives that discourage trade, none is easier to eliminate than the U.S. practices of taxing foreign earned income . . . and none will produce faster or more substantial results for our balance of trade." In an effort to show what damage the 1976 and 1978 Acts had done as of 1980, the Committee cited the example of the U.S. construction and engineering industry operating in the Middle East. American companies in this sector "had over ten percent of the construction volume in the Middle East four years ago and now has less than two percent—almost entirely due to the current U.S. tax treatment of overseas Americans," the Committee noted, "and industry is finding it very difficult to recapture its former standing." (U.S. & Overseas Tax Fairness Committee, Press Release, June 16, 1980.)

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The message is as clear today as it was in 1980: Changes in the foreign earned income exclusion generate a substantial and direct impact—positive or negative—on the ability of U.S. companies and American workers to compete in overseas markets.

APPENDIX D

Highlights of the Price Waterhouse Study

"ECONOMIC ANALYSIS OF THE FOREIGN EARNED INCOME EXCLUSION"

Price Waterhouse LLP, in a study prepared in 1995 for the Section 911 Coalition, found that:

- The U.S. is the only major industrial country that does not completely exempt from taxation the foreign earned income of its citizens working abroad.
- Because the Section 911 exclusion is not adjusted for inflation, its real value has dropped by 43 percent since 1982. If the exclusion had been adjusted for inflation since it was set at $70,000 in 1987, the exclusion would rise to over $111,000 in the year 2000. If the exclusion is not indexed for inflation soon, its value will continue to decline.
- Without the Section 911 exclusion, compensation levels for Americans abroad would need to increase by an average of 7.19 percent to preserve after-tax income. Section 911 was shown to provide benefits in both low tax and high tax nations. Moreover, the exclusion represents a larger share of the compensation of low income than of high income Americans working abroad.
- A 7.19 percent increase in required compensation would result in a 2.83 percent decrease in Americans working abroad. Without Section 911, U.S. exports would decline by 1.89 percent or $8.7 billion. This translates into a loss of approximately 143,000 U.S.-based jobs. [N.B.-These figures do not include service-related jobs or indirect employment, which would likely double the number of jobs lost.]
- From a tax policy standpoint, the 911 exclusion meets the traditional standards for evaluating income tax provisions: Fairness—Absent Section 911, Americans working abroad would pay much higher taxes than U.S.-based workers with the same base pay. Economic efficiency—Absent 911, U.S. tax law would discourage U.S. companies from hiring Americans in overseas positions, causing foreign nationals to be hired even where Americans would, but for taxes, be preferred. Simplicity—The current structure of Section 911 was specifically enacted by Congress in 1981 in reaction to the unmanageable complexity of the rules enacted in 1978.
- Section 911 also adheres to three additional tax policy standards often used to evaluate provisions that affect international income: Competitiveness—The competitiveness standard, that U.S. capital and labor employed in foreign markets bear the same tax burden as foreign capital and labor in those markets, would be achieved if the U.S. excluded all foreign earned income (without the current cap). Protecting the U.S. tax base—Section 911 applies only to income that is earned abroad for activities that are performed abroad by individuals who are not residents of the USA. Harmonization—True harmonization with other nations would require an unlimited exclusion, as was in effect in the USA from 1926 to 1952.

APPENDIX E

Section 911 Survey Results are in

SURVEY FINDS EXCLUSION IS ESPECIALLY IMPORTANT TO SMALL & MEDIUM-SIZED COMPANIES

The Section 911 Coalition has announced the findings of its "American Competitiveness Survey." With nearly 150 companies and associations responding to the survey, it represents the largest and most broad-based Section 911 survey ever conducted.

The six-page survey examined the importance of the $70,000 foreign earned income exclusion (under Section 911 of the U.S. Tax Code) and its impact on America's global competitiveness. A report prepared by economists at the Johns Hopkins University School of Advanced International Studies, Drs. Charles Pearson and James Riedel, found that:

- The Section 911 exclusion is especially important to small and medium-sized firms (including International and American schools abroad), which are at least ten times more dependent on Section 911 than are the large firms that were surveyed. Eighty-two percent of small and medium-sized firms said that a loss of the exclusion

would result in a moderate (6 to 25 percent) or major (above 25 percent) change in their ability to compete abroad.

- Nearly two-thirds (65 percent) of respondents felt that their ability to secure projects and compete abroad would be improved if the exclusion ($70,000 in 1995) were raised to $100,000—a long-standing position of Americans resident overseas.
- Americans abroad showed a strong tendency to source goods and services produced in the United States. Seventy-seven percent of respondents said that nationality has an effect on sourcing decisions. Among small and medium-sized firms, the number is even higher: 89 percent said their American expatriate employees prefer to Buy American.
- Compensation costs are significant in determining whether or not to hire U.S. nationals overseas, and the Section 911 exclusion is important in holding down compensation costs. Eighty percent of respondents said elimination of Section 911 would have a moderate or major negative effect on compensation costs, with 66 percent saying elimination of the exclusion would have an important negative impact on future hiring practices.

The survey results strongly suggest that the Section 911 exclusion plays a key role in America's competitiveness and the creation of U.S. jobs through exports. For further information, please contact the Section 911 Coalition.

Chairman ARCHER. Thank you, Mr. Hamod. Mr. Dean, you may proceed.

STATEMENT OF WARREN L. DEAN, JR., PARTNER, THOMPSON COBURN LLP, AND REPRESENTATIVE, SUBPART F SHIPPING COALITION

Mr. DEAN. Good afternoon, Chairman Archer, and distinguished Members of the Committee. On behalf of the Subpart F Shipping Coalition, I commend the Committee for examining U.S. international tax policy and its impact on competitiveness in the U.S. economy.

The Subpart F Shipping Coalition is a group of U.S.-controlled foreign-flag shipping companies that are adversely affected by U.S. international tax policy. They strongly support the Shaw-Jefferson bill, H.R. 265, the Shipping Income Reform Act of 1999, which is pending before the Committee.

Mr. Chairman, I represent the interests of transportation companies engaged in foreign commerce. For the last 10 years, I have also been an adjunct professor in international transportation law in the graduate program of Georgetown University Law Center. I have taught and written extensively on the affects of U.S. tax and regulatory policy on the competitiveness of U.S. enterprise.

To make a long story short, Mr. Chairman, if the United States wants a shipping presence of any kind, U.S. or foreign flag in its foreign commerce, then the application of Subpart F to shipping income has got to go. It is just that simple. Subpart F's affect on the economy is essentially threefold. It erodes the competitiveness of the shipping industry. It effects the results of the worldwide consolidation affecting shipping. And it has an adverse affect on U.S. exports that are carried by that shipping.

Prior to the inclusion of shipping income in Subpart F in 1975, the United States owned approximately 25 percent of the world fleet. That number has declined to 5 percent today and is continuing to fall fast. As U.S.-controlled investment in shipping has declined, so has sealift capability and the Treasury revenues from that income.

The National Foreign Trade Council's recently completed study entitled "The NFTC Foreign Income Project International Tax Policy for the 21st Century" confirms those findings. The study showed that the U.S.-controlled foreign fleet cannot afford to compete effectively in an international market against trading partners that have adopted tax policies and incentives to support their international shipping industries.

Last, the purpose of the inclusion of shipping income in Subpart F has not been achieved. Shipping industry tax revenues decreased from approximately $90 million in the year before 1975 (that's $250 million in today's dollars) that resulted from the voluntary repatriation of dividends from that income—to less than $50 million today.

Further, the application of Subpart F to shipping income has affected the trend in worldwide consolidation in transportation industries. To survive in increasingly competitive international markets, transportation enterprises, like American President Lines, must be able to expand their operations, often through combinations with other carriers. Assuming a suitable foreign flag carrier can be identified, the only question then is the form of the merged entity, whether the U.S. carrier is the acquired or the acquiring company. That decision should be a marketplace decision, even though there are compelling national interests at stake in preserving U.S. control over U.S. flag shipping.

Subpart F's application to foreign-based shipping income of companies like American President Lines ensures that the surviving company cannot be a U.S. taxpayer. If the foreign corporation acquires American President Lines and rationalizes its operations, none of its foreign flag vessels will be subject to U.S. taxation. If, on the other hand, American President Lines were to acquire a foreign company, all of the foreign flag vessels of the combined enterprise would be subject to current U.S. taxes. In cases like the acquisition of American President Lines or the acquisition of Lykes Steamship Co. by a Canadian corporation, those cases demonstrate that Subpart F substantially harms the competitiveness of U.S.-owned foreign-flag shipping, fails to raise revenues, and it adversely affects the national security, and it costs American workers their jobs.

The last thing I want to address is the impact of this tax on our exports. Sir Walter Raleigh once observed that whoever commanded the sea commanded the trade of the world and, hence, the world itself. Subpart F has cost American jobs and export opportunities in related industries as a result of our declining presence in world shipping. U.S. owned and controlled transportation companies are much more likely to identify and promote export opportunities for both related and unrelated U.S. manufacturers and their employees. The fact of the matter is that if we act like isolationists on tax policy, it should be no surprise that the American public is going to turn isolationist on trade policy and reject further liberalization.

Mr. Chairman, we live in the global marketplace with formidable challenges and opportunities. Americans, I believe, are prepared to embrace those challenges, provided Washington doesn't get in the way. We have seen too many Americans recently lose their job in

shipping and other important industries just because poorly conceived tax policies inadvertently dictate that they would lose in this era of worldwide consolidation. In this regard, I refer you to the compelling statement of Crowley American Transport submitted to this Committee on June 24, 1999. If we want to be competitive in world commerce, we must start here in Washington. Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of Warren L. Dean, Jr., Partner, Thompson Coburn LLP, and Representative, Subpart F Shipping Coalition

Good morning, Chairman Archer and distinguished Members of the Committee. On behalf of the Subpart F Shipping Coalition, I commend the Committee for examining U.S. international tax policy and its impact on the competitiveness of the U.S. economy. The coalition appreciates the opportunity to appear before you today.

The Subpart F Shipping Coalition is a group of U.S.-controlled foreign-flag shipping companies that are adversely affected by U.S. international taxation policy. Our members include General Ore International Corporation Limited, Seaboard Marine (a wholly-owned subsidiary of Seaboard Corporation), and Tropical Shipping (a wholly-owned subsidiary of NICOR, Inc.). Our members support the Shaw-Jefferson bill, H.R. 265, which is pending before the Committee, and they are submitting statements on the record in support of that legislation.

Mr. Chairman, I chair the Transportation Group at Thompson Coburn LLP and represent the interests of transportation companies engaged in foreign commerce. For the last ten years I have also been an Adjunct Professor of International Transportation Law in the Graduate Program of Georgetown University Law Center. I have taught and written extensively on the effects of U.S. tax and regulatory policy on the competitiveness of U.S. enterprise. My statement will, therefore, be general and policy-oriented.

At the outset, let me clarify one very important point. Amending Subpart F to reinstate the deferral of foreign-base company shipping income will not adversely affect the competitive position of the remaining subsidized U.S.-flag shipping companies that operate in our foreign commerce. In fact, as reflected in written statements submitted to this Committee, it would substantially improve their ability to compete in foreign commerce, since they also operate foreign-flag vessels.

In sum, if the United States wants a shipping industry of any kind—U.S.-flag or foreign-flag—then the application of Subpart F has got to go. It is just that simple.

* * * * *

My testimony focuses on three key issues that are of great concern to U.S. shipping companies and U.S. manufacturers and exporters. First, I will discuss the impact of U.S. international tax policies on the competitiveness of the U.S. shipping industry. Next, I will describe how the shipping industry's worldwide consolidation has exacerbated this decline. And finally, my testimony will describe the impact that this decline in U.S. shipping capability is having on U.S. exports.

COMPETITIVENESS OF THE U.S. SHIPPING INDUSTRY

International shipping is a highly competitive industry. Foreign-flag operators that are relatively unburdened by direct or indirect national taxes determine its rate structure. Most maritime nations, including those in the European Union, have adopted tax policies that ensure that their operators are able to compete with ships operated under flags of convenience. The United States has taken no such action. Instead, in response to the liberalization of international shipping taxes by the world's great shipping nations, it has increased its taxes. As a result, the United States is no longer a major force in international shipping.

Of course, the tax I am referring to is Subpart F of the Internal Revenue Code, which imposes taxes on U.S.-owned businesses abroad as if they were operating in the United States. Before Subpart F was extended to shipping—it was extended partially in 1975 and fully in 1986—American citizens and corporations owned or controlled more than 25 percent of the world's fleet. Now that figure has slipped to less than 5 percent, and is falling fast. As U.S.-controlled investment in shipping has declined, so have U.S. sealift capability and U.S. Treasury revenues from shipping. This anti-competitive tax regime has also reduced new ship acquisition by U.S.-controlled companies, and it has resulted in U.S. owners becoming minority participants in vessels they once owned and operated.

The National Foreign Trade Council's recently completed study, titled "The NFTC Foreign Income Project: International Tax Policy for the 21st Century," confirms these findings. The study showed that the U.S.-controlled foreign fleet cannot afford to compete effectively in the international market against trading partners that have adopted tax policies and incentives to support their international shipping industries.

Let me give you an example. Assume an American-controlled shipping company needs, for competitive purposes, to offer service between Indonesia and Japan. U.S.-flag services by a U.S. corporation is not an option. The expense of flying crews back and forth alone would be prohibitive. Subpart F, the purpose of which is to prevent tax-motivated earnings through foreign corporations, reaches this transportation service and taxes it more onerously than it would tax U.S.-flag service—even though this transportation is not within any rational definition of U.S. commerce. There is no legitimate tax policy foundation for this absurd result.

Sadly, the U.S. government has gained nothing from extending Subpart F to shipping income. While the tax imposed upon this industry was originally designed to generate revenues, it has cost the U.S. Treasury millions of dollars. Shipping industry tax revenues have decreased from approximately $90 million a year before 1975 ($250 million in today's dollars) to less than $50 million today.

WORLDWIDE CONSOLIDATION

The marketplace for transportation services is increasingly global, as international trade responds to the liberalization of commerce under new multilateral trade agreements. In response, the ocean shipping industry has been consolidating to take advantage of worldwide service networks. These actions are not unique to ocean shipping. The international airline industry is experiencing a comparable evolution.

This worldwide consolidation is leaving the United States with significantly diminished shipping capacity, due in large part to U.S. international tax policy. Take, for example, American President Lines, one of the premier U.S.-flag operators for nearly 150 years with terminal and transportation facilities on the West Coast that are extraordinarily valuable, both economically and militarily. It is also one of the major participants in the Maritime Security Program. American President Lines relies in part on its foreign-flag fleet to compete on a global basis.

To survive in the increasingly competitive international markets, transportation enterprises like American President Lines must be able to expand their operations, often through combinations with other carriers. Assuming a suitable foreign-flag carrier can be identified, the only question then is the form of the merged entity, i.e., whether the U.S. carrier is the acquired or the acquiring company. That decision should be a marketplace decision, even though there are national interests at stake in preserving U.S. control over subsidized U.S.-flag operators.

Subpart F's application to the foreign-base company shipping income of companies like American President Lines ensures that the surviving company cannot be a U.S. taxpayer. If a foreign corporation acquires American President Lines and rationalizes its operations, none of its foreign-flag vessels will be subject to U.S. taxation. If American President Lines were to acquire a foreign company, on the other hand, all of the foreign-flag vessels of the combined enterprise would be subject to U.S. taxes.

In fact, Neptune Orient Lines, a Singapore corporation, acquired American President Lines. As a result, American President Lines' foreign-flag operations are effectively exempt from U.S. taxation. (Singapore does not tax the shipping income of its nationals, whether from Singaporean or non-Singaporean vessels.) The U.S. government has lost in terms of both a potential dividend revenue base and the realization of its taxpayer-subsidized national security objectives.

If our tax laws had been more competitive—meaning the United States had maintained a policy to allow vessels to compete in the tax-free environment that determines the rate structure for international shipping—American President Lines might have acquired Neptune Orient Lines instead. Examples like American President Lines, or the acquisition of Lykes Steamship Co. by a Canadian corporation, demonstrate that Subpart F substantially harms the competitiveness of U.S.-owned foreign-flag shipping, fails to raise revenue to the U.S. Treasury, adversely affects U.S. national security, and costs American workers their jobs.

U.S. EXPORTS

Sir Walter Raleigh once observed that whoever commanded the sea commanded the trade of the world and hence the world itself. More recently, Tom Clancy wrote a novel describing a world eventually dominated by a third-world nation that gained

control of ocean shipping. Simply put, our tax laws effectively prohibit Americans from owning and operating the shipping companies that carry the world's commerce. This means lost tax revenue, diminished presence in international markets, and an increased threat to the nation's economic security.

Subpart F has cost Americans jobs and export opportunities in related industries as well. As the once significant U.S.-owned fleet expatriated to remain competitive, related industries, including insurance brokers, ship management companies, surveyors, ship brokers, technical consultants, and many others who provided services to the maritime industry, followed. Further, Subpart F's application to shipping adversely affects the export opportunities of U.S. enterprises. U.S.-owned and controlled transportation companies are much more likely to identify and promote export opportunities for both related and unrelated U.S. manufacturers and their employees. They are also more likely to offer jobs to American citizens, such as ships' officers, who are not already employed on U.S.-flag shipping. That's how real economic opportunities for Americans are developed and marketed in a global economy.

If we act like isolationists on tax policy, it should be no surprise that the American public may turn isolationist on trade policy by rejecting further liberalization of international trade.

CONCLUSION

The Subpart F Shipping Coalition urges the Committee to level the playing field so that U.S.-shipping companies can once again be viable competitors in the international market. We encourage the Committee to approve H.R. 265, sponsored by Congressmen Shaw and Jefferson. It would restore the competitive opportunities for U.S.-controlled foreign-flag corporations by excluding shipping income from Subpart F. Under the proposed legislation, taxes would be deferred, not exempted, and would eventually be paid into the U.S. Treasury when repatriated.

Mr. Chairman, we live in a global marketplace, with formidable challenges and opportunities. Americans, I believe, are prepared to embrace those challenges—provided Washington doesn't get in the way. We have seen too many Americans recently lose their jobs in shipping, and other important industries, just because poorly conceived tax policies inadvertently dictated that they would lose in this era of worldwide consolidation. In this regard, I refer you to the compelling statement of Crowley American Transport, Inc. submitted to this Committee on June 24, 1999. If we want to be competitive in world commerce, we must start here in Washington.

If Subpart F is not amended, companies like the ones I am representing today will eventually be forced out of business or driven into partnerships with foreign companies, having been weakened over the years by unnecessary tax obligations. We look forward to working with you and the Ways and Means Committee to address this important issue.

Chairman ARCHER. Thank you, Mr. Dean. Mr. Houghton.

Mr. HOUGHTON. Thank you very much, Mr. Chairman. Yes, I would like to ask two or three different questions and whoever would like to respond, I would appreciate that. If you were to take a look—and you probably have been here through some of the other testimony—at all the testimonies that have been given, concentrating on various aspects of the tax law, what is the number one change you would make in the United States international tax laws? If you could pick one thing?

Mr. LAITINEN. Well, I have, obviously, testified on the interest allocation rule and I think that is one of the most egregious examples.

Mr. HOUGHTON. It is important, but is it the most important?

Mr. LAITINEN. Yes, sir. I believe so.

Mr. HOUGHTON. You are a good advocate for your cause. Does anybody else have a comment?

Mr. CONWAY. Mr. Houghton, I would like to suggest that I think the most important change would be if we looked at an alternative,

maybe a territorial system. I think the foreign tax credit system that we put in place when we enacted the income tax system was designed to be a de facto territorial system. We pay tax in the United States and we pay tax outside the United States, but we get a full credit when we brought the money back and we were taxed. And I think what has happened is over the past 25 years since I have been involved in taxes, we have chipped away at that foreign tax credit system and introduced tremendous complexities.

So I think the most important change we could make is to really reconsider what kind of a system we want to have. Half of the OECD member countries have territorial systems, and I think we ought to look at that alternative. So I think that would be the most important change.

Mr. HOUGHTON. Well, now, Mr. Chip, didn't you—I wasn't here for your testimony, but I read it. Didn't you talk a little bit about that in terms of the European Union as one basket?

Mr. CHIP. Yes, sir. I would have to agree, though, with my colleague from General Motors. If you asked the business community at large the one thing, assuming we kept our basic system, that they find the most unconstructive are the interest allocation rules. Although I would say that for those companies that operate in Europe—and I think any company that wants to be a global business nowadays has to have a strong European presence—being able to treat the European Union as a single country so that it would be possible to incorporate your business in one of those countries and not be treated as engaged in tax haven operations simply because you then had activities in other parts of the European Union would be very important.

But all of these problems—and I have to agree with what was said before—all of these issues would go away if we had a territorial tax system that accepted that the country where the business actually is conducted should have the only right to tax that business income to pay for business infrastructure and the United States should tax the income only when it is distributed to U.S. individual shareholders to pay for the things that they need in the country where they reside.

Short of moving to a territorial system, which is really the answer, I would have to agree that the interest allocation rules are probably the biggest problem for U.S. business, but I would put the problems we have rationalizing our business in the European Union as a close second.

Mr. DEAN. Congressman.

Mr. HOUGHTON. Yes.

Mr. DEAN. Congressman, I would like to add one thing. The problems we are discussing are all symptomatic of a broader problem. The Tax Code is being gamed in the application of these rules to collect revenue in circumstances where it is simply not appropriate. We have to take a fundamentally careful look at the way we apply these rules to make sure that enterprises are not punished solely because they are owned and controlled by our own citizens. It is a truly pathetic irony that we are in a situation now where American owned enterprises are being punished by their own government precisely because of the nationality of their ownership.

That is the case of Subpart F. That is the case of the interest allocation expense. And it is the case of the foreign tax credit as well.

Mr. HOUGHTON. Well, I think it is very helpful to be able to listen to people like yourselves because I have a feeling that business is far ahead of government in this respect. In the old days, businesses used to have export agreements, licensing agreements; what was made overseas was for them and what was made here was for us. And, of course, that is absolutely out now. And we obviously have got to bring up our tax laws to recognize that.

Now let me just ask you one other question. Mr. Levin and I have proposed a tax simplification bill. Are there any other issues—I don't know if you have seen this—are there any other issues we should get into that we haven't touched on? Not that we can put them in now, but thinking ahead for another session?

Mr. CHIP. As some of the other witnesses have said, in addition to studying some of these micro issues, I would hope that Congress would give serious consideration to studying moving to a fully territorial system. Short of moving to a pure sales tax system, which probably would be more competitive than our competitors since they have income tax systems, would at least give us the most competitive income tax system possible.

Most of our competitors come much closer to the most competitive income tax system that you can have if you are going to have that kind of system. And I think it would be worthwhile for—but it is not something that you can do very simply. And I would be fooling you if I pretended that it is. Among other things, you have to get into the issue of the double taxation of shareholders. When we distribute corporate income to shareholders, they don't get a credit for the taxes paid by the company. Most of our competitors—at least, a lot of our competitors—do have an integrated tax system.

So you can't really isolate even the international area. You have to look very deeply into the system, and I think that now is as good a time to get started as any.

Mr. MOGENSON. I think that what you are hearing is various themes all of which kind of come back to a similar concept which is give the freedom for U.S. multinationals to compete on a foreign marketplace, you know, on equal footing with the competitors that are not United States based. The notion that the U.S. rules should extend globally is what is causing the handicap.

I can tell you that I sit daily and deal with transactions which are entirely foreign-to-foreign transactions that are being proposed or conducted by our foreign affiliates and need to overlay the U.S. rules on top of that, whereas a similarly situated foreign bank or foreign securities firm merely has to focus on what are the U.K. rules or what are the German rules in that particular situation. And I come back to the common theme of saying let the foreign transactions or foreign business opportunities stand in that marketplace and don't extend the U.S. rules into there, whether it be compliance or substantive.

Mr. HOUGHTON. Well, thanks very much. Thank you, Mr. Chairman.

Mr. HAMOD. Congressman, if I may be an advocate for Section 911 very briefly. I don't believe it is in the bill now, but we hope you will give it serious consideration. One of the things that impresses me most about Section 911 is its remarkable versatility. It helps large companies, it helps small companies. It helps big wage earners, it helps small wage earners. It helps in high-tax nations, it helps in low-tax nations. In fact, as far as we can tell, the only folks it doesn't help is the competition, and that's the way it should be. Thank you.

Chairman ARCHER. Amo, you have asked some very excellent questions and it has piqued my interest to follow up a little bit.

What, if we went to a purely territorial system, would you recommend as the best way to implement that? Simply not to tax foreign-source income or find a way to give a tax credit for foreign-source income?

Mr. CONWAY. Mr. Chairman, I think we really should seriously look at a system which would exempt foreign income from tax. We operate in 180 countries and if you read our annual report, you will see that we pay a lot of taxes both in the United States and outside the United States. The minute that you have a foreign tax credit system, it introduces tremendous complication. Every time we go to make an acquisition and we compete for acquisitions with non-U.S. companies, we find ourselves doing an analysis and coming out on the short end of the stick because of these rules.

We have learned in business that the best way to simplify a process is, many times, to eliminate a process. If we can, we should eliminate the foreign tax credit system. Our main goal is to increase our net income. If our taxes go up, that is OK. We don't mind paying taxes as long as our profits go up at the same time. So I think the point is that American companies would be in a much more competitive position. We would still be paying taxes. And, in the end, I think we would wind up winning the global competition.

Chairman ARCHER. With all of the capabilities today and with the enormous intricate interrelationship between companies operating all over the world would there not be some opening for gaming of the system so that you would be able to transfer your domestic income to become foreign income to where it would not be taxed? Depending again upon the level of taxation in the country in which you were operating, would not transfer pricing methods and other methods, be an attractive nuisance to encourage a gaming of the system?

Mr. CONWAY. I think there would be issues, but I think, given the sophistication in technology and information, we ought to take a serious look at a territorial system. I think those issues could be addressed just by defining the source rules and could be dealt with that way. What we find in our businesses is that we are generating income where the customers are. And I gave the example of the Otis Elevator Co. We have to operate where the elevators are in order to earn the income. And it is pretty clear what the source of income is in that case. When we are manufacturing and selling, then, you know, there are some issues because we cross borders with an export sale.

But I think it would be worthwhile to seriously study those issues. I think we would be far ahead in trying to craft some reasonable rules. There will always be people who will game the rules. But I think we could craft rules that could cover the vast majority of companies, and I don't think we would necessarily jeopardize our revenue base.

Mr. CHIP. Mr. Chairman, those transfer pricing issues you alluded to are present in the current system because we still allow a certain amount of deferral of foreign income and there is an advantage to a U.S. company today to try to allocate as much income as possible to its lowest taxed subsidiaries. For that matter, that problem would exist in a sales tax system. And a concern about that, I think, was one of the main reasons subpart F was enacted in the first place and, indeed, it is one the main reasons for not having a territorial system.

But I think we need to take account that the Congress has amended the Internal Revenue Code to provide the Internal Revenue Service with very powerful tools in the transfer pricing area, including very severe penalties for transfer pricing violations. And most of our competitor countries have followed our lead in that area so that the likelihood that a large company could successfully achieve an irrational shifting of large amounts of income, even under the current system let alone under an exemption system, is not nearly as severe as perhaps it may have been perceived to be 30 years ago and should not really stand in the way of moving to any other system, because the problem will exist under all systems. It is not limited to any one system.

Mr. MOGENSON. That is right, Mr. Chairman. When you contemplate a new system, you are correct that you would have to craft rules that would maintain the integrity of the U.S. tax base and the U.S. income that is earned here. That means that you would have to accurately define foreign-source income that is going to be exempted as under a territorial system and you must define the deductions or the expenses that relate to the income that you are not taxing.

However, following up on the transfer pricing point, at least you would deal with transfer pricing in a very detailed way when the United States is one side of the transaction where it is in or out of the United States, but you have taken off the table the multitude of foreign-to-foreign transactions as far as applying the U.S. rules to them.

Chairman ARCHER. Well, I can see that there would still be complexities with the IRS requiring an awful lot of compliance types of administrative red tape for you to be sure that, quote, we are not in some way taking domestic income and putting it into foreign income through all of the various methods that would be possible to a clever individual who knows how to work the intricacies and the sophistication that is available today. I do wonder why you say the sales tax would bring the same thing, because in the sales tax, you would have no recordkeeping for income whatsoever.

Mr. CHIP. Well, you do have the issue of inputs coming into the United States and items going out.

Chairman ARCHER. Now if you just had a retail sales tax, you would not have any question of input coming into the United States.

Mr. CHIP. Well, not if you are thinking of a Customs system where you apportion the tax depending on the value-added or the value of the product. There will always be a question of what the real value is when it is being passed from a related to an unrelated person.

Chairman ARCHER. Not with a retail sales tax, Mr. Chip. With a retail sales tax it would be all collected at the point of sale irrespective of how much came into the country through imports or how much was domestically produced. There would be no records for an income tax that would have to be kept. Transfer pricing or any other manipulation through some sophisticated system of interrelationship between two different countries would not be questioned. You eliminate all of that.

Mr. CHIP. Yes, Mr. Chairman, a purely retail sales tax that applied exclusively to transactions between businesses and unrelated customers would, you are correct, not have those problems.

Chairman ARCHER. Well, I just wanted to make that clear, because you said you would have the same problem with the sales tax but you would not have the same problem in a sales tax.

Mr. CHIP. Many of the alternatives to the income tax system that have been considered, including value-added taxes and other taxes do have those problems, but, I agree that a purely retail sales would not have that problem.

Chairman ARCHER. OK. Because your statement was even with the sales tax, you would have the same problem and that is not accurate relative to a retail sale tax.

Mr. CHIP. Not a retail sales tax.

Chairman ARCHER. OK. OK. All right. Well, I hope I live long enough to where we can see an elimination of all the extra complexities that an income tax inevitably seems to put on us. The sad thing about an income tax is that we can talk about how we are going to simplify it, but I have been through many efforts to simplify the income tax and each time we attempt to simplify it, we make it more complex.

1986 was the great simplification Act, and we added many new complexities that were not present prior to 1986. In fact, I was sitting right here at the time of the debate on the 1986 Act and my friend Jimmy Baker, who was then Secretary of the Treasury, who I grew up with in Houston was testifying. He was presenting Treasury II, which was a 500-page summary of their proposal for tax reform, entitled Fairness, Growth, and Simplicity.

I had scanned through it the night before, which was the only time we had available. I came to the foreign-source income provision section and read with incredulity what was in their own summary. In their own summary. It said the current system is extremely complex and very difficult to administer and our proposal will make it more complex. I read that to him and I said how can you entitle this Fairness, Growth, and Simplicity and he smiled and said that is why we put simplicity third in the order of things. [Laughter.]

Then the Congress made it worse.

So I have about lost confidence that we can simplify the income tax. We will get into that at another time.

Are there any other questions? Mr. Portman.

Mr. PORTMAN. Mr. Chairman, that is a perfect segue because, as you know, it was the 1986 Act that you looked at that made these interest allocation rules so complicated and it really puts us here.

Chairman ARCHER. By the way, I ended up leading the opposition to that bill, I want all of you to know. I am on record.

Mr. PORTMAN. Yes. But I also would say that even eliminating the corporate income tax and instituting a business sales tax, which could be called a VAT tax, whether it is subtraction or a credit method, would avoid many of these problems of allocation of income. It would create new problems, but I would venture to say they would not be nearly as complex for you all and ultimately for the American consumer as the current income tax system.

But let me get back to reality for a second to what we might be able to do in the short-term on interest allocation. The Houghton-Levin bill, I think, is wonderful and Mr. Houghton and Mr. Levin are to be commended for rolling up their sleeves and getting into this international area at all. It is an area only less attractive to most members than the pension laws that we are trying to get into as well. But they deserve a lot of credit. They have a study, as you know, on the interest allocation rules. And then there is this additional legislation that I just dropped in recently with Mr. Matsui that tries to get at some of the points that were raised both in this panel and in the previous panel on interest allocation.

And I just have a couple of follow-up questions to see whether we can maybe better identify some of the problems. And then, perhaps, talk about ways in which that legislation could be altered to make it more broadly applicable to some of the companies including, I listened to Mr. Green's testimony earlier, to UtiliCorp. He had some concerns, I think, about applicability to some companies, perhaps focusing on the 80 percent rule. Maybe lowering that 80 percent to some smaller percentage.

But if I could start with asking you, Mr. Laitinen, about your question regarding U.S. investment. You basically said that the home team is disadvantaged even on the home court, in so many words. And if you could follow through on that a little bit and explain why, for instance, a foreign car manufacturer, as compared to a GM, would be at an advantage.

And I guess this relates also to the fact that all of your competitors probably live under a different tax system. So we know with some certainty how they are going to be taxed, which would be on the U.S. system, to the extent they are investing in the United States. Whereas our tax system would have interest allocated that is U.S. domestic interest allocated to foreign sources and therefore would put us at a disadvantage. Could you explain that?

Mr. LAITINEN. Well, basically, interest on U.S. debt incurred by a U.S. multinational to invest in the United States is subject to these interest allocation rules, whereas a foreign-based company with a subsidiary in the United States that borrows funds here to make a similar investment in the United States is not subject to those rules because that U.S. subsidiary of the foreign company is not going to have foreign assets to allocate interest to.

An example, if I could give one, would be in the late 1980s, when GM borrowed funds in the United States to build a Saturn Corporation plant in Spring Hill, Tennessee. And a portion of the interest expense on the debt was allocated to foreign-source income and, in effect, a current deduction was lost for part of that interest expense. But, by way of contrast, about the same time, Nissan built a plant down the road in Smyrna, Tennessee. As a foreign-based competitor, they weren't subject to the interest allocation rules on any borrowings they might have had for that plant. That is the type of thing that can happen again.

Mr. PORTMAN. So they got the full deduction on their interest that they borrowed for their expansion, whereas GM did not because some of that was allocated to foreign-source.

Mr. LAITINEN. Right. I use that as an example. I don't know their actual facts as to their borrowings and so on, but——

Mr. PORTMAN. Yes. Well, you don't know about their borrowings, necessarily, but we do know enough about the tax system in Japan or in Germany or in any of the other EU countries to know with some certainty that they would have been subject to a different set of rules.

Mr. LAITINEN. Right, but, in effect, the U.S.-based multinational investing in the United States is at a competitive disadvantage. That is why I was saying that it is not a level playing field, even in our home turf.

Mr. PORTMAN. Right. The other question I have which I raised a second ago was do you all have any thoughts as to how the legislation that we introduced, H.R. 2270, might be altered to make it more applicable to more companies? I mentioned the percentage of foreign ownership, for instance. Any thoughts of any of the panelists? Mr. Laitinen, anybody?

Mr. LAITINEN. Well, the percentage of affiliation is 80 percent in your bill and it could be lowered to 50 percent. The CFC rule, for example, could be used for what foreign affiliates you take into account. I mean, that would be a way of broadening it. Also, there is a subgroup rule in the bill which we think is important. Under your bill, as I understand it, a company could elect to stay in the current law or elect worldwide fungibility with the subgroup election also. If that subgroup election were made available under current law, again, it would provide some additional flexibility.

I mean, there are ways to broaden the bill slightly and still maintain the two important points of worldwide fungibility and subgroup elections, which are, as you know, the key points in your bill.

Mr. PORTMAN. Well, again, we appreciate your help and giving us advice on that. I will say that any change, obviously, has an impact on revenue. At least those two changes you mentioned would, I believe, raise an issue as to the revenue impact. But I think we have made some progress through Mr. Houghton's legislation and if we can get some interest allocation relief as well, it seems to me from what we have heard today, that will be a major help to U.S. companies trying to compete worldwide. Thank you, Mr. Chairman.

Chairman ARCHER. I am constrained to ask whether there is any coalition of overseas companies that has been put together to try to determine the best way to do the interest allocation change. I

understand that different businesses are affected differently, based on how we make the change. The 1986 Senate proposal, for example, does not help a lot of businesses. I wonder if there has been any effort to get the business community together to make a recommendation. I see Mr. Murray raising his hand in the audience out there. [Laughter.]

Mr. PORTMAN. National Foreign Tax Council.

Chairman ARCHER. Well, we would appreciate the input of any one with practical experience on how we to make the best possible choice to remove this barrier to our competitiveness overseas. I think Mr. Portman's questions were very well-taken.

Let me quickly ask you this and then excuse you and move on. If we were to get a pure territorial system, would most of the research that your corporations do be brought back to the United States? There would be no incentive to do it overseas if you are not. By reducing your foreign-source income, you would not be helping yourself in your bottom line net. However, if you brought it here and you take a deduction against your domestic income, then it seems to me it would be very attractive for you to start bringing your research activities, whatever they might be, back to the United States of America. Am I correct in that?

Mr. CONWAY. Mr. Chairman, I think you are correct. If you are potentially adversely impacted by the foreign tax credit rules in the R&D allocation, it absolutely would make sense to move the R&D back because, you know, it would absolutely neutral from a tax standpoint and, quite frankly, I think for most companies, most of the R&D is done in the United States anyway. This is where the technology base is and to the extent that we not only get a deduction, but we get an R&D credit here as well, which has been extended—in fact, it has been approved with the alternative research credit—more and more countries are enacting R&D incentives.

There are now 16 major countries which have R&D incentives. So I think a territorial system would provide an incentive to do more R&D here.

Chairman ARCHER. OK. Thank you very much. Are there any other questions by members? Thank you very much. Your input has been very helpful to us. The Committee will be adjourned.

[Whereupon, at 2:42 p.m., the hearing was adjourned.]

[Submissions for the record to follow:]

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

Both H.R. 681 (introduced by Reps. McCrery and Neal) and Section 101 of the International Tax Simplification for American Competitiveness Act of 1999 (H.R. 2018, introduced by Reps. Houghton and Levin) highlight 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 Fi-

nance 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 operation 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.

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:

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[1] For 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).

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 absolute 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.

Statement of Larry Bossidy, AlliedSignal, and The Business Roundtable

I am Larry Bossidy, Chairman and CEO of AlliedSignal and Chairman of the Fiscal Policy Task Force of The Business Roundtable. I am submitting this statement for the record to express the views of The Business Roundtable on the corporate tax component of the 1999 tax reduction bill. The Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States.

As the Committee designs a tax cut to return the budget surplus to taxpayers, we urge that you allocate the tax cut between corporate and individual taxpayers as their tax collections have jointly contributed to the budget surplus. Specifically, we urge the Committee to reduce corporate income taxes by $1 for every $4 that it cuts from individual income taxes, as this $1 to $4 ratio reflects the collection of income tax over the current economic expansion from 1992. Thus, if a tax bill is structured around income tax cuts of $778 billion, the 10-year target for corporate income tax reduction would be approximately $156 billion. Such a corporate tax cut would stimulate savings, investment, economic growth and job creation.

In the United States, corporations employ more people, pay more wages, fund more research, invest in more plant and equipment, and support more employee benefits than any other type of business. We also pay more federal income tax. Therefore, one of our main public policy interests is how taxes are affecting corporations in their central economic role as engines pulling the national economy.

From that perspective, we urge the Committee to reduce the corporate income tax. Corporate funds that are not diverted to taxes can go into building the economy and underwriting prosperity in future years. The old saying is true: the time to invest is when you have it. The condition of the federal budget, itself a beneficiary of economic growth, makes corporate tax reduction feasible. Corporate tax reduction, in turn, can help sustain a strong recovery.

As shown in the accompanying table, the proposed 1-to-4 tax cut ratio reflects the collection of federal income taxes since the U.S. economy began its solid, long period of growth in 1992. Following the 1-to-4 guideline for the corporate component of the tax bill will——

Be equitable, because the budget surplus will be paid back to taxpayers in the same proportion as it is being created.

Preserve the balance between individual and corporate income taxes that has prevailed during our sustained prosperity, and

Assure that some portion of the tax bill will make a contribution to continuing economic growth and job creation.

The Roundtable believes that the corporate portion of the tax-cut bill should center around reducing corporate income tax rates. A rate reduction is the fairest and simplest way to cut business taxes. It would benefit corporations of all sizes. It would put funds into play to compete for economic projects that have the best prospects for creating value and stimulating growth. The alternative is for the government to pick business winners based on politics and thus dilute the beneficial impact of a business tax reduction. As you know, the top corporate tax rate was raised from 34 percent to 35 percent in 1993 solely for deficit reduction, which is now an obsolete rationale. A two-percentage-point rate cut might be phased in—one point early in the 10-year planning period and another point later—to fit the time pattern of cuts that Congress has defined.

We are also interested in other aspects of corporate taxes, such as simplification of international tax rules, a permanent R&E credit, and repeal of the corporate AMT.

The international provisions of the U.S. tax law represent a significant barrier to the competitiveness of U.S. companies in the global marketplace. The U.S. tax regime imposes costs on the foreign operations of U.S.-based multinationals that are not borne by our foreign competitors. With the ever-increasing globalization of the economy, there is a great need for fundamental reform of the U.S. international tax rules. U.S. companies must be able to compete abroad on equal terms if we are to compete successfully at home.

The International Tax Simplification for American Competitiveness bill, introduced recently by Representative Houghton and Representative Levin and supported by many Members of the Committee, addresses many of the needed reforms. Of particular significance is the request that the Treasury Department study the interest expense allocation rules. The present-law rules severely penalize U.S.-based multinationals by artificially restricting their ability to claim foreign tax credits for the taxes they pay to foreign countries, thereby subjecting them to double taxation. The interest allocation rules must be reformed to eliminate the distortions that cause this double taxation and to eliminate the competitive disadvantage at which the present-law rules place U.S. multinationals.

The Tax Reform Act of 1997 included the prospective repeal of a rule enacted in 1986 that restricted the ability of U.S. companies to claim foreign tax credits for foreign taxes paid by less-than-majority owned foreign subsidiaries; the international simplification bill enhances this important simplification by accelerating the repeal of this rule. In addition, the bill would provide more appropriate tax treatment for the sale by a foreign subsidiary of an interest in a partnership.

In addition to these simplification measures, another particularly important provision is the permanent extension of the subpart F exception for active financial services income. This provision is essential to allowing the U.S. financial services industry compete with their foreign counterparts.

These are just a few of the most pressing issues that need to be addressed in the U.S. international tax rules. We commend the Committee for its attention to these critical issues and look forward to working with the Committee to achieve the necessary reforms.

We will make our tax directors available to your staff with information and comments in these and other areas if that would be helpful to your Committee.

Federal Income Tax Collections During the Current Economic Expansion, 1992–1998

[By fiscal year, in billions of dollars]

Fiscal year	Individual Income Taxes	Corporate Income Taxes	Individual/ Corporate Ratio
1992	476.0	100.3	4.7
1993	509.7	117.5	4.3
1994	543.1	140.4	3.9

Federal Income Tax Collections During the Current Economic Expansion, 1992–1998—Continued

[By fiscal year, in billions of dollars]

Fiscal year	Individual Income Taxes	Corporate Income Taxes	Individual/ Corporate Ratio
1995	590.2	157.0	3.8
1996	656.4	171.8	3.8
1997	737.5	182.3	4.0
1998	828.6	188.7	4.4
Total	4,341.4	1,058.0	4.1

Statement of the American Bankers Association

The American Bankers Association (ABA) is pleased to have an opportunity to submit this statement for the record on the impact of U.S. tax rules on international competitiveness.

The ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, savings banks and thrifts—makes ABA the largest banking trade association in the country.

As technology and expanding trade opportunities change the global market place, financial institutions have had to make rapid adjustments in order to remain competitive with foreign financial entities. With respect to the international operations of U.S.-based financial institutions, the tax law has not kept pace with technological advances and changes in the global economy.

The ABA supports the enactment of legislation that would simplify the international tax law and that would assist, rather than hinder, U.S. financial institutions' global competitiveness. We agree with the observation that we can't 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 at a competitive disadvantage. In that regard, the ABA would like to commend Representatives Amo Houghton (R–NY) and Sander Levin (D–MI) for the introduction of H.R. 2018, the *International Tax Simplification for American Competitiveness Act of 1999.* H.R. 2018 contains a number of important provisions that would do much to update U.S. international tax law and promote global competitiveness in the financial services industry. We would also like to commend Representatives Jim McCrery (R–LA) and Richard Neal (D–MA) for the introduction of H.R. 681, which would permanently extend the active financing exception to subpart F.

This statement will address a number of proposals currently under consideration, many of which have been included in H.R. 2018 and H.R. 681.

PERMANENT EXTENSION FOR SUBPART F ACTIVE FINANCING INCOME EXCEPTION

Prior to 1987, subpart F allowed deferral of U.S. tax on income derived in the active conduct of a banking business until the income was distributed to a U.S. shareholder. In 1986, Congress repealed the provisions put in place to ensure that a controlled foreign corporation's active financial services business income would not be subject to current tax in response to concerns about the potential for taxpayers to route passive or mobile income through tax havens.

In 1997, Congress added an exception to the subpart F rules for the active income of U.S.-based financial services companies. The 1986 rules were modified for a number of reasons. An important reason was the fact that many U.S. financial services companies found that the existing rules imposed a competitive barrier in comparison to the home-country rules of many foreign-based financial services companies. Moreover, the logic of the subpart F regime was flawed, given that most other U.S. businesses were not subject to similar subpart F restrictions on their active trade or business income. The 1997 Taxpayer Relief Act added rules to address concerns that the provision would be available to shelter passive operations from U.S. tax. Due primarily to revenue constraints, the exception was made effective for only one year. In 1998, the provision was extended and modified for the 1999 tax year.

Thus, under current law, the active business income of U.S. financial institutions is subject to tax only when that income is distributed back to the U.S. This temporary exception to subpart F will expire in 1999, ending deferral of financial serv-

ices income and placing financial institutions on a more uneven playing field vis-á-vis domestic manufacturing companies and global competitors.

Generally, 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-á-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 is important to U.S. companies. They need to know the tax consequences of their business operations, which are generally evaluated on a multi-year basis.

Failure to extend the active financing exception this year would countermine legislative efforts to promote competitiveness and simplification. Moreover, the tax structure would revert to a regime that inequitably penalizes international financial institutions, as the National Foreign Trade Council's report on subpart F [1] indicates.

The ABA supports the permanent extension of the active financing exception to the subpart F for financial services companies.

Simplify the Foreign Tax Credit Limitation for Dividends from 10/50 Companies

The foreign tax credit rules impose a separate foreign tax credit limitation (separate baskets) for companies in which U.S. shareholders own at least 10 but no more than 50, percent of the foreign corporation. The old law 10/50 rule imposed an unreasonable level of complexity, which Congress sought to correct in the 1997 Tax Relief Act by eliminating the separate baskets for 10/50 companies using a "look through" rule. However, the 1997 Act change is not effective until after year 2002, and itself imposes an additional set of complex rules.

The ABA supports the proposal to accelerate the effective date of the 1997 Act change to apply the look-through rules to all dividends received in tax years after December 31, 1998, irrespective of when the earnings constituting the makeup of the dividend were accumulated. Such change would dramatically reduce tax credit complexity and the administrative burdens on financial institutions doing business internationally. It would also help level the playing field with respect to global competitors.

Subpart F Earnings and Profits Determined under Generally Accepted Accounting Principles (GAAP)

The ABA supports the proposal to determine the subpart F earnings and profits of foreign subsidiaries under GAAP. Under current rules, determining the earnings and profits of foreign subsidiaries for subpart F purposes may comprise as many as five steps involving a series of complex and time-consuming computations. For example, the process would start with the local books of account of the foreign subsidiary, continuing through a series of complicated accounting and tax adjustments to the parent institution. On audit, each of the steps would have to be explained and justified to IRS agents. We agree with the proposition offered by certain witnesses at this hearing that using GAAP to determine earnings and profits would provide equally reliable figures at a fraction of the time and cost to the institution. In this connection, we point out that H.R. 2018 contains such a provision, which we urge you to consider.

Treatment of Certain Dividends of Regulated Investment Companies

The ABA supports legislation that would exempt from U.S. withholding tax certain dividends distributed by a U.S. mutual fund to non-resident alien individuals.

The U.S. mutual fund industry has established a favorable global reputation for providing professional portfolio management as well as significant shareholder safeguards. However, current law hinders foreign individual investment in U.S. mutual funds in that the law does not extend the exemption from U.S. withholding tax on capital gains and interest income in investment portfolios to such funds. In particular, interest income and short-term capital gains, which otherwise would be ex-

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[1] International Tax Policy for the 21st Century: A Reconsideration of Subpart F (March 25, 1999). In that report, the NFTC concluded that the development of a global economy has substantially eroded subpart F's policy rationale; that subpart F subjects U.S.-based companies cross border operations to a heavier tax burden than that borne by their foreign-based competitors; and that subpart F applies too broadly to various categories of income that arise in the course of active foreign business operations, and should be substantially narrowed.

empt from U.S. withholding tax when received by foreign investors directly or through a foreign fund, are subject to U.S. withholding tax as "dividends" when distributed by a U.S. fund to its investors.

We note that H.R. 2018 contains a provision that would exempt such dividends from U.S. withholding tax. This change would help U.S. firms compete with foreign-based companies in attracting investments and we commend it to you for your consideration.

CONCLUSION

We appreciate having this opportunity to present our views on these issues. We look forward to working with you in the further development of solutions to our above-mentioned concerns.

[By permission of the Chairman]

Statement of Hon. Bill Alexander, American Citizens Abroad (ACA), Geneva, Switzerland

Mr. Chairman, Members of the Committee: Let me thank you for the great pleasure of having this opportunity to submit a written statement. The subject that you are addressing is a worthy one and also a challenging and perplexing one. It is a subject that has been of particular interest to me for many years, including the twenty-four years while I served in this body representing my constituents in the First Congressional District of Arkansas.

My District is one of the major rice growing areas of the United States. Having open and fair access to world markets is of great concern to my former constituents. To better understand their challenges, and to better serve their interests, I helped organize the House Export Caucus. Later, because of active involvement in issues of trade and competitiveness, I had the privilege of serving on the President's Export Council during the Carter Administration. Through contacts with American business and labor leaders, I began to understand even more clearly how the laws we enact, with what we believe to be a very justifiable and noble purpose in mind, can have very important unintended consequences in other areas that are also vital to the health and welfare of all Americans. It is in this conflict between noble and justifiable aims, and their related unintended consequences, that leads to the necessity to continually revisit questions such as the one we are addressing here again today.

While serving on the Export Caucus and the President's Export Council, I had the opportunity to meet with leaders of a number of organizations which have been created by Americans living abroad, whose daily lives are touched by the laws and regulations of the United States and, in particular, those laws and regulations that alter the nature of their competitive standing in the marketplaces of the world.

One of these organizations, American Citizens Abroad (ACA), has been forceful and eloquent in articulating the concerns of this expatriate community. For more than twenty years they have been writing reports, drafting legislation, and proposing other forms of appropriate redress for the grievances that they feel are causing harm not only to themselves but also to all Americans. It is my privilege today to be speaking on behalf of ACA, one of the strongest and clearest voices of the more than 3 million U.S. citizens who live and work abroad.

Addressing the specific topic of this hearing, we ask: "Are the tax laws of the United States having an impact on the competitiveness of American goods and services in world markets?"

There is another equally important and often overlooked question. Are U.S. tax laws making it difficult for U.S. citizens to live and work abroad in competition for jobs and as entrepreneurs with citizens of other countries?

The quick answer to both of these questions is quite simple. Yes, the tax laws are having an impact and it is highly negative.

It is negative principally because the United States is the only country that has seen fit to extend its domestic tax laws to embrace the income of its citizens living and working away from home. This extra-territorial reach of domestic legislation into foreign markets fundamentally distorts the economic rules of the game and tilts the playing field. Competitors in the marketplaces of the world compete by two sets of rules and two cost structures. One applies to Americans, the other applies to everyone else.

What the United States did in unilaterally distorting the competitive environment to the detriment of its expatriate citizens did not pass unnoticed. Shortly after the

United States started to impose domestic taxation on its overseas citizens in 1962, the major developed countries of the world, meeting under the auspices of the Organization for Economic Cooperation and Development (OECD), took up this very question of how citizens living away from home should be treated from a taxation point of view. The OECD members decided that a common set of standard rules applying to all participants in the same market should be the norm. The OECD drafted, therefore, a model bi-lateral tax treaty that defines the tax status of citizens living away from their home countries. This bi-lateral tax treaty takes as its fundamental premise that workers should have a unique tax liability to be defined by the country in which the individual is residing after a certain minimum period of time. Double taxation is considered not only unfair but also detrimental to efficient trading. The OECD model proposes taxation of individuals that is predictable, consistent and applies equally to everyone in the same geographical market.

When the United States negotiates tax treaties, it also uses the OECD model as a base. Then, however, it unilaterally adds additional language that states boldly that the protections in these treaties against double taxation will not apply to U.S. citizens! In other words, bi-lateral tax treaties negotiated by the United States that ensure competitive equality to foreign citizens living and working in the United States, at the same time guarantee competitive inequality and extra competitive handicaps to Americans living and working abroad. That, surely, is an incomprehensible trade policy.

Does this really make a difference? Does imposing an additional tax burden on overseas Americans really have any impact on the ability of the United States to export American goods and services?

When I was serving on President Carter's Export Council in 1979, we set up a special task force to look into these and related questions on the impact of American taxation on trade. Our analysis was convincing and our conclusions were unambiguous. The taxation of overseas Americans was costing the United States billions of dollars in lost trade, and tens of thousands of export-related jobs each year. We recommended twenty years ago that the United States stop taxing Americans living and working abroad so that they might once again enjoy a level playing field throughout the world.

How has the situation changed since then? We have a lot of anecdotal evidence to suggest that it hasn't improved very much. I regret very much that more concrete official statistical and analytical data is still lacking on this subject. I would have welcomed the chance to comment on any studies of the cost-benefit analysis of the taxation of overseas Americans carried out recently by at least one responsible agency of the U.S. Government. Unfortunately, no such studies seem to be available.

How do we explain that the U.S. Commerce Department prepares an annual assessment of barriers to trade imposed by other countries, but has never shown any similar curiosity concerning the barriers we impose on ourselves?

How do we explain the anomaly of the aggressive efforts of the Office of the Special Trade Representative, ardently negotiating at the WTO and with foreign governments to open up foreign markets for U.S. origin goods and services, but never negotiating internally within the U.S. Government to eliminate the impediments that we ourselves have erected to the exploitation of these new market opportunities by our own citizens?

In the absence of any such official information on this subject, I asked ACA to prepare the table that is attached to my statement. This shows the evolution of the Gross Domestic Product (GDP) of the United States since 1960, before the taxation of overseas Americans began, right up through the end of 1998. It also shows the evolution of imports, exports and the balance of trade since then.

This table shows that when the law introducing expatriate taxation was first enacted, trade was still a very modest percentage of GDP, and the United States was enjoying a small trade surplus. Not long thereafter, when the tax bite was starting to be felt abroad, trade grew to play a more important role in our domestic economy and a trade deficit began to appear. Trade as a percentage of GDP increased from less than 10% in 1962 to almost 25% in 1998. At the same time, the United States began to generate and accumulate the world's largest and most chronic trade deficit, which grew to 2% of GDP in 1998 alone.

Taking an international comparative perspective, are the practices of the United States really that different from those of other countries? One of the founders of ACA looked specifically at this question. He carried out a study a few years ago comparing the way the major trading nations of the world treat their citizens living and working in foreign countries, and discovered that taxation was only one of the areas where the practices of the United States differed fundamentally from the practices of our competitors. Citizenship of children born abroad, access to social security programs, health care, educational benefits, and myriad other issues are all

areas where other countries are usually much more generous than the United States. These are additional dimensions of the competitive advantage enjoyed by non-Americans. Sadly, the United States comes last in two categories. It imposes heavier burdens and grants fewer benefits than almost every other major trading nation.

Does it make a difference when it is more expensive and bureaucratically burdensome for an American expatriate than an expatriate of another country? Let's put the question a different way. Would we ever consciously send our armed forces abroad to fight in foreign conflicts with severe competitive military handicaps compared with our adversaries? If not, why do we feel so complacent and have such a different attitude toward our overseas Americans who have to compete in the equally ferocious trade battles?

How specifically does the U.S. taxation of overseas Americans create a handicap? Let me give a few brief examples.

If Americans have to pay taxes to two countries on the same income, and if both countries define income, and taxes, differently, there will inevitably be income that is taxed more than once. Many taxes paid abroad are not recognized as tax eligible for credit under U.S. tax rules because the tax is novel and not used the same way in the USA. Even in the case of credit given for some foreign income taxes paid abroad, the United States has moved recently to reduce the value of this credit by applying the Alternative Minimum Tax to the foreign earned income exclusion. In other words, today there is a mandatory minimum amount of double tax that has to be paid on certain incomes, even if that income has already been fully taxed at the same rate by another country!

The extra tax paid abroad obviously has to come from somewhere. Either the American expatriate taxpayer then has to live with a lower take-home pay than colleagues of other nationalities earning the same gross income, or the employer will have to make up the difference. In many multinational companies, the practice in recent years has been for equal take-home pay for equal work for all expatriate employees of any nationality. Thus, the employer has to endure an extra expense for every U.S. citizen on the payroll. Ask, as I have done, whether corporations overseas are less inclined to hire Americans than people of other nationalities and the answers are usually clear and unambiguous. Americans are less likely to be hired because they are more expensive. The net difference in cost is a payment that has to be made to the U.S. government for the privilege of having an American on the payroll. And, because of the way the repayment of the extra tax is made, the burden grows larger every year. So even if an American is hired to work abroad, the extra cost for an expatriate American keeps getting larger and larger. This is another incentive to reduce the American expatriate staff.

Even more perplexing and competitively debilitating is the exquisite complexity of the U.S. tax laws as they apply to Americans living and working abroad. Because they are so hard to understand, many Americans are forced to have recourse to expensive tax and legal consultants and can end up paying even more in service charges to correctly fill out their tax returns than they end up paying in tax. The competitive handicap then becomes double. Not only is the tax a burden, but the cost of complying with the complexity of the tax compounds the burden.

Finally, Mr. Chairman, we should be paying much more attention to the competitive handicap that our tax laws create for American entrepreneurs overseas, especially those who are willing to set up a small business in remote parts of the world. The costs associated with the filling out of forms and filing returns for small entrepreneurial controlled foreign corporations are a very heavy disincentive. The only way many such businesses could survive is by simply ignoring the current law and risking the consequences. Yet who better than an American entrepreneur should be encouraged to go abroad, set up an innovative new business, and manifest the virtues and benefits of the liberal democratic political and economic system we have found to be so propitious to our welfare and way of life at home.

In other words, does it really make sense for the United States to spend billions of dollars each year of taxpayer money on aid projects in developing countries when, without any cost to the United States, we could simply turn loose our American entrepreneurs and wish them well? If we would get rid of the expense and complexity of our current tax laws as a disincentive to our entrepreneurs, I believe we could much more effectively help developing countries become much more prosperous, and at a much lower cost to the American taxpayer.

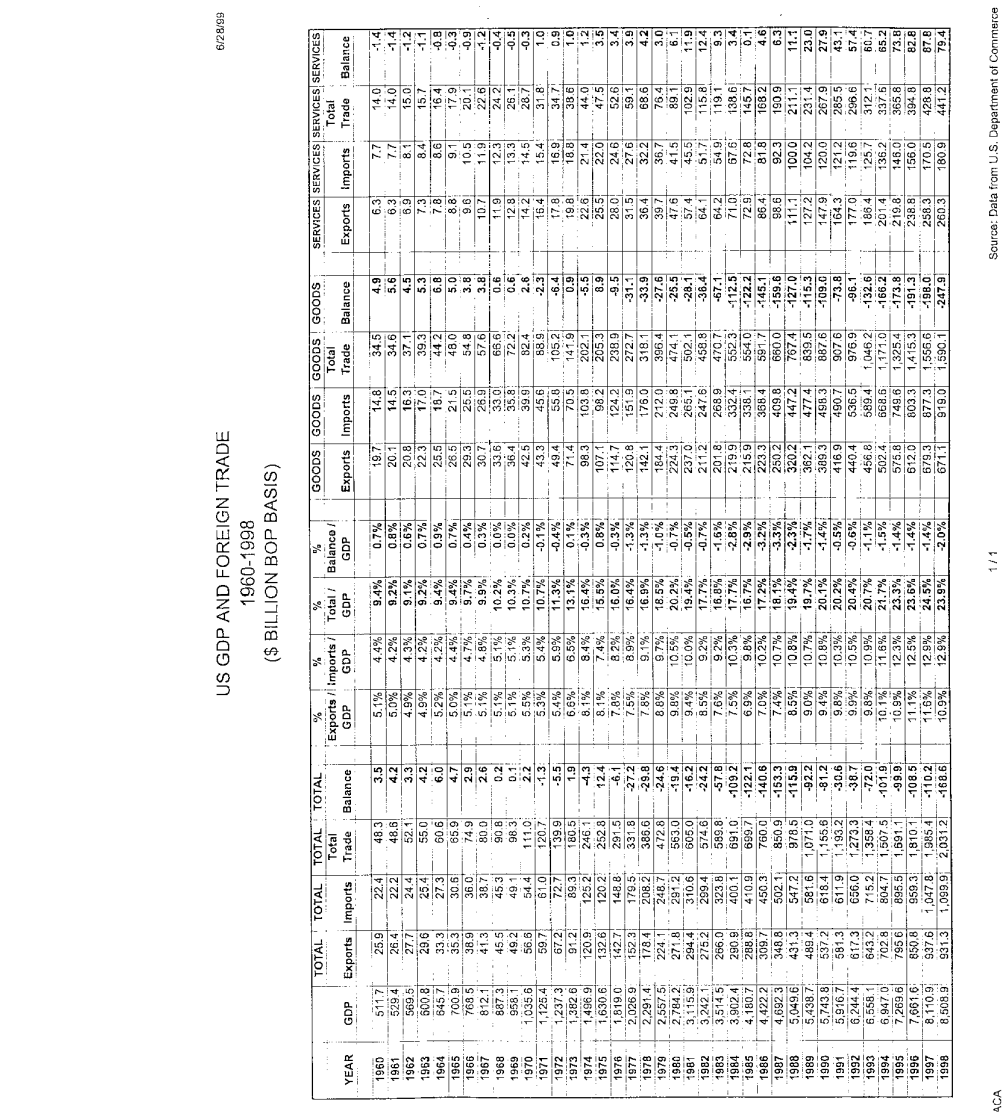
My concern about the importance of overseas Americans to the long term economic health and vitality of our country motivated me to introduce legislation to end the taxation of Americans overseas. The last bill, which I introduced in 1992 (102nd Congress HR 4562), was co-sponsored by my good friend Congressman Ben Gilman, now the Chairman of the House Committee on International Relations.

In summary, my conviction is that changing the tax laws of the United States would have a dramatic and material impact on the ability of Americans to compete in foreign markets. I believe that this would encourage many more Americans to live and work abroad, to set up small businesses abroad, and be a powerful contribution toward a more safe and prosperous world.

It is noteworthy that overseas Americans have never asked the U.S. Government for special competitive favors abroad. Are they really asking for too much when they request the right to be able to compete on a more level playing field? I think not.

My hope, therefore, Mr. Chairman, is that you and your colleagues will agree that giving overseas Americans a fair and equal chance to compete abroad is not only good for them, but good for us all. Amending the tax laws of the United States would have a positive impact on the international competitiveness of our country and its citizens at home and abroad.

Thank you.



US GDP AND FOREIGN TRADE
1960-1998
($ BILLION BOP BASIS)

6/28/99

YEAR	GDP	TOTAL Exports	TOTAL Imports	TOTAL Total Trade	TOTAL Balance	% Exports / GDP	% Imports / GDP	% Total / GDP	% Balance / GDP	GOODS Exports	GOODS Imports	GOODS Total Trade	GOODS Balance	SERVICES Exports	SERVICES Imports	SERVICES Total Trade	SERVICES Balance
1960	511.7	25.9	22.4	48.3	3.5	5.1%	4.4%	9.4%	0.7%	19.7	14.8	34.5	4.9	6.3	7.7	14.0	-1.4
1961	539.4	26.4	22.2	48.6	4.2	5.0%	4.2%	9.2%	0.8%	20.1	14.5	34.6	5.6	6.3	7.7	14.0	-1.4
1962	568.5	27.7	24.4	52.1	3.3	4.8%	4.3%	9.1%	0.6%	20.8	16.3	37.1	4.5	6.9	8.1	15.0	-1.2
1963	600.8	29.6	25.4	55.0	4.2	4.9%	4.2%	9.2%	0.7%	22.3	17.0	39.3	5.3	7.3	8.4	15.7	-1.1
1964	643.7	33.3	27.3	60.6	6.0	5.2%	4.2%	9.4%	0.9%	25.5	18.7	44.2	6.8	7.8	8.6	16.4	-0.8
1965	700.9	35.3	30.6	65.9	4.7	5.0%	4.4%	9.4%	0.7%	26.5	21.5	48.0	5.0	8.8	9.7	17.9	-0.9
1966	768.5	38.9	36.0	74.9	2.9	5.1%	4.7%	9.7%	0.4%	29.3	25.5	54.8	3.8	9.6	10.5	20.1	-0.9
1967	812.1	41.3	38.7	80.0	2.6	5.1%	4.8%	9.9%	0.3%	30.7	28.9	59.6	1.8	10.7	11.9	22.6	-1.2
1968	887.3	45.5	45.3	90.8	0.2	5.1%	5.1%	10.2%	0.0%	33.6	33.0	66.6	0.6	11.9	12.3	24.2	-0.4
1969	958.1	49.2	49.1	98.3	0.1	5.1%	5.1%	10.3%	0.0%	36.4	35.8	72.2	0.6	12.8	13.3	26.1	-0.5
1970	1,035.6	56.8	54.4	111.0	2.2	5.5%	5.3%	10.7%	0.2%	42.5	39.9	82.4	2.6	14.2	14.5	28.7	-0.3
1971	1,125.4	59.7	61.0	120.7	-1.3	5.3%	5.4%	10.7%	-0.1%	43.3	45.6	88.9	-2.3	16.4	15.4	31.8	1.0
1972	1,237.3	67.2	72.7	139.9	-5.5	5.4%	5.9%	11.3%	-0.4%	49.4	55.8	105.2	-6.4	17.8	16.9	34.7	0.9
1973	1,382.6	91.2	89.3	180.5	1.9	6.6%	6.5%	13.1%	0.1%	71.4	70.5	141.9	0.9	19.8	18.8	38.6	1.0
1974	1,498.9	120.9	125.2	246.1	-4.3	8.1%	8.4%	16.4%	-0.3%	98.3	103.8	202.1	-5.5	22.6	21.4	44.0	1.2
1975	1,630.6	132.6	120.2	252.8	12.4	8.1%	7.4%	15.5%	0.8%	107.1	98.2	205.3	8.9	25.5	22.0	47.5	3.5
1976	1,819.0	142.7	148.8	291.5	-6.1	7.8%	8.2%	16.0%	-0.3%	114.7	124.2	238.9	-9.5	28.0	24.6	52.6	3.4
1977	2,026.9	152.3	179.5	331.8	-27.2	7.5%	8.9%	16.4%	-1.3%	120.8	151.9	272.7	-31.1	31.5	27.6	59.1	3.9
1978	2,291.4	178.4	208.2	386.6	-29.8	7.8%	9.1%	16.9%	-1.3%	142.1	176.0	318.1	-33.9	36.4	32.2	68.6	4.2
1979	2,557.5	224.1	248.7	472.8	-24.6	8.8%	9.7%	18.5%	-1.0%	184.4	212.0	396.4	-27.6	39.7	36.7	76.4	3.0
1980	2,784.2	271.8	291.2	563.0	-19.4	9.8%	10.5%	20.2%	-0.7%	224.3	249.8	474.1	-25.5	47.6	41.5	89.1	6.1
1981	3,115.9	294.4	310.6	605.0	-16.2	9.4%	10.0%	19.4%	-0.5%	237.0	265.1	502.1	-28.1	57.4	45.5	102.9	11.9
1982	3,242.1	275.2	299.4	574.6	-24.2	8.5%	9.2%	17.7%	-0.7%	211.2	247.6	458.8	-36.4	64.1	51.7	115.8	12.4
1983	3,514.5	266.0	323.8	589.8	-57.8	7.6%	9.2%	16.8%	-1.6%	201.8	268.9	470.7	-67.1	64.2	54.9	119.1	9.3
1984	3,902.4	290.8	400.1	691.0	-109.2	7.5%	10.3%	17.7%	-2.8%	219.9	332.4	552.3	-112.5	71.0	67.6	138.6	3.4
1985	4,180.7	288.8	410.9	699.7	-122.1	6.9%	9.8%	16.7%	-2.9%	215.9	338.1	554.0	-122.2	72.9	72.8	145.7	0.1
1986	4,422.2	309.7	450.3	760.0	-140.6	7.0%	10.2%	17.2%	-3.2%	223.3	368.4	591.7	-145.1	86.4	81.8	168.2	4.6
1987	4,692.3	348.8	502.1	850.9	-153.3	7.4%	10.7%	18.1%	-3.3%	250.2	409.8	660.0	-159.6	98.6	92.3	190.9	6.3
1988	5,049.6	431.3	547.2	978.5	-115.9	8.5%	10.8%	19.4%	-2.3%	320.2	447.2	767.4	-127.0	111.1	100.0	211.1	11.1
1989	5,438.7	489.4	581.6	1,071.0	-92.2	9.0%	10.7%	19.7%	-1.7%	362.1	477.4	839.5	-115.3	127.2	104.2	231.4	23.0
1990	5,743.8	537.2	618.4	1,155.6	-81.2	9.4%	10.8%	20.1%	-1.4%	369.3	458.3	827.6	-109.0	147.9	120.0	267.9	27.9
1991	5,916.7	581.3	611.9	1,193.2	-30.6	9.8%	10.3%	20.2%	-0.5%	416.9	490.7	907.6	-73.8	164.3	121.2	285.5	43.1
1992	6,244.4	617.3	656.0	1,273.3	-38.7	9.9%	10.5%	20.4%	-0.6%	440.4	536.5	976.9	-96.1	177.0	119.6	296.6	57.4
1993	6,558.1	643.2	715.2	1,358.4	-72.0	9.8%	10.9%	20.7%	-1.1%	456.6	589.4	1,046.2	-132.6	186.4	125.7	312.1	60.7
1994	6,947.0	702.8	804.7	1,507.5	-101.9	10.1%	11.6%	21.7%	-1.5%	502.4	668.6	1,171.0	-166.2	201.4	136.2	337.6	65.2
1995	7,265.6	765.6	895.5	1,661.1	-99.9	10.5%	12.3%	23.3%	-1.4%	575.8	749.6	1,325.4	-173.8	219.8	148.0	365.8	73.8
1996	7,661.6	850.8	959.3	1,810.1	-108.5	11.1%	12.5%	23.6%	-1.4%	612.0	803.3	1,415.3	-191.3	238.8	156.0	394.8	82.8
1997	8,110.9	937.6	1,047.8	1,985.4	-110.2	11.6%	12.9%	24.5%	-1.4%	678.3	877.3	1,555.6	-198.0	258.3	170.5	428.8	87.8
1998	8,508.9	931.3	1,089.9	2,021.2	-158.6	10.9%	12.8%	23.8%	-2.0%	671.1	919.0	1,590.1	-247.9	260.3	180.9	441.2	79.4

Source: Data from U.S. Department of Commerce

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Statement of the American Petroleum Institute

I. INTRODUCTION

This statement is submitted by the American Petroleum Institute (API) for the June 30, 1999 Ways and Means hearing on the impact of U.S. tax rules on the international competitiveness of U.S. workers and businesses. API represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining and marketing.

Significance of Foreign Operations for U.S. Oil Companies

While U.S. petroleum reserves are depleting, federal and state government policies increase restrictions on exploration for, and development of, new deposits. To stay in business, U.S. petroleum companies must find new reserves overseas. This is at a time when U.S. oil industry is losing its leadership position because of the shrinking advantages over its foreign competition from U.S. technology and investment capital.

The loss of ground by U.S. oil companies relative to their foreign competitors is alarming. In 1974, 6 of the 10 largest oil companies in the world, and 4 of the top 5, were U.S.-based. In 1995, only 5 of the top 10 companies, and 2 of the top 5, were U.S.-based. According to a recent API study for the period of 1985 to 1995, foreign production by U.S. companies increased by 300,000 barrels/day. Nevertheless, that was not enough to offset the declines in U.S. production, so that U.S. companies' total global production during that period actually declined. Over that same period, production by similarly sized foreign oil companies other than those from OPEC countries expanded nearly 60%.

U.S. Tax Policy Adversely Affects Competitiveness

A major factor in the decline in U.S. companies' relative share in global production is U.S. international tax policy. U.S. tax rules impose a substantial economic burden on U.S. companies not faced by their foreign competition. This is because the U.S. tax regime exposes U.S. multinational companies to double taxation (that is, the payment of tax on foreign source income to both the host country and to the U.S.) and to taxation before repatriation of profits. Moreover, complexities of the U.S. tax rules result in significant compliance costs not faced by foreign competitors. As a result, U.S. companies may be forced to forego foreign investment altogether based on projected after-tax rates of return, or they may be preempted in bids for overseas investments by their foreign competitors.

Since the early sixties, U.S. tax policy has been driven by the goal of capital export neutrality which purports to remove any tax advantages of foreign investment by equalizing the tax burden for U.S. and foreign investments. A continuing adherence to this policy ignores that the allocation of investment capital is no longer controlled by multi-national corporations alone but is increasingly influenced by portfolio investors, reflecting the development of a global capital market. Thus, tax policy no longer exerts the same control over domestic vs. foreign investment by U.S. corporations as in the past, but may affect whether U.S. residents invest through U.S. or foreign corporations.

Foreign Investment Strengthens the U.S. Economy

U.S. tax policy with respect to foreign source income, although intending to tax the return on foreign and domestic investment the same, has developed a demonstrable bias against foreign operations. This policy was based on the postulate that foreign investment by U.S. business loses jobs and capital for the domestic market. This is not empirically demonstrable. More importantly, this ineffective policy, as a relict of a past era, conflicts with global integration and removal of trade barriers.

With the entry into the information age, foreign investment by U.S. companies must no longer be viewed in the context of a Runaway Plant problem, but as creating new opportunities for U.S. employment in management and support functions as well as the export of products and technology. Moreover, for U.S. oil companies the location of opportunities for investment is dictated by subterraneous geological history. It is merely a question of whether the U.S. company or its foreign competitor will have the opportunity of the investment in the oil and gas project. But in case of a failure of the U.S. company to obtain the business opportunity, it is not at all certain that the freed up capital be invested in the U.S. First of all, there may be a lack of comparable domestic investment opportunities. Secondly, the U.S.

portfolio investor, who ultimately controls the available capital, may shift his investment to a foreign competitor who has access to more profitable projects.

Foreign investment by a U.S. oil company has significant benefits. A persistent, strong foreign presence of U.S. oil companies maintains foreign employment of U.S. personnel and utilization of U.S. technology in foreign markets and maintains domestic employment in activities which support those companies' foreign operations. The U.S. oil and gas industry directly employs almost 60,000 Americans in the U.S. in jobs directly dependent on these companies' international operations. Over 140,000 additional Americans are employed in the U.S. by U.S. suppliers to the industry's foreign operations. An additional 150,000 Americans are employed in the U.S. supporting those working for the oil companies and their suppliers. Thus, over 350,000 Americans owe their jobs to the international success of the U.S. oil and gas industry.

As distinguished from tax policy, U.S. trade policy supports foreign investment by U.S. oil companies. Examples are the encouragement to U.S. participation in the oil field of the Caspian Sea countries which was praised by the Administration as fostering the political independence of those newly formed nations, as well as securing new sources of oil to Western nations, still too heavily dependent on Middle-East imports.

The opening of the countries of the former Soviet-Union to foreign capital and the privatization of energy in portions of Latin America, Asia and Africa—all offer the potential for unprecedented opportunity in meeting the challenges of supplying fuel to a rapidly growing world economy. In each of these frontiers, U.S. companies are poised to participate actively. However, if U.S. companies cannot compete because they operate under comparatively disadvantageous home country tax rules, foreign resources will instead be produced by foreign competitors, with little or no benefit to the U.S. economy, U.S. companies, or American workers.

The Goal of Capital Export Neutrality Overshot

Tax Code provisions that are driven by capital export neutrality often violate their theoretical underpinning. As we will discuss below, the fractioning of the foreign tax credit (FTC) basket, the income sourcing and deduction allocation rules, the imposition of U.S. concepts in testing the income tax character of a foreign tax,[1] the limited excess credit carryover, and the transfer pricing criteria, all can result in double taxation, clearly in violation of capital export neutrality. Similarly, where the foreign tax is higher, there is no reduction of the U.S. tax and the foreign investment bears more tax as compared to the domestic opportunity, failing to assure export neutrality.

Hearing Promises Correction in Priorities of U.S. tax policy

We welcome this Hearing as a recognition of the need of an overhaul of the taxation of foreign source income that is driven by a reformulated U.S. tax policy with multinational competitiveness[2] as primary criterion.

In the past, revenue raising in and of itself was paramount. One will recall that in the last hours of the deliberations of the Tax Reform Act of 1986 it was the taxation of foreign source income that was used as a source of additional revenue. To further illustrate, the Treasury Department's January 1993 interim report on "International Tax Reform" lists simplification as primary objective, followed by administrability, consistency, economic efficiency, and (only last) "competitiveness." The Committee's focus on what should be the primary criterion of a sound tax policy for the taxation of foreign source income will assure that tax policy will fall into step with a modern trade policy.

The international competitiveness of U.S. firms must become the primary criterion for U.S. taxation of foreign source. This will agree with U.S. foreign trade policy for the new global market place which. Efforts must continue to level the playing field as regards home country taxation. Such efforts should include considerations of whether the time has come for the introduction of a territorial system of taxation by the United States.

A realignment of the present system with today's global market place will contribute to a strengthening of the foreign presence of U.S. oil companies which assures not only employment of U.S. personnel both abroad and in domestic support

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[1] In other words, the arrogated preemption of the foreign sovereign's choice of how to exercise its power to tax.

[2] By the JCT defined as "the ability of U.S. multinationals (firms headquartered in the United States that operate abroad) that locate production facilities overseas to compete in foreign markets. . . . This definition of competitiveness focuses on the after-tax returns to investments in production facilities abroad." E.g., JCS–6–91, at 8 (1991).

functions, but also exports of equipment and supplies from the U.S. for use in the foreign operations.

Passage of The International Tax Simplification for American Competitiveness Act of 1999, H.R. 2018 Would be a Significant Step Towards Leveling the Playing Field in the Global Market Place

The proposed International Tax Simplification for American Competitiveness Act of 1999, H.R. 2018, goes a long way toward simplifying the current U.S. international tax rules and removing some of the inequities in the existing system. As reflected in our subsequent discussion, of particular interest to our members are: the repeal of compliance costly Code Section 907 additional separate limitation on Foreign Oil and Gas Extraction Income (FOGEI) as obsolete because of the numerous cross-crediting limitations under the FTC basket rules and the all industry encompassing dual capacity taxpayer regulations (Sec. 208); the acceleration of the repeal of the separate FTC limitation for dividends received from noncontrolled 10/50 companies (Sec. 204); the recognition of the need to treat the European Union as one country under the subpart F rules (Sec. 102); the introduction of symmetry through the adoption of an overall domestic loss recapture (Sec. 202); the look-through for sales of partnership interests (Sec. 107); the extension of look-through rules to interest, rents, and royalties from a noncontrolled Section 902 corporation or a noncontrolled foreign partnership (Sec. 205); the repeal of the 10% limitation on the use of FTCs under the Alternative Minimum Tax (AMT)(Sec. 207); the option to determine subpart F E&P under generally accepted accounting principles (Sec. 104); the exception of foreign operations of foreign persons from the uniform capitalization rules (UNICAP) (Sec. 302); the clarification that income solely from pipeline transportation through a foreign country is not subject to subpart F (Sec. 105); the extension of the FTC carryforward to ten years (Sec. 201) and the change of the ordering rules so that carryover credits are deemed to be used first (Sec. 206); and the recognition of the need to correct the distorting and complex interest allocation rules (Sec. 309).

Our statement comments in more detail on these provisions. We also highlight other aspects of current law which affect our members' international competitiveness due to potential double taxation, the taxation of controlled foreign corporations' (CFC) earnings before repatriation, and the disproportionate compliance costs. We suggest relief from these problems which should have no or little revenue effects.

II. How U.S. Tax Rules Place U.S. Companies at a Competitive Disadvantage in the Global Marketplace

Foreign Tax Credit and Deferral as Corollaries of World Wide Taxation

One of the most serious risks to foreign operations by multinational firms is their vulnerability to double taxation. Two approaches have been adopted to remedy this problem: worldwide taxation with a credit for taxes paid to foreign governments, and territorial taxation which limits a home country's taxation of its citizens to income generated within its national boundaries.

The U.S. taxes domestic corporations on worldwide income. That is, U.S. companies are subject to the same U.S. tax liability whether that income is earned at home or abroad. As a complement to world-wide taxation, the FTC is, of course, designed to prevent double taxation. Furthermore, world-wide income should be taxed only when realized by the subjects of U.S. taxation, i.e., U.S. citizens (including U.S. corporations) and resident aliens. Legislative and administrative changes within the last several decades have severely diluted and emasculated these tenets.

The Flawed Foreign Tax Credit Regime

Although the U.S. allows a credit against a company's U.S. tax liability for taxes paid to foreign governments, the FTC does not fully protect U.S. companies against double taxation, placing U.S. companies at a competitive disadvantage. In addition, the FTC will not assure export neutrality where the host country imposes a higher tax than the U.S. tax because there is no refund of the excess tax burden.

But even where the host country tax is equal to or lower than the U.S., many of the FTC rules prevent export neutrality because they subject US corporations to double taxation. As discussed, these restrictive features include the rules on (1) creditability of foreign taxes which impose U.S. income tax criteria on foreign tax regimes; (2) limited credit carryover periods which do not take into account the differences in income and deduction recognition timing under the host country rules; (3) the numerous FTC baskets; (4) transfer pricing; (5) sourcing of income; (6) allocation of deductions; (6) transfer pricing; (7) and loss of deferral which inhibits effective tax credit management.

Many of our trading partners limit home country tax of their citizens to income generated within their national boundaries. Foreign competitors based in territorial taxation countries still enjoy a benefit even where the host country tax is lower than the U.S. tax and the above mentioned distorting effects do not come into play.

For example, when income earned abroad by a U.S. company is subject to a foreign income tax rate that is less than the U.S. rate, then U.S. companies are subjected to a tax burden (to the U.S.) not borne by foreign competition from a country with territorial taxation:

	U.S.-based company	Competitor from territorial system home country
Income from Host Country	100	100
Host country tax at 25%	25	25
Take home	75	75
Home country taxable income	100	0
U.S. tax at 35%	35	
FTC	25	
Residual U.S. tax	10	
After Tax Income	65	75
Competitor's Higher Return		15.4%

U.S. Shareholders are Taxed on Deemed Dividends

As originally adopted, world-wide taxation by the U.S. was intended to capture the income of citizens and residents. However, driven by a concern that US taxpayers could keep movable passive income in CFCs outside the US taxation, anti-deferral rules were adopted which tax the U.S. shareholder before it realizes certain earnings of its CFC. Despite this "movable passive income" rationale for the subpart F regime, anti-deferral rules were extended to certain operating income despite the fact that such earnings were not received by the shareholder and may have been reinvested by the CFC in active business operations.

III. Relief from Major Adverse Rules

A. Defects in the Foreign Tax Credit Regime

Foreign Tax Credit Separate Basket Rules. Foreign taxes can be utilized as a credit only up to the amount of U.S. tax on foreign source income. Thus, an overall limitation on currently usable FTC's is computed by taking the ratio of foreign source income to worldwide taxable income and multiplying this by the tentative U.S. tax on worldwide income. The FTC separate basket rules further limit the allowable FTC. The overall FTC limitation must be computed separately for more than nine separate categories, or baskets, of foreign source income. Thus, U.S. tax rules force taxpayers in the active conduct of a trade or business to divide their active business income into multiple baskets, with the concomitant inability to cross credit. U.S. companies are often unable to make up for differences in timing and the mutations of the income/expense profiles, etc., of the tax regimes of the host countries. Because the separate basket rules increase the likelihood that a U.S. company will owe residual U.S. tax on foreign source income, they further widen the gap between the U.S. companies' and their competitors' home countries tax systems, to the disadvantage of U.S. businesses.

Foreign taxes on active business income should be available for cross credit. We must return to the roots of the FTC and allow full credit against U.S. taxes on foreign business income for all foreign taxes and not limit their use through the imposition of a schedular system. Any undesirable shielding of U.S. tax on offshore passive income can be prevented by one separate passive basket.

Foreign Oil and Gas Extraction Income and Foreign Oil Related Income. Code Section 907. In the computation of the overall FTC limitation foreign oil and gas income falls into the general limitation basket. But before this limitation for general operating income, foreign income taxes on foreign oil and gas income have to clear the additional tax credit hurdle of Code Section 907.

Section 907 limits the utilization of foreign income taxes on FOGEI to that income times the current U.S. corporate income tax rate. The excess credits may be carried back two years and carried forward five years, with the creditability limitation of Section 907 being applicable for each such year. Section 907 also authorizes Treasury to provide in regulations that a purported income tax on foreign oil related in-

come (FORI) is not creditable but only deductible to the extent such income tax on FORI is materially greater than the amount of tax imposed on income other than FORI or FOGEI. FORI is income derived from the foreign refining, transportation, and distribution, of oil and gas and its primary products. Furthermore, Section 907 provides that, if the taxpayer has an overall foreign extraction loss in a year that reduces non-extraction income, a corresponding amount of FOGEI in a subsequent year has to be re-characterized as income which is not FOGEI.

Section 907 was originally enacted in 1975 in reaction to the first oil crisis and out of a concern that the high oil and gas production taxes paid to host countries might be in part the economic equivalent of ground rents or royalties. Unlike the U.S. and some Canadian provinces, mineral rights in other countries vest in the foreign sovereign, which then grants exploitation rights. Because of this identity of the grantor of the mineral rights and the taxing sovereign, the high tax rates imposed on oil and gas profits have become subject to scrutiny whether this government take is in part payment for the grant of "a specific economic benefit" from the mineral exploitation rights.

Congress intended for the FOGEI and FORI rules to purport to identify the tax component of payments by U.S. oil companies to foreign governments. The goal was to limit the FTC to that amount of the foreign government's "take" which was perceived to be a tax payment vs. a royalty as payment for the production privilege. But even the so identified creditable tax component should be not be used to shield the U.S. tax on certain low taxed other foreign income, such as shipping.

These concerns have been adequately addressed in subsequent administrative rulemaking and legislation. After several years of discussion and drafting, Treasury completed in 1983 the "dual capacity taxpayer rules" of the FTC regulations which set forth a methodology for determining how much of an income tax payment to a foreign government will not be creditable because it is a payment for a specific economic benefit. Such a benefit could, of course, also be derived from the grant of oil and gas exploration and development rights. These regulations have worked well for both IRS and taxpayers in various businesses (e.g., foreign government contractors), including the oil and gas industry. In addition, the multiple separate basket rules were enacted in 1986, restricting taxpayers from offsetting excess FTC's from high-taxed income against taxes due on low-tax categories of income.

Since 907 has been rendered obsolete since the function of Section 907 is now fully covered by the FTC baskets of the 1986 Act and the "dual capacity taxpayer regulations" under Code Section 901. Furthermore, the Section 907 limitation has raised little, if any, additional tax revenue because excess FOGEI taxes would not have been needed to offset U.S. tax on other foreign source income. Nevertheless, oil and gas companies continue to be subject to burdensome compliance work. Each year, they must separate FOGEI from FORI and the foreign taxes associated with each category. These are time consuming and work intensive analyses, which have to be replicated on audit. Section 907 should be repealed as obsolete [Sec. 208 of The International Tax Simplification for American Competitiveness Act of 1999] which would promote simplicity and efficiency of tax compliance and audit.

Dividends Received from 10/50 Companies. The 1997 Tax Act repealed the separate basket rules for dividends received from 10/50 companies, effective after the year 2002. A separate FTC basket will be required for post-2002 dividends received from pre-2003 earnings. Because of these limitations, U.S. companies will continue to forego in many cases foreign projects through noncontrolled 10/50 corporations. Accordingly, the repeal will remove significant complexity and compliance costs for taxpayers and foster their global competitiveness.

The repeal of the separate limitation basket requirement with respect to dividends received from 10/50 companies therefore should be accelerated. In addition, the requirement of maintaining a separate limitation basket for dividends received from E&P accumulated before the repeal should be eliminated [see Sec. 204 of The International Tax Simplification for American Competitiveness Act of 1999].

Look-through Treatment for Sale of Partnership Interests. The distributive share of partnership income of an at least 10% partner of a foreign partnership brings with it all tax attributes, including the FTC basket classification. By contrast, the gain on the sale of a partnership interest falls into the passive income FTC category. A 1988 amendment to Code Section 954 characterizes the gain on the disposition of a foreign partnership as Foreign Personal Holding Company Income (FPHCI) which is referenced in the passive income definition of the FTC categories.

The passive income categorization is particularly burdensome for the oil and gas industry. Because of frequent inability to secure 100% of the mineral interest from foreign governments, the business strategy to spread the risk of exploration by participating in several projects instead of "putting all the eggs into one basket," or because of capital restraints, U.S. companies typically find themselves as joint ven-

turers in foreign exploration projects. Unless there is an election-out under the Joint Operating Agreement, the venture will be a partnership for U.S. purposes. Under current rules the gain from the sale of such venture participation would be passive income even though it is the disposition of an interest in business operations whose venue was not chosen for tax reasons but because of nature's placement of the natural resource.

The 1988 amendment conflicts with the aggregate theory of partnership taxation. It is generally applied in foreign income taxation with respect to the effect of partner level transactions. Furthermore, there is no rationale for treating the disposition gain different from the income distribution. Both are realizations of values generated in the partnership and differ only in the form of realization.

Economically, any gain on the sale of the partnership interest is attributable to the value of the partnership assets. If the partnership sold the assets, the FTC categories for such income would flow through to the partner. The same rule should apply if the partner by selling its partnership interest sells the equivalent of its undivided interest in the partnership assets [See Section 107 of The International Tax Simplification for American Competitiveness Act of 1999 which removes the gain on disposition of a partnership interest from passive income not only for purposes of the FTC basket rules but also from FPHCI]. It is not only inequitable but also counterintuitive for the legal form of the value realization to control the FTC basket characterization.

Look-through Treatment for Interest, Rents, and Royalties With Respect To Non-Controlled Foreign Corporations and Partnerships. U.S. companies are often unable, due to government restrictions or operational considerations, to acquire controlling interests in foreign corporate joint ventures. To align their position with general participation situations in foreign projects, they also should be granted the look-through treatment for interest, rents and royalties received from foreign joint ventures as in the case of distributions from a CFC.

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% by U.S. owners) must be treated as separate basket income to the joint venture partners. Again, as in the case of corporate joint ventures, look-through treatment should be extended to these business entities. This would abolish distinctions in treatment of distributions that are based on participation percentages which may be beyond the control of the U.S. taxpayer [See Section 205 of The International Tax Simplification for American Competitiveness Act of 1999].

Recapture of Overall Domestic Losses. When in a tax year foreign source losses reduce U.S. source income (overall foreign loss or OFL), this perceived beneficial domestic taxation effect has to be "recaptured" by resourcing foreign source income in a subsequent tax year as domestic source. Of course, this re-characterization reduces the ratio of foreign source income to total income, which in turn reduces the ratio of tentative U.S. tax which can be offset against foreign taxes. However, if foreign source income is reduced by U.S. source losses, there is no parallel system of "recapture." Taxpayers are not allowed to recover or recapture foreign source income that was lost due to a domestic loss. The U.S. losses thus can give rise to excess FTC's which, due to the FTC carryover restrictions, may expire unused. Only a corresponding re-characterization of future domestic income as foreign source income will reduce the risk that FTC carryovers do not expire unused [See Section 202 of The International Tax Simplification for American Competitiveness Act of 1999].

Foreign Tax Credit Carryover Rules. The utilization of income taxes paid to foreign countries as FTC is limited to the U.S. tax that is owed on the foreign source income. Thus, an overall limitation on currently usable FTC's is computed by taking the ratio of foreign source income to worldwide taxable income and multiplying this by the tentative U.S. tax on worldwide income. The excess FTC's can be carried back to the two preceding taxable years, or to the five succeeding taxable years, subject in each of those years to the same overall limitation. If the credits are not used within this time frame, they expire.

Because of the ever increasing limitations on the use of FTC's, coupled with the differences in income recognition between foreign and U.S. tax rules, excess credit positions are frequent. Present law's short seven year carryover (2-year carryback and 5-year carryforward) period easily results in credits being lost, most likely resulting in double taxation.

As a modernization step, clearly within the long-standing policy of not taxing the same income twice, the carryover periods for excess FTCs should be extended, in accordance with the rationale of the much longer period allowed for net operating loss utilization [See Section 201 of The International Tax Simplification for American Competitiveness Act of 1999 which extends the carryforward to 10 years and Sec. 206 assuring first use of carryover credits].

Allocation of Interest Expense. Current law requires the interest expense of all U.S. members of an affiliated group to be apportioned to all domestic and foreign income, based on assets. The current rules deny U.S. multinationals the full U.S. tax benefit from the interest incurred to finance their U.S. operations. For example, if a domestically operating member of a U.S. tax consolidation with foreign operations incurs interest to finance the acquisition of new environmental protection equipment, a portion of the interest will be allocated against foreign source income of the group and therefore become ineffective in reducing U.S. tax. A U.S. subsidiary of a foreign corporation (or a U.S. corporation—or affiliated group—without foreign operations) would not suffer a comparable detriment.

Unless allocation based on fair market value of assets is elected, allocations of interest expense according to the adjusted tax bases of assets allocate too much interest to foreign assets. For U.S. tax purposes, foreign assets generally have higher adjusted bases than similar domestic assets because domestic assets are eligible for accelerated depreciation while foreign-sited assets are assigned a longer life and limited to straight-line depreciation. For purposes of the allocation, the E&P of a CFC is added to the stock basis. Since the E&P reflects the slower depreciation, the interest allocated against foreign source income is disproportionately high.

Rules similar to the Senate version of interest allocation in the Tax Reform Act of 1986 would alleviate the current anti-competitive results. In addition to the domestic consolidated group, the allocation group would include all companies that would be eligible for U.S. tax consolidation but for being foreign corporations. The interest allocated to foreign source income under this worldwide taxpayer rule would be reduced by the interest that would be allocable to foreign source income from the foreign corporations if treated as separate group. Second, as an exception to the "one taxpayer" rule, "stand alone" subsidiaries could elect to allocate interest on certain qualifying debt on a mini-group basis, i.e., looking only to the assets of that subsidiary, including stock.

Furthermore, taxpayers should be allowed to elect to use the E&P bases of assets, rather than the adjusted tax bases, for purposes of allocating interest expense. Use of E&P basis would produce a fair result because the E&P rules are similar to the rules now in effect for determining the tax bases of foreign assets [See H.R. 2270 introduced by Messrs. Portman and Matsui as the Interest Allocation Reform Act].

Foreign Tax Credit Limitation under the Alternative Minimum Tax. U.S. tax rules prohibit the use of FTC's to reduce the tentative minimum tax (AMT) to less than 10% of the tax before the FTC (AMT FTC Cap). Excess credits are eligible for carryover under the same carryover rules discussed above. The AMT FTC Cap was part of a general floor for the use of net operating loss (NOL) and investment tax credit (ITC) carryovers. But the FTC serves a function distinct and different from NOLs or the ITCs, the other tax attributes whose utilization is limited for AMT purposes.

The NOL carryover rules are designed to overcome any hardships resulting from the annual accounting concept. The ITC is a tax benefit designed to foster investment in productive capital. Both provisions developed only over time and do not have the systematic cogency of the FTC. As the logical and systematic result of the U.S. claiming worldwide taxing jurisdiction over U.S. corporations, the FTC has been a fixture of the U.S. tax system since 1918. Concurrently with the adoption of worldwide taxing jurisdiction, the U.S. ceded primary taxing jurisdiction to the host country. To deny a full offset of AMT with FTC violates this principle of secondary U.S. taxation of foreign source income.

The AMT's rationale to assure U.S. tax payments on economic income is inappropriate with respect to foreign source economic income if the result is double taxation. While the AMT envisions acceleration of tax payments which otherwise would become due in the future (only deferred because of preferences or tax attributes like NOL and ITC), the availability of FTC's reflects that an appropriate tax already has been exacted from the taxpayer. To the extent of FTC's, there is no economic income which escapes taxation. Accordingly, the AMT FTC Cap should be repealed [See Section 207 of The International Tax Simplification for American Competitiveness Act of 1999].

Repeal Code Section 901(j) which Denies Foreign Tax Credit with Respect to Countries Supporting Terrorism, Etc. The global political landscape has changed considerably since the enactment of this provision in 1986. Not only are confrontational polarizations into opposing power centers fading, so is terrorism as means of international politics. Barriers have come down so fast that the establishment of diplomatic relations cannot keep up with global integration.

The retention of this provision merely hinders business developments because of the lag in establishing full diplomatic relations.

State Tax Allocation to Foreign Income. Pursuant to a statutory grant of general rulemaking authority, Treasury has issued regulations requiring the allocation of

State income taxes or income based franchise taxes to foreign source income if taxable income determined under State law exceeds Federal taxable income. Because of the often substantial variances between these two tax bases, U.S. taxpayers may be subject to double taxation because foreign taxes attributable to the foreign income that is eliminated by the misallocation of State taxes will not offset U.S. tax on worldwide income. State income taxes are a cost of doing business in a particular State and generally have nothing to do with a U.S. taxpayer's foreign operations; they should affect only income generated from activities within the State. From a technical standpoint, the allocation rule is defective because it compares State taxable income with Federal taxable income; the respective regimes may differ substantially as to inclusiveness and timing. This misallocation therefore should be abolished.

Overreaching Treasury Regulations on Dual Consolidated Losses. IRC Section 1503(d) was designed to forestall a perceived abuse where a U.S. affiliate's net operating loss was not only deducted against the income of another U.S. company but under a foreign tax regime also reduced the income of a foreign affiliate. That Section authorizes regulations to except U.S. corporations from this loss disallowance to the extent the losses do not offset the income of another foreign corporation under the foreign tax law. Treasury has issued a regulation pursuant to which practically every foreign business operation of a U.S. corporation jeopardizes the deduction of a loss from the foreign venture for the U.S. tax consolidation unless unreasonable administrative undertakings are stipulated. For example, a U.S. consolidated return corporation with foreign nexus, including a mere interest in a foreign partnership, can use a loss in computing consolidated return income only if it enters into a burdensome agreement with the IRS which requires continuous monitoring and in many cases annual reporting. In light of the burdensome and overreaching administrative rule, the statute should limit loss disallowance to the targeted abuse and preempt the current regulatory overkill.

B. Relief from Shareholders' Current Taxation of CFC Earnings

Repeal the Byzantine High-Tax Kick-Out. According to FTC basket rules, otherwise passive income is not included in the passive FTC basket if it is subject to a foreign tax rate in excess of the U.S. rate. The implementing regulations impose a regime that defies a brief summary.

These labyrinthine rules add enormous complexity. The computation of subgroups and sub-baskets, together with the various sets of rules for determining the amount of tax on a particular type of income, impose inordinate burdens on the foreign and domestic tax personnel of U.S. multi-national corporations.

The primary reason for the separate passive income basket is the perceived easy mobility into low tax jurisdiction. If this goal is not realized, there is no reason to mingle passive income with operating income, because the underlying characteristic of mobility and its passive character remains. "Once passive income, always passive income." Accordingly, the "high-tax kick-out" should be repealed.

E&P for Sub-part F Should be Based on GAAP Financial Statements. Under current rules, for the taxation of the US shareholder, E&P of foreign corporations have to be determined according to US tax accounting rules. The accounting personnel and accounting systems of foreign subsidiaries typically do not allow simple adjustments to US tax books. Proposed regulations under Code S964 recognize the unrealistic nature of such a requirement and grant relief from most book to tax adjustment. Unfortunately, this relief—because of a perceived lack of statutory authority—does not extend to the determination of E&P in connection with computing whether or not there is a deemed distribution of subpart F income that may have been realized by the CFC.

Nevertheless, the reasons for the dispensation from the book to tax adjustments under the proposed Section 964 regulations apply equally in connection with subpart F. Without extension of the relief to the E&P computation for subpart F purposes, the Section 964 relief is meaningless. Because of the possibility that a CFC may realize income of the type that may give rise to subpart F income it has to track its E&P under current rules according to US tax accounting principles.

A uniform recognition of financial statements of CFCs for all purposes of the taxation of its US shareholders would remove an unnecessary, costly compliance feature [See Section 104 of The International Tax Simplification for American Competitiveness Act of 1999].

Anti-Deferral Rules Should Not Be Applied To Pipeline Transportation. Under Code Section 954(g), a CFC's foreign base company oil related income (FBCORI, i.e., a CFC's FORI derived other than in a country of extraction or consumption) includes pipeline transportation income. In the past such income was typically derived

as integral part of downstream oil and gas operation (processing, refining, and marketing).

Large pipeline projects through non-producing countries without further processing are a recent phenomenon. The original ratio legis behind the FBCORI category does not apply to such pipeline transportation. The location is not subject to tax consideration but is controlled by the most feasible connection between production site and intended naval transshipping or consumption point, taking into account construction and maintenance cost, as well as political considerations.

Accordingly, income from carrying oil and gas in a pipeline through a country should be excepted from FBCORI [See Section 105 of The International Tax Simplification for American Competitiveness Act of 1999].

Treat European Community as Single Country. In recognition of economic realities, all countries comprising the European Community (EC) should be treated as a single country for purposes of the subpart F rules on foreign base company sales income and foreign base company service income. Where the perceived taint of tax arbitrage through cross-border transactions is missing, US tax rules except what would otherwise be subpart F income if derived from transactions within the CFC's country of incorporation. The same rationale should applies in excepting transactions to the unified market of the EC nations, representing customs and monetary unity with the goal of tax harmonization. This would be an important step in the reduction of the disadvantage CFCs experience in the common market vis a vis their EC based competitors.

The recognition of the EC as one country should also apply to the "same country" exception FBCORI. Without such modification, the EC's recognition as one country would not carry over into refining, distribution, and marketing of oil and gas as well as their primary products. For example, a CFC's sale in Germany of gasoline from its refinery in The Netherlands would continue to be tainted, even though the transaction takes place within the borders of what now is recognized as one economy [The problem is recognized in the study commissioned under Section 102 of The International Tax Simplification for American Competitiveness Act of 1999].

IV. Provisions Common to FTC and Anti-Deferral Rules

Exempt Foreign Operations of Foreign Persons from the Uniform Capitalization Rules

The Uniform Capitalization Rules (UNICAP) of Code Section 263A are designed to assure that (1) all production cost are capitalized and (2) the same rules apply to the production activities of all industries. Perceived tax accounting differences among industries and activities were seen as unwelcome factors in resource allocation and structural alignments. Moreover, it was argued that a better matching of income and expenses would also prevent unwarranted deferral of income taxes.

The application of UNICAP to foreign operations of foreign persons was not a concern of Congress. It has been the Service's failure to exercise its regulatory discretion which still subjects foreign operations of foreign persons to UNICAP.

An exemption from UNICAP would bring simplicity. It would not violate equity. Any attempt to equalize tax postures of foreign persons with respect to foreign operations is futile because of the ever changing tax regimes in the host countries. Because of excess FTCs it would be revenue neutral. Because of a relief from compliance cost, the exemption would promote competitiveness [See Section 302 of The International Tax Simplification for American Competitiveness Act of 1999].

V. Conclusions

The risk of double taxation presented (1) by restrictions on the use of FTC and (2) by the current taxation to the U.S. shareholder of certain CFC income regardless of distribution, continues to adversely affect the ability of U.S. businesses to compete worldwide. The complexity of the U.S. tax rules obfuscate tax planning and introduce often substantial risks, hindering effective capital investment. Simplification, removal of inequitable and ineffective rules, and alignment with today's global economy would encourage compliance, facilitate the free flow of capital, and improve the competitive position of U.S. multinational concerns. The passage of The International Tax Simplification for American Competitiveness Act of 1999 would go a long way to the realization of these goals.

Statement of Rod Paige, Council of the Great City Schools, and Superintendent of Houston Public Schools

Mr. Chairman, Congressman Rangel, and members of the Ways and Means Committee, I am Rod Paige, Superintendent of the Houston Public Schools. I am submitting testimony regarding the significant need for major federal school infrastructure aid on behalf the Houston Public Schools and the Council of the Great City Schools, the coalition of some fifty of the largest central city school districts of the nation.

It has been five years since the General Accounting Office's study of school infrastructure needs garnered national attention. To the surprise of many, the school infrastructure inadequacies were found to be nearly universal, though not unexpectedly more severe in urban schools. A $112 billion backlog of serious infrastructure needs was identified back in 1994. But despite the efforts of some states, and school districts like Houston committing significant resources to address our most severe facility problems, the remainder of the $112 billion historic backlog still remains. In fact, the wave of new school enrollments from the so-called "baby boom echo" have lifted the estimated national school infrastructure needs to approximately $200 billion as this century comes to a close.

Houston is very proud that our voters elected to finance a $678 million bond authority in 1998 by a 73% to 27% vote. I believe that this represents a renewed vote of confidence in our public schools after a narrow defeat of a previous bond authority in 1996. However, even though Houston will be spending over $1/2 billion in the next 3 years, we have not addressed the full range of our school facility needs. Our facilities staff projects the need for over $800 million in additional funds to meet our current requirements. In fact, during a review of needs before our bond election, we estimated that unless we are able to address our needs in deferred maintenance and renovations, in 10 years time the cost to repair the schools would approach replacement value. At that time, it is unlikely we would ever catch up with the problem. Infrastructure problems if not addressed in a timely manner, may be the most serious facilities problem facing large urban district now and certainly in the future.

The State of Texas has done little to assist districts such as Houston over the years. Although the State does have an education fund which is used to help obtain higher bond ratings, little money has been put into the big districts for facilities. While we are continuing to work for the full inclusion of facilities funding into the State's school funding laws and some movement in that direction occurred this year, I see little hope that the State will soon come to our aid in any significant manner.

In order to address the massive national school facility needs, substantial participation is critical not only from our local public schools, but also from our state and our national governments. A $200 billion gap cannot be closed without a significant financial commitment from all levels. The Houston Public Schools and the Council of the Great City Schools, therefore, support a major federal investment to close a sizable portion of this national school facilities gap.

It also is essential to optimize the volume and the timeliness of school construction and renovation generated by each federal aid dollar, and that the communities with the highest concentrations of poor are assured of receiving the greatest amount of assistance.

There are a variety of school infrastructure assistance bills pending before both houses of the Congress. I would like to address a few of these legislative proposals using Houston as an example:

TAX SUBSIDIZED, ZERO INTEREST SCHOOL FACILITY BONDS

There are a number of tax-subsidized, zero-interest school facility bond proposals pending in both houses of Congress with the major difference found primarily in the distribution formulas of the tax subsidizes. Cong. Rangel's H.R. 1660, Cong. Johnson's H.R. 1760, and Sen. Lautenberg's S. 223, each provide tax credits in lieu of interest income to the holders of qualified school facility bonds, thus allowing school districts to pay back these infrastructure bonds without the normally associated interest costs of such financing. This mechanism could cut the cost of school construction financing by nearly half. Both H.R. 1660 and S. 223 would ensure that the school districts with the largest number of low-income children would receive a substantial benefit from these tax incentives. Houston would be authorized to issue $240 million under H.R. 1660 and $168 million under S. 223 in these bonds. H.R 1760 would leave allocations for Houston and other school districts with the highest numbers of poor children in the nation to the political whims of their states—an historically inequitable position. The tax credit mechanism in these three bills

would have a five-year federal budget impact of approximately $3.5 billion, but would leverage approximately $25 billion in school construction and renovation.

Arbitrage Spend-down Flexibility

There are also a number of legislative proposals, including Cong. Goodling's H.R. 2, Cong. Dunn's H.R. 1084, and Sen. Graham's S. 526, which would extend the spend-down restrictions on safe harbor arbitrage income from two years to four years, and would increase the small issuer exception to $15 or $20 million. These arbitrage flexibility proposals would have a five-year federal budget impact of approximately $1.4 billion. Using our recent $678 million Houston bond issue as an example, under current market conditions 28 basis points are being realized by investing our unexpended funds. Therefore, the maximum annual benefit for Houston on a $678 million issue would be about $1.9 million in arbitrage.

Tax Exempt Private Activity Bonds for School Construction

Another legislative proposal, included in Sen. Graham's S. 526, is the proposed use of tax exempt private activity bonds for school construction purposes. A new $10 per capita volume limit would be authorized for each state to allow private entities to finance the development of schools through these tax-exempt instruments. This private activity bond proposal would have a five-year federal budget impact of approximately $1.2 billion. Though the allocation of these tax-exempt bonds would be at the discretion of the state, Houston could issue nearly $20 million in bonds, if the state allotted us our per capita share of the state's allotment. Operationally, the school district would lease the school facility from the private developer until the bond was paid, and then the school would be turned over to the school district. Unfortunately, most school districts would have to make lease payments out of their operating budgets, thus diluting available funds for teacher compensation, instructional materials, computers, and even facility maintenance. Based on market conditions, we would expect lease payments to be at higher rates than would traditional bonds. The amount of the school lease payments appears to be at the discretion of the private developers.

Obviously, Houston would be glad to accept all the school infrastructure assistance that Congress can provide. But realistically all of these legislative proposals cannot be enacted with limited federal resources. Therefore, Congress should spend its federal budget resources as efficiently and effectively as possible—in effect securing the most school construction for the buck. From our analysis, H.R 1660 would subsidize $240 million of school construction bonds for Houston at a cost of five-year $3.5 billion to the federal treasury. At one-third to two-fifths of the costs to the Treasury, neither arbitrage reform nor private activity bonds would provide one-tenth of this level of school facility aid. Qualified school facility bonds, in our opinion, represent the approach to federal aid that will have a truly consequential impact on meeting the infrastructure needs of Houston and other large urban high poverty districts. Under a similar H.R. 1776, Houston would not be assured of receiving any assistance at all, as the state would have total discretion over the allocation of this federal assistance—a major weakness from out perspective.

Mr. Chairman, there is a clear link between proper school facilities and improved educational achievement. How can we hold our children accountable for educational progress, if their local, state and national leaders are not providing them with modern schools and the tools needed for success? Thank you for focusing the attention of the Committee on this issue during the hearing process. It is encouraging that the Committee is looking at the school facility needs of the nation. On behalf of the Houston Public Schools and our colleagues in the other Great City Schools, I urge the Committee to include in the upcoming tax bill at least $3 to $4 billion in immediate subsidies that will leverage $25 to $30 billion in new school infrastructure improvements. Thank you for the opportunity to submit testimony for the Committee hearing record.

CROWLEY MARITIME CORPORATION
WASHINGTON, D.C., 20004
June 24, 1999

Hon. BILL ARCHER, *Chairman,*
House Ways & Means Committee
Washington, DC.

Re: June 30 Hearing on International Tax Rules—Statement of Crowley Maritime Corporation

Dear Chairman Archer:

Crowley Maritime Corp. (Crowley) commends the Chairman and committee for holding this hearing, and appreciates the opportunity to submit this statement on the subject of international tax rules. Our statement consists of this letter and the attached presentation on "Shipping Income Tax Reform" given last September at the national meeting of the Propeller Club of the United States. We hope soon to provide a supplemental statement updating some of the information in the attached presentation.

We have also discussed these issues with others who will be submitting oral testimony at the hearing, including Mr. Peter Finnerty of Sea-Land Service, Inc., and Prof. Warren Dean. We anticipate general agreement with their testimony, and submit this separate statement only because of the importance of these issues and the urgency with which they need to be addressed.

By way of background, Crowley (headquartered in Oakland) is the second-largest American shipping company. Crowley subsidiary Crowley American Transport, Inc. (CATI) (based in Jacksonville) is a major regional liner operator, offering the most comprehensive container services to Latin America. Other operating subsidiaries include Crowley Marine Services, Inc., a diversified marine contractor, Crowley Petroleum Transport, Inc. (both based in Seattle), and Crowley Marine Transport, Inc. (based in Houston).

As discussed in the attached presentation, tax reform legislation is urgently needed to level the playing field for American carriers competing against foreign carriers, and to provide an environment in which American citizens will maintain and expand their investments in the maritime industry. According to Journal of Commerce PIERS data, nine of the top ten liner shipping companies carrying America's imports and exports are foreign carriers (eight of which are based in Asia). Moreover, according to Maritime Administration data, the U.S. flag liner companies' share of the U.S. import-export market fell by about 50% between 1990 and 1996. As others have demonstrated, American citizen control of the world's commercial fleet fell by about 80% between 1975 (the last year in which American carriers were taxed about the same as foreign carriers) and 1996.

It must be emphasized that the decline of America's shipping companies has nothing to do with any comparative advantage foreign carriers have over American carriers. In fact, given nondiscriminatory government policies, and recognizing that American carriers are based in the world's largest trading nation, American carriers likely would have an inherent competitive advantage over foreign-based carriers if the market for international shipping services were totally free of government influence.

As we all know, however, many governments subsidize shipping in a wide variety of ways and for many reasons. American subsidies over the past quarter-century, for good and sufficient reasons, have been focussed on maintaining a fleet of US-flag vessels. Subsidies would not be needed for American shipping companies (as distinct from their US-flag fleets) except for the fact that foreign governments, through income tax policy, subsidize their shipping companies. An internal Crowley study shows that, in 1996, American carriers paid more than 45% of their profits in income taxes, while foreign carriers received a net tax credit of about 2%.

This huge disparity in bottom line earnings goes a long way in explaining why it is that American carriers have sold out to foreign competitors. Given their inherent competitive advantage over foreign carriers, the loss of American shipping companies reflects the utter failure of American tax policy in the international arena. Thousands of high-paying jobs have been lost, jobs that should, in a free market, go to Americans. Our nation's security has been harmed as the amount and reliability of sealift available for military contingencies is reduced. Our economic security is degraded as foreign firms exert total control over the movement of our imports and exports.

Legislation that takes important steps toward correcting this tax disadvantage has been introduced. As a matter of sound tax policy, and to address clear threats to our nation's military and economic security, we strongly urge that it be enacted as quickly as possible.

Respectfully Submitted,

MICHAEL G. ROBERTS
Vice President, Government Relations

Shipping Income Tax Reform

Good morning and thank you for including me in this discussion of legislation affecting the maritime industry. Two years ago last week, at the end of the 104th Congress, we celebrated passage of the Maritime Security Act. The MSP saved what was surely one of the most endangered species existing in the world's oceans—American mariners sailing on commercial ships in international trades. With the clock running out on the existing government support programs, enactment of MSP was essential—in the words of Congressman Herb Bateman, a matter of the very survival of the American mariner in international trade. The entire maritime industry—liner carriers, non-liner carriers, unions, shipbuilders, ports—the entire industry pulled together and pushed MSP through Congress despite long odds. While MSP needs to be expanded and made permanent, its passage has helped assure the survival of a critical part of the American maritime industry.

We are now confronted, as we move toward the 106th Congress, with the threatened extinction of another critical part of our industry—the American shipping company operating in international trade. According to the U.S. Maritime Administration, American liner carriers' share of the market for moving U.S. import and export cargoes fell by almost half between 1990 and 1996, from over 17% of the market in 1990, to less than 9% in 1996. As the first slide shows, that's a huge and precipitous drop, an exodus that starts from an already unacceptably low level of U.S. carrier participation. Let me add that, while this slide focuses on liner cargoes, I understand that U.S. carriers' share of non-liner cargoes is even more dismal—in the one to three percent range.

We can assess the strength of American shipping companies not only on the basis of our share of the cargo market, but also based on the vessel capacity we own or operate. With this group I don't need to go into the number of U.S. flag vessels remaining. We know the U.S. flag fleet operated in international trades has been in long term decline. It is approaching the 47 ships in the MSP, and it will likely expand only if and when the government decides to expand MSP.

Slide 2 shows the decline in U.S. controlled tonnage flying foreign flags of convenience. And let me at this point touch on the issue of U.S. carriers operating foreign flags of convenience vessels. We all want to see as many ships as possible flying the U.S. flag and manned by U.S. crews. That's one of the central purposes of this organization. But unless and until we are able to eliminate the huge cost advantages available to flag of convenience vessels, we have to fully reconcile ourselves, as most of us have, to the fact that U.S. carriers must have the same ability to operate flag of convenience vessels as do our foreign competitors. To the extent we limit or condition U.S. carriers' rights in this regard (and not also limit or condition foreign carriers' rights), we don't stop or reduce flag of convenience shipping one bit. We simply shift it to foreign carriers instead of U.S. shipping companies. And U.S. shipping companies become more and more irrelevant.

This is not in any way meant as an endorsement of flag of convenience shipping. On the contrary, I thoroughly and completely agree that flag of convenience shipping fosters a "culture of evasion" that hurts the entire industry. David Cockroft, one of the leaders of the International Transport Workers Federation, was a little more blunt when he said the system "stinks," and I agree with that, too.

But as we all know, we have tried for decades to come up with a way to stop foreign flags of convenience, and as this chart shows, all we've succeeded in doing is to take Americans out of the business while flag of convenience shipping continues to grow. In 1975, U.S. carriers owned about 22 million of the 85 million gross registered tons in the world flag of convenience fleet. This accounted for about 26% of the world fleet. By 1996, the world flag of convenience fleet had almost tripled, to 241 million tons, while U.S. carrier ownership fell almost in half. The next slide shows what this means on a percentage basis, as American carriers' share of that fleet fell in 1996 to one-fifth the level it was in 1975.

So it's not a pretty picture, whether you look at cargo flows or vessel ownership. America, the world's largest trading nation, is almost a non-factor in the business of transporting its imports and exports.

Let me take a few minutes to talk now about why it is we have seen such a stark decline in the American shipping industry, and then get into what we might consider doing about it. First, let's be clear as to what is *not* the cause of our decline. It is *not* because we are incompetent. Looking at the liner sector, Sea-Land is the largest container shipping company serving the United States. Not the most profitable, but the biggest. Crowley is not the most profitable nor the biggest, but it is big and has consistently been rated the "Best of the Best" of the world's shipping companies. Lest this seem too much like a plug, APL has for many years been one of the world's strongest container lines, and other American shipping companies have been similarly well-managed. Even our biggest detractor, Rob Quartel, has conceded that Americans are the best in the world at this business.

So I'm pleased to report that we're not stupid and incompetent. And I don't believe the decline of our industry results from a comparative cost advantage that foreign carriers enjoy over U.S. carriers. Certainly in the liner sector, most costs are simply not affected by the nationality of the shipping company. With respect to vessel costs, which account for about one-fifth of total costs, American carriers operating U.S. flag MSP ships or foreign flag charters can be fully cost competitive. The remaining portion of liner operating costs, consisting of administration and overhead, does vary by nationality of the carrier, according to living costs in the area where these services are provided. But with headquarters located in places like Jacksonville or Charlotte, American carriers actually have a cost advantage over foreign carriers operating out of Tokyo or Hong Kong or London.

So what is the problem, why is the American shipping industry internationally in such a state of decline if not because of incompetence or cost disadvantages? The answer, as a matter of simple logic, must be profitability. The prices we charge keep going down, revenues are inadequate and returns, or profitability, is unacceptably low. This next slide, from Mercer Management, shows operating margins for the liner shipping industry compared to the operating margins for companies included in the Standard & Poors 500. As you can see, profits for the 24 liner shipping companies surveyed consistently averaged between one-third and one-half of the average profits earned by S&P 500 companies.

The unprofitability of the international liner industry can be traced, at least in substantial part, to two factors. First is overcapacity, which is attributable in part to the cyclical nature of the business, but also to the fact that governments love to subsidize the building of ships. Too many ships are built not because of market demand for transportation services, but because of the desire primarily of foreign governments to put their people to work building ships. Those of us in the ship operating business are left to deal with this mess and try to make a living with too much capacity in our markets. Hopefully, the OECD Shipbuilding Agreement or something like it will be implemented so that capacity in the shipping business can settle back toward a more rational, market-based level.

Another reason for unprofitability, at least in the liner sector, is a hyper-competitive market structure. Having 15 or 20 shipping companies doing the same thing in the same markets is not efficient nor conducive to rational business decision making, especially when some of the state-owned competitors are not fully motivated to making decent profits. Industry consolidation may be painful, but it is needed and is likely, particularly given the imminent enactment of the Ocean Shipping Reform Act. Consolidation, we hope, will eventually produce a more stable market structure and better profit margins.

These factors help explain why the industry as a whole is not profitable, but not why it is apparently less profitable for American carriers than for foreign carriers. Why is it, then, that foreign carriers are growing while American carriers decline if foreign carriers (1) have no cost advantage, (2) have no quality advantage, and (3) foreign investors apparently have the same incentive as Americans to seek higher investment returns elsewhere? Who can say for sure, but the one factor that we can readily identify and that goes a long way in explaining this mystery, is income taxes. To be clear, I'm talking about income taxes, below-the-line taxes assessed after all the costs and above-the-line tax benefits—accelerated depreciation, generous deductions, etc.,—are taken out of the revenues. American carriers pay income tax at a base rate of 36%. Most foreign carriers pay little or no income tax. The next slide is an analysis we've done in-house using the actual financial statements of nine liner carriers—three American, six foreign. While a larger sample of financial statements needs to be analyzed, even this small sample absolutely illustrates the point. On average, the foreign carriers sampled got a net tax credit in 1996, while American carriers paid over 45% of their profits to Uncle Sam. In 1997, it was about 7% foreign income tax liability versus 43% for the Americans.

What this all means is that, if the industry has an average profit margin of say 6%, the *effective* rate of return for foreign investors may range from 8% to 11% de-

pending on foreign income tax rates. Considering that some companies in some years do much better than 6%, it's not a bad return if you're a foreign carrier paying no income tax. Certainly, the incentive for foreign investors to leave the industry is much less than for American investors. In short, it is the income tax disadvantage, more than any other factor that I can identify, that explains the current condition of the American shipping industry. In fact, I understand that income tax liability played a crucial—perhaps decisive—role in the decision to merge APL into NOL instead of the other way around.

We've got to fix this problem, and there are any number of ways to do it. Most of the attention has centered around restoring Subpart F tax deferral, which until 1986 provided a means for American carriers to defer their income tax liability on shipping income earned using foreign flag vessels. Congressmen Shaw and Jefferson have introduced legislation that would restore the Subpart F exemption, but improve on it by allowing tax deferred money to be invested in U.S. flag shipping. Their bill has broad but not unanimous support within the industry. A variation on this approach would not just allow tax deferred money to be reinvested in U.S. flag shipping, but require such reinvestment as a condition for receiving tax deferral on some or all of the foreign flag earnings. Still another approach would not involve Subpart F at all, but would simply adjust the income tax rates of American shipping companies engaged exclusively in international trade to match the average tax rates of our foreign competitors.

I'm not here today to suggest a specific solution to the problem. But I would like to do two things. First, is to express the hope that the top leadership of the maritime industry—primarily seagoing unions and shipping companies—will commit to make a concentrated effort over the next several months until we find a solution to this problem. It took a long time, but the entire industry eventually came together over MSP and we got a program that has helped insure the survival of American mariners. We need to make the same commitment to assure the survival of American shipping companies, and I am hopeful and optimistic that we will.

Secondly, I'd like to suggest at least a couple of principles that would help guide our work. There are undoubtedly others, but the two that come to my mind are as follows:

First, "Foreign income tax advantages harm all American shipping companies in international trade, and must be addressed on an industry wide basis." We simply cannot afford to lose time while companies or unions jockey for advantage against one another over this issue. If we succeed in fixing the problem, the pie will grow maybe a lot and everyone's sustainable, long-term benefit will far exceed what might be gained or lost by attempting to rig the system. Let's not beat each other up, but let's be fair and work together for tax equity.

Secondly, "The solution to this problem must avoid placing burdens on American carriers that are not faced by their foreign competitors." This is the whole point of the exercise. If we don't stick to that very basic and obvious and important principle, we run a real risk of getting nowhere, or passing legislation that will accomplish nothing, and see the final loss of what's left of our industry.

Thank you very much for your attention, and I'd be happy to hear your comments and answer your questions.

[Charts are being retained in committee filed.]

ERNST & YOUNG LLP
WASHINGTON, D.C., 20036
July 7, 1999

Hon. BILL ARCHER, *Chairman*
House Committee on Ways and Means
Washington, D.C.

Dear Mr. Chairman:

We are pleased have an opportunity to share with the Committee on Ways and Means our views on an issue of vital importance to high technology businesses—the tax rules regarding bona fide research and development ("R&D") cost sharing arrangements. We are concerned that recent interpretations of the R&D cost sharing rules by the Internal Revenue Service ("IRS") will make leading edge U.S. based companies less competitive than their foreign counterparts and, in some cases, will have the effect of encouraging such companies to relocate R&D activities outside the United States. We request that this letter be made part of the formal record of the Committee's June 30, 1999, hearing to examine the effect of U.S. tax rules on the

competitiveness of U.S. businesses as well as ". . . the policies (tax or otherwise) our international tax rules ought to reflect and implement."

BACKGROUND

The proper allocation of income resulting from research and development activities, and the derivation of benefit from the use of valuable intangible property developed from those activities, has been a continuing source of controversy between the IRS and taxpayers, especially when an affiliate of a U.S. multinational company is using the intangible property in a low tax jurisdiction. Prior to 1984, the IRS had adopted an administrative ruling position that allowed intangible property developed in the U.S. to be transferred in a tax-free transaction under Internal Revenue Code ("IRC") section 367 to a foreign affiliate of a U.S. taxpayer provided that the intangible property was not used to create products destined for the U.S. market. In 1984, Congress ended this practice by enacting section 367(d), which requires arm's length taxable compensation on intercompany transfers of intangible property.

As part of the Tax Reform Act of 1986, Congress amended section 482 by adding a sentence that provides, "In the case of any transfer (or license) of intangible property . . ., the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." The legislative history to this provision indicated that by enacting the "commensurate with income" provision, Congress did not intend to prohibit use of bona fide R&D cost-sharing agreements, provided that such agreements were structured consistently with the intent of the provision.

Under a cost sharing agreement, related parties agree in advance to share the financial risk (i.e., the costs) of R&D activities in return for agreed-upon rights to exploit any intangible property developed as a result of the R&D. Cost sharing payments received by a U.S. party conducting R&D reduce the deductible amount of R&D expense, while cost sharing payments made by a U.S. taxpayer are a deductible expense. A U.S. multi-national company conducting R&D in the U.S. that is a party to a cost sharing arrangement with a foreign affiliate gives up the right to current R&D deductions to the extent of the cost sharing payment. In return, the foreign affiliate attains the right to exploit any valuable intangible property created without further payment (other than its annual obligation to fund additional R&D under the cost sharing agreement).

The 1989 Treasury/IRS White Paper on Transfer Pricing and the 1996 cost sharing regulations enunciated several principles that ought to be taken into account if a cost sharing arrangement was to meet the criteria of the commensurate with income provision. These principles included the following:

- Costs of R&D should be shared proportionately based upon expected benefits to be earned by the participants.
- Costs should include direct and indirect operating expenses attributable to the covered R&D.
- Provisions should be made in the arrangement to account for material changes in actual benefits from expected benefits.
- Participants entering into a cost sharing arrangement should pay an arm's length amount for preexisting and in process R&D (a "buy in") that may take the form of a declining arm's length royalty.

Subsequent to enactment of the "commensurate with income" provision, the IRS engaged in a series of litigation challenging transfers of intangible property with limited success. These cases have involved such industries and products as contact lenses, medical equipment, semiconductors and computer disk drives.[1] The IRS's typical position in these cases is to limit the profitability of the offshore affiliate to a limited function contract manufacturer's profit and to ignore the fact that arm's length parties who make substantial investments to exploit technologies created by another expect to receive a reasonable share of the profits to be earned from exploiting the intangible property.

In order to avoid the costs[2] and risks inherent in licensing intangible property for which no exact comparable licensing transactions exist, many taxpayers have entered into cost sharing agreements. Until recently, most taxpayers believed that these agreements would be respected as bona fide by the IRS provided there was a reasonable buy-in payment and that U.S. Generally Accepted Accounting Prin-

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[1] Bausch & Lomb (contact lenses); Perkin Elmer (medical equipment); National Semiconductor (semiconductors); Seagate (disk drives).

[2] The recent IRS "Report on the Application and Administration of Section 482 "estimates IRS litigation costs in two recent cases at $4.6 million and $2.1 million. Taxpayer costs were much higher.

ciples ("GAAP") R&D expenses were shared based upon reasonably expected benefits of the R&D activity the costs of which were being shared.

THE ISSUE

The IRS National Office has recently advanced two new positions for evaluating bona fide cost sharing arrangements that have the effect of making the tax cost of such arrangements so high that they are uneconomical for U.S. technology-intensive companies. These positions are that:

- Costs to be shared should include stock option "expense" attributed to R&D activities.
- A buy-in payment should be measured either by the taxpayer's total market capitalization less the value of its book assets or by reference to premiums in value over book assets in recent M & A transactions.

WHY THE IRS'S POSITIONS ARE UNWISE TAX POLICY

- The IRS's positions are technically insupportable and conflict with the legislative support for cost sharing.

Congress recognized in the 1986 Tax Reform Act that bona fide R&D cost sharing arrangements should be available as an alternative to licensing under the commensurate with income standard. The abuse that Congress sought to eliminate in the 1986 Act (and in 1984) was that technology developed in the U.S. was being transferred outside the U.S. for no consideration to the U.S. developer. However, Congress neither prohibited transfers of intangible property outside the U.S., nor did it outlaw the availability of cost sharing arrangements.

No party at arm's length would enter into a technology development (cost sharing) arrangement where it was required to buy into the agreement by paying a share of the U.S. developer's market capitalization. In addition, at any moment, in-time market capitalization of an individual company is profoundly affected by the intrinsic volatility of the overall market; the market's view of the industry and the company's overall competitive position within that industry; and the anticipated long-term earnings power of the company which extends far beyond the useful life of its current technology or other intangibles. Thus, market capitalization value is not a good benchmark upon which to base a buy-in payment. Furthermore, accounting goodwill created in an acquisition is as much a measurement of post-merger synergy of the two companies as it is a measure of the intangibles of the acquired company.

R&D cost sharing is not an uncommon risk sharing arrangement between unrelated joint parties, especially in technology-driven industries. We have never observed an instance in which unrelated parties have agreed to cost share the compensation element (i.e., the difference between the fair market value of the stock and the exercise price) of stock options attributable to R&D employees, nor do we think unrelated parties would even consider sharing such an unpredictable, non-cash expense. Thus, we believe that the IRS's position on stock option expense as it relates to cost sharing is non-arm's length.

- These positions will lead to double taxation of U.S. multinationals.

In our experience, the conventional arm's length methods, all of which are based on varying degrees of comparability in third-party transactions, are still the international norm for settling cross-border disputes regarding intercompany compensation for the use of intangibles. Market capitalization for intangibles is clearly unconventional. As a result, a U.S. government position based on market capitalization values will lead to irreconcilable differences in competent authority proceedings resulting in higher incidents of double taxation of U.S. multinationals.

In a similar vein, the treatment of stock option exercises varies by country. For example, the spread between the fair market value of the option and the exercise price in not the measure of compensation in all countries, nor is the employee's exercise the event which gives rise to the compensation in all countries. Accordingly, even in the unlikely event that a foreign country can be persuaded that arm's length parties would incorporate a stock option additive into a cost sharing equation, it is unlikely that the foreign country would agree on the U.S. definition of the timing or amount. Thus, this stock option position, if pursued by the IRS, will also inevitably lead to double taxation of U.S. multinationals.

- These positions may encourage U.S. companies to move R&D out of the U.S.

Simply put, U.S. multinationals just could not afford the tax cost of licensing or transferring intangibles to affiliates if today's market capitalization values became a proxy for the required arm's length consideration. A U.S. tax-induced limitation on the deployment of intangibles will undoubtedly hurt U.S. competitiveness. It may, in fact, encourage U.S. multinationals to move their R&D activities outside the U.S. where the resulting intangibles can be exploited in a far more tax effective

manner. Many tax have jurisdictions already offer significant incentives to locate R&D in their countries; the IRS position will add to those existing incentives.

Compensation for qualified U.S. engineers is already among the highest in the world. Stock options have become a common incentive for attracting and retaining U.S. engineers in this highly competitive market place. Clearly, the tax deductible portion of the stock option spread defrays some of the high compensation costs for U.S. engineers. If the deduction is lost because it is required to be charged to cost sharing foreign affiliates, the defrayal is lost as well. Absent this much needed defrayal, U.S. multinationals may establish R&D operations outside the U.S., staffed with lower cost engineering talent.

- These positions are an indirect attempt by the IRS to eliminate deferral contrary to Congressional intent.

Since 1962, Congress has recognized that U.S. multinationals should be allowed to defer U.S. tax on active business income earned by affiliates outside the U.S. until such income is repatriated in the form of dividends. Rather than undertake a direct challenge to deferral, as the IRS and Treasury attempted in Notices 98–11 and 98–35, the IRS's recent adoption of these positions is a back door attack on deferral. By imposing excessive charges on foreign affiliates for buy-in and cost sharing payments, the IRS intends that there will be little or no profit to defer or repatriate.

Why Congress Should Act Now

Cost sharing arrangements are used by some of the most innovative and dynamic growth companies in the U.S. The active business profits generated by foreign affiliates of these companies are used to fund overseas expansion. Many of these companies are global leaders in their fields. Under the old IRS "contract manufacturer" position and its new cost sharing position, the IRS would subject all or nearly all of the active business profits of these foreign operations to a "toll charge" of current U.S. taxability. The abuse that Congress sought to end in 1984 and 1986 was the tax-free transfer overseas of intangible property developed in the U.S., not to end deferral for active profits earned outside the U.S. after payment to the U.S. of a fair amount for developing the intangible property.

Under typical IRS dispute resolution procedures, issues like these can take 5–12 years to resolve. While the issues remain in dispute, taxpayers will be required to incur substantial administrative costs and outside adviser fees to defend against the IRS's claims.[3] In addition, these claims cause substantial financial uncertainty for companies since IRS agents often demand several times the amounts they realistically expect to obtain.[4] Taxpayers use cost sharing arrangements to avoid the uncertainties inherent in the "commensurate with income" standard applicable to licenses. Years of uncertainty and inefficiency could be avoided if Congress would move now to establish some objective criteria for cost sharing arrangements.

Our Recommendations. We believe that Congress should:

- Clarify the cost sharing rules to limit buy-in payments and cost sharing payments to amounts that unrelated parties dealing at arm's length would pay. We believe that actual transfers of reasonably comparable intangible property are a proper reference point for buy-in payments and that direct and indirect R&D expenses as determined under GAAP are a good reference point for defining R&D costs to be shared.
- Consider whether the "commensurate with income" provision is serving its intended purpose or whether, as interpreted by the IRS it is being used as a device to end legitimate deferral of U.S. tax by U. S. multinationals.

These views and recommendations are based on our nearly 50 years of collective experience with Ernst & Young LLP providing tax advice to many of the leading U.S. biomedical and high-tech firms that operate on a worldwide basis. Should you wish, we would be happy to meet with you or your staff to discuss these important

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[3]The recent IRS Report on Section 482 states that IRS costs for resolving two recent transfer pricing litigation were $4.6 million and $2.1 million while costs to resolve comlex Advance pricing Agreements averaged $72,000.

[4]According to the IRS report, since 1994, the average amount of Section 482 adjustments proposed by IRS examiners sustained by Appeals was 27%. In the recent litiigation with DHL, the IRS Notice of Deficiency asserted a value in excess of $500 million for the transferred trademark and trade name, which value was reduced by IRS to around $300 million at trial, of which the Tax court sustained an adjustment of $100 million.

issues. We can be contacted through Donna Steele Flynn in Ernst & Young LLP's Tax Legislative Services group in Washington at 202–327–6664.

Sincerely,

PETER KLOET
MICHAEL F. PATTON
JOHN WILLS

Statement of the Financial Executive Institute, Morristown, NJ

Chairman Bill Archer and Members of the House Ways and Means Committee:

The Financial Executives Institute ("FEI") Committee on Taxation appreciates this opportunity to present its views on the impact of U.S. tax rules on international competitiveness.

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 you, Mr. Chairman, for your support of H.R. 2018, the International Tax Simplification for American Competitiveness Act of 1999, recently introduced by Mr. Houghton and Mr. Levin. 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 de-

ferral, 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, simplifying 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 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 CFC income.

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:

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[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.

• 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.

• Subpart F adversely affects companies attempting to cope with difficult exchange control and customs issues, frequently encountered in developing countries. The risks of controlled currencies and adverse customs results can be avoided if the U.S. multinational sells into the country through a controlled subsidiary incorporated in another country. However, the current Subpart F regime results in loss of deferral. Non-U.S. competitors are not faced with this additional cost.

• 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-á-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. Therefore, 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.

Indeed, 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 Warren Thompson, Director of Tax, Frank Russell Company, Tacoma, WA

My name is Warren Thompson; I am the Director of Tax for Frank Russell Company. The testimony offered herein presents Russell's experience concerning the manner in which current US tax law seriously impedes the growth potential of the US mutual fund industry. In addition, we would like to register our support of H.R. 2430, the Investment Competitiveness Act of 1999. H.R. 2430 is sensible and long overdue legislation that is critical if the US mutual fund industry is to become an attractive investment alternative for global investors. The Frank Russell Company strongly supports this legislation and commends the bill's sponsors, Representatives Crane, Dunn, and McDermott for their efforts to address this issue.

The Frank Russell Company, headquartered in Tacoma, Washington, is recognized as one of the premier global money managers and pension consulting firms in the world, providing investment strategy consulting worldwide to such institutional investors as GM, IBM, AT&T, XEROX, Boeing, UAL, Unilever, Shell, Monsanto, and others. From nine offices worldwide, Russell advises clients on over $1 trillion of investment assets and manages over $50 billion in funds, including mutual funds (otherwise known as regulated investment companies or "RICs"), common trust funds, commingled employee benefit funds, and private investment partnerships. In addition, Russell conducts research on nearly 2000 investment managers in more than twenty countries.

We have found, from our experience around the world, that the US mutual fund industry is the most technologically advanced in the world and, therefore, the most efficient in delivering services to clients. However, research of the current practices of global investment managers shows that global institutional investors and managers use US mutual funds very sparingly. One of the principle reasons they do not use US mutual funds is the withholding tax on dividends and short-term capital gains imposed under current US tax law.

As the Committee is already well aware, current US tax laws have, in many cases, failed to kept pace with our increasingly dynamic and competitive US and global market, often to the detriment of US companies. In the case of the US mutual fund industry, current US law blocks US-based mutual funds from competing for international investment dollars by making it virtually impossible for US mutual funds to sell their products outside the United States. As a direct result, US mutual fund companies are forced outside the United States to simply sell their products and compete with foreign funds that are not subject to similar withholding taxes.

CURRENT TAX RULES

Income earned by a mutual fund is comprised of four elements: (1) interest; (2) short-term capital gains; (3) long-term capital gains; and (4) dividends. Of these four, generally, only dividend income is subject to withholding tax.

Under current law, when the income earned by a mutual fund is distributed, the interest income and short-term capital gains income are converted into dividend income, effectively re-characterizing the principal earnings of the mutual fund as dividend income. When received by a foreign investor, this "dividend income" is subject to a 30 percent withholding tax. Tax treaties may reduce this rate to 15 percent or less for residents of certain treaty countries. Nonetheless, this tax significantly reduces the attractiveness of US-based mutual funds to foreign investors.

Interest Income

The Deficit Reduction Act of 1984 generally repealed the 30 percent withholding tax for portfolio interest paid to foreign investors on obligations issued after July 18, 1984. Tax treaties between the United States and a number of foreign countries also exempt interest paid to foreign investors from the withholding tax.

For a US mutual fund, however, interest income is characterized as dividend income when it is distributed. The portfolio interest exemption and reduced treaty rates, therefore, do not apply and all such income is subject to withholding tax when received by foreign investors.

Short-term capital gains

A US mutual fund must also characterize short-term capital gains as ordinary income dividends, making such income subject to withholding tax when received by foreign investors. In direct contrast, if a foreign investor invests directly in US securities, through a unit-trust, partnership, or foreign mutual fund, such short-term capital gain income is not be subject to withholding tax.

CURRENT US TAX LAW CREATES A MAJOR IMPEDIMENT TO FOREIGN INVESTMENT

We have found, in our discussions with potential investors throughout the world, that the first fund of choice for a foreign investor is one based in its own country. The second choice, all other things being equal, typically is investment in US funds, for the following reasons:

- The US system of regulation is unparalleled in its commitment to investor protector.
- The US fund system uses the most advanced investment management technology, including the best accounting and recordkeeping knowledge and expertise.
- The US mutual fund industry has by far the best marketing and client servicing capabilities.

Until 1980, US-based institutional investors had very few, if any, investments outside the United States. Today, these funds invest 15 percent or more of their assets in overseas equity and debt instruments. Similarly, institutional investors in foreign countries, such as those in the United Kingdom, Japan, and Switzerland are also increasing their investments outside their home country. These investors include insurance companies, banks, trusts, pension funds, reinsurance pools, central banks, and government entities.

The US withholding tax, however, provides a strong disincentive for foreign investors for two reasons—it effectively imposes an export tax on the US mutual fund industry, making US based funds less attractive from a pricing standpoint; and it creates an administrative burden.

Large, institutional investors have a broad choice of investment vehicles worldwide. It has been our experience that these investors will not hesitate to move investment assets wherever necessary to obtain the highest after-tax yield available at their particular risk-tolerance level. The US withholding rate of 30 percent reduces yields for US mutual funds to levels substantially below world market rates, thus creating a significant impediment to US investment managers selling their funds outside the US.

While some foreign investors may be entitled to a refund of the withholding tax paid (under tax treaty provisions), the administrative burden and the loss of use of the funds (for periods of time frequently in excess of a year) outweigh the expected yields. Thus, the foreign investment in US securities is achieved through other means.

Foreign investors can avoid the withholding tax by investing directly in US securities. However, our experience is that foreign investors, particularly institutional investors, prefer to employ highly experienced professional investment managers to diversify their investments overseas through the use of "pooled" vehicles. Recently,

Russell conducted a survey of its potential investment clients in Europe. We learned that, in general, those investors prefer a pooled vehicle such as a mutual fund for their global investment strategies. This is no surprise. Pooled investments represent the most efficient way to diversify a portfolio across multiple markets and among several currencies. However, because the US tax code imposes a tax penalty in the form of the 30 percent withholding tax, those investors generally go elsewhere to access the global markets.

This has resulted in the dramatic increase in institutional funds located in such tax-favored jurisdictions as Luxembourg, Ireland, Bermuda, and the Cayman Islands. Many of the funds created in these jurisdictions invest in US securities. Foreign-based institutional investors find these funds attractive because their investments are not subject to the US withholding tax.

US Mutual Fund Companies Must Locate Outside the US in Order to Compete

The 30 percent withholding tax imposed on US mutual funds can be totally avoided by establishing funds outside the US. Since interest and capital gains earned directly (i.e. without being "converted" into dividends) generally are not subject to US withholding tax, funds based outside the US are not subject to the same 30 percent cut that is imposed on funds located inside the US. US mutual fund companies, therefore, routinely set up "clone" or "mirror" funds of their US-based funds outside US borders. This is currently the only way US funds can effectively avoid the 30 percent tax and compete for foreign investment dollars.

Frank Russell Company, along with many other US mutual fund companies, would prefer not to have to set up operations outside the US to make their products attractive to foreign investors. Keeping these operations at home would allow US companies to benefit from their existing operations and systems. It would also allow us to avoid additional taxation and expenses associated with locating in foreign countries and it would allow us to develop jobs at home rather than abroad.

Russell's experience in Canada exemplifies this point and the impact of the US withholding tax.

Russell's Experience

In 1992, Russell entered into an arrangement to provide a series of investment funds to be marketed to the individual retirement account market in Canada by a Canadian brokerage. The US withholding tax made Russell's existing US mutual funds unattractive investment vehicles for Canadian investors.

Russell was thus forced to create a new Canadian-based family of funds (that are essentially "clones" of existing Russell US-based mutual funds), solely for the purpose of providing a tax efficient pooled investment vehicle to Canadian investors who wish to invest a substantial portion of their retirement portfolio in US securities. These funds became fully operational in January 1993, and grew to over $100 million (Canadian) in assets in less then six months. They have since grown to over $2 billion in assets.

One reason these funds are so successful is because, increasingly, foreign investors are attracted to Russell's "multi-style, multi-manager" investment approach. This investment approach is particularly attractive to investors with a long-term asset/liability management focus, such as pension funds, individual retirement plans, and insurance pools. In using the investment technology it has developed over the last 25 years advising some of the world's largest investment pools, Russell is regarded as possessing cutting edge global investment technology. This proprietary technology and "know-how" represents a quantum leap over other investment products available in the global market.

Yet, these funds—managed in Canada but substantially invested in US securities—employ Canadian accounting, custodial, trustee, and recordkeeping services and pay investment management fees to select Canadian investment managers. Russell's Canadian affiliate pays Canadian corporate income tax on its earnings from this operation.

It is worth noting at this point that several foreign jurisdictions have enacted "magnet" legislation to attract the pooled investment business to their countries. Ireland is a recent example of this trend, having enacted legislation to permit pure "pass-through" treatment for funds located there, and significantly lowering the income tax rate for investment management firms that conduct funds operations in Dublin. Such foreign legislation thus creates a double incentive to locate US funds businesses off shore.

If H.R. 2430 had been in place at the time Russell was organizing its funds in Canada, there would have been no need for Russell to create a separate set of "clone" funds in Canada.

In general, H.R. 2430 effectively removes the 30 percent penalty imposed on US mutual funds by allowing interest and short-term capital gains income to retain their original character when distributed to a foreign shareholder. Rather than being converted to dividend income subject to the 30 percent withholding tax, interest earned by a US mutual fund would flow through to foreign shareholders as interest income. Likewise, short-term capital gains income would flow through as short-term capital gains income. This would permit US mutual funds to sell their investment products to investors outside the US without the withholding tax impediment.

POLICY ISSUES RELATING TO H.R. 2430

Competitive Considerations. US mutual funds, such as those sponsored by Frank Russell Company, should be placed on a level playing field with foreign mutual funds. The international funds business is highly competitive and marked by very narrow profit margins. Often, mere basis points (hundredths of a percentage point) separate the bidders for institutional investment business. The US fund industry, if allowed to compete on level ground with foreign funds, could employ its production efficiencies and cutting edge technology to attracting significant foreign capital. Under current US tax law, companies like Frank Russell cannot compete, and the foreign investment dollar is left to a foreign fund, with little or no direct benefit accruing to the United States.

Neutrality of Tax Law In Investment Decisions. Foreign investment in US securities may be accomplished in several ways: directly, or indirectly, through foreign or US vehicles. Current US tax law favors direct investment or indirect investment through foreign funds. Effectively, US tax law compels a particular investment approach by foreign investors, which denies US mutual funds access to the market. We do not believe sound tax policy is served by the current tax structure. Tax law should be neutral with respect to its impact on investment decisions. We believe that such tax neutrality would permit taxpayers such as Frank Russell Company the ability to fully benefit from the technological and strategic advantage we have worked hard to develop over the years.

Application of the 1984 Act. In the Deficit Reduction Act of 1984, Congress exempted from US withholding tax certain payments to foreign direct investors and exempted investments in the underlying obligations from US estate tax. Congress enacted these provisions to promote capital formation and substantial economic growth in the United States. This bill would continue to foster capital formation and economic growth by providing wider access for US mutual funds to the billions of foreign investment dollars currently lodged in foreign mutual funds.

CONCLUSION

During the last decade, the US mutual fund industry has become one of the fastest growing segments of the US financial services industry. US mutual fund assets now total over $2 trillion. Such a thriving domestic industry must be allowed to flourish on an international level as well. Yet, the current tax environment prevents this industry from exporting its product. H.R. 2430 would create a worldwide market for US mutual funds, thus unleashing additional flows of international capital into US investments. For the Frank Russell Company, H.R. 2430 adjusts US tax law to reflect today's dynamic, international financial services market. It is legislation that it critically important from both a business and policy prospective.

Statement of M. David Blecher, Principal, Hewitt Associates, LLC

INTRODUCTION

Hewitt Associates is a global management consulting firm specializing in human resource solutions, with 10,000 associates worldwide, and 73 offices in 34 different countries, including 27 offices across the U.S. We have been recognized by Business Insurance magazine as the largest U.S. benefits consulting firm and the second-largest benefits consulting firm worldwide. Our clients include over 75 percent of Fortune 500 companies.

Our primary business falls into three main areas:

- Strategy, design, and implementation of human resources, benefits, and compensation programs both domestically and globally.
- Financial and performance management of programs including actuarial services, cost quality, employee satisfaction, measurement, and analysis for all retirement and health-related benefits.
- Ongoing administration of programs including outsourced delivery. For example, we manage all aspects of employee benefits plan administration, including coordination with third parties (e.g., individual health plans) and improve customer service for employee benefits plan participants.

Both in our capacity as a global employer and in our capacity as a consultant to companies with international interests, we have, over time, become aware of various problems with U.S. tax laws, problems caused in some instances by the contents of the laws and in other instances by the way the laws are enforced.

Some of our concerns have been ably addressed in the materials filed by witnesses at the June 30 hearing. Specifically, we endorse the need to correct problems created by subpart F, section 911, the foreign tax credit rules, and the alternative minimum tax, and we generally support the current efforts to reform these areas of the law. Some of the items that we have found especially troublesome are listed, without discussion, as "Other Important Items" toward the end of this statement.

Rather than use up our limited space in reiterating arguments that have already been cogently made, we would like to focus on some specific problems that, as far as we are aware, have not been raised before the Committee. These relate to the effect of tax rules on individuals rather than corporations. In their way, they contribute toward the reduction in global competitiveness of U.S. companies.

SUMMARY

In our current age of increasing globalization, U.S. companies more than ever before need employees with international experience. Increasingly, this need is no longer confined to corporate executives, but is felt at a much broader level than formerly. Features of the tax code and its application, however, militate against the transfer of employees overseas; indeed, they encourage companies to operate abroad employing non-U.S. employees. We believe that the effect of this is to impair the competitiveness of companies in the United States.

The problem stems from the requirements of the Internal Revenue Code relating to individuals living and working outside the United States. In addition to substantive rules that we would consider anti-competitive, the Code's provisions are complicated and make compliance difficult. The complicated tax law, lengthy forms, and cost to individuals and companies for tax preparation services encourages companies to eliminate U.S. employees from the candidate pool when considering international assignments. The converse is true, too; we have seen U.S. employees refuse overseas assignments because of their complicated and unpleasant tax implications. Without international work and living experiences, U.S. employees will become less competitive in the global workforce.

Topics that illustrate the problems we perceive are the complex tax filing requirements, the tax-related costs typically borne by U.S. employers (and, if not the employer, then the U.S. employees), and the rules relating to retirement benefits for expatriate employees; each of these we discuss briefly below. While these issues may not in themselves cause a company to take such drastic action as establishing headquarters outside the U.S., they do contribute to overall anti-competitiveness and could be addressed without major overhaul of the Internal Revenue Code.

RECOMMENDATIONS FOR FURTHER STUDY BY THE COMMITTEE

Our suggestions of areas for further study by the Committee with respect to the taxation of individuals include:

1. Review tax forms such as Forms 673, 2555, 5471, and W–4, with a view to reducing their complexity or even eliminating forms where administrative costs outweigh the benefits of the information contained in the forms.
2. Consider legislation under which the U.S. would enable expatriate employees participating in foreign retirement plans to be treated for U.S. income tax purposes as if the employees were participating in U.S. qualified plans, provided the foreign plans are genuine retirement plans and are qualified under the laws of the host country. Tax-deferred rollovers or transfer of distributions from foreign retirement plans to U.S. plans should be included in any such rules.
3. Consider negotiating tax treaty provisions that would prevent expatriate employees from being taxed in the host country when they continue to accrue benefits under U.S. plans while on assignment in the host country.

4. Explore ways of encouraging states to adopt uniform provisions for the consistent tax treatment of individuals on international assignments.

In addition, we suggest the Committee consider addressing the items listed as "Other Important Items" toward the end of this statement pertaining to both business and individual taxation.

FILING REQUIREMENTS

The filing requirements for expatriates have been made somewhat simpler in recent years. Form 2555EZ, on which a taxpayer claims relief under the foreign earned income exclusion of Code section 911, is more straightforward than the standard Form 2555, although the bookkeeping requirements to complete the form are substantial—the taxpayer must carefully track when he is in and out of the U.S., and what he was doing when he was in each location (work versus personal time)—and the "EZ" form cannot be used if the taxpayer also wishes to claim the foreign housing exclusion.

In addition to tracking travel and work days, the employee must complete Form 673, Statement for Claiming Benefits Provided by Section 911 of the Internal Revenue Code. This form provides written documentation to the employer that the employee is eligible for the section 911 exclusions, and provides the amounts by which income may be reduced before withholding is necessary. The employee may also need to complete a revised Form W–4 to take into account the foreign tax credit or a statement indicating that the employee is subject to tax withholdings in the host country, so that no federal withholding is necessary. Both Form 673 and Form W–4 are difficult to understand and complete; the average taxpayer is unable to complete either form without professional assistance.

The U.S. filing complexity is eclipsed only by the various states' requirements for residents on international assignments. Much of the difficulty of state tax filings would be eliminated if unnecessary federal filing requirements were curtailed or if the states could agree on a uniform approach to the taxation of employees on international assignments.

TAX-RELATED COSTS

Many U.S. taxpayers on international assignments are paying some income tax required by the U.S. tax code even though they did not earn the income in the U.S. Because the majority of U.S. multinational companies have a policy of tax-equalization (the employees will pay only as much in taxes as they would have paid had they remained at home), this cost is borne by U.S. corporations. On top of the tax cost, we must consider the cost to administer payroll (calculating appropriate withholdings, reviewing documentation for payroll, etc.) and the cost of tax return preparation services relating to employees' overseas employment.

In our professional experience, we have seen companies decide not to transfer U.S. citizens or residents because of the additional costs and complexities involved. If they are to continue to succeed in the global economy, U.S. companies need employees with international experience. In short, the U.S. tax code may adversely affect the competitiveness of U.S. companies by making international assignments prohibitively expensive and complicated.

RETIREMENT INCOME

(a) U.S. Plans v. Foreign Plans

The U.S. system of taxing its citizens and residents on their worldwide income has some adverse effects in the area of retirement benefits. For example, if a company transfers a U.S. citizen abroad, the expatriate employee may continue to be covered in his or her U.S. retirement plans (commonly the case where the employee is transferred for a relatively short-term assignment) or the employee may cease participation in U.S. plans and, instead, become a member of one or more plans in the host country. These two scenarios have different tax results:

(1) Continued participation in U.S. plans. Under current law, if the expatriate employee continues to participate in U.S. plans, the U.S. tax treatment will be essentially the same as if he or she were still in the U.S. Specifically, contributions on the employee's behalf to, and benefits under, U.S. qualified plans will not normally be taxable to the employee until he or she receives a distribution of benefits from the plans. The problem for U.S. expatriate employees is that the employee may well find that the host country is subjecting the employee to taxation on his or her U.S. benefits, such as 401(k) deferrals or benefit accruals under a pension plan, on the basis that they represent income with a host-country source and that U.S. plans do not qualify for favorable tax treatment under the host country's laws.

When this occurs, U.S. law may afford the employee a foreign tax credit to offset those taxes, but the way the foreign tax credit works, it will not always operate to fully avoid double taxation of the individual.

(2) Participation in host country plans. If an expatriate employee participates in retirement plans in the host country, the employee may escape current taxation in the host country if those plans are qualified for favorable tax treatment in that country. From the U.S. perspective, however, it is close to certain that the foreign plans will not contain all the provisions needed for them to be qualified in the U.S. To the extent, therefore, that an expatriate's overseas accruals are vested, the U.S. will subject the individual to current rather than deferred taxation of the benefits. This gives rise to complicated tax calculations when the individual eventually retires, having already been taxed on the overseas benefit and being likely taxed by the host country at the time of payout.

It would be much simpler, and should involve no significant (if any) loss of revenue if the U.S. and foreign countries could work out a system of reciprocity under which an expatriate participating in tax-qualified retirement plans in the host country could have the home country deem the host country plans to be tax-qualified in this situation.

This kind of arrangement is not unprecedented. The income tax treaty between the U.S. and Canada contains a provision (Article XVIII, section 7) that enables expatriate employees (e.g., U.S. citizens working in Canada and participating in Canadian retirement plans) to defer the taxation of retirement income in the home country until the time the employee actually receives a distribution of that income.

In addition, in the United Kingdom, the Inland Revenue (without reciprocity from the U.S.) has a procedure under which U.S. retirement plans can be submitted for "corresponding approval" under U.K. law. In order to obtain such approval, a plan need not demonstrate that it complies with all the requirements for a U.K. "approved scheme."

We believe that the U.S. should seriously consider establishing similar procedures under which the Internal Revenue Service could deem foreign retirement plans to be qualified for purposes of deferring taxation of U.S. citizens and residents.

(b) Rollovers and Transfers of Benefits.

Under current rules, benefits from a nonqualified retirement plan cannot be rolled over or transferred to a qualified retirement plan without jeopardizing the qualification of the latter plan. As virtually no foreign plans are qualified for U.S. purposes, this effectively precludes an employee who is transferring to (or back to) the United States from transferring any benefits he or she may have received from a qualified foreign plan to the U.S. qualified retirement plans in which the employee participates. Such transfers, if permitted, would facilitate the transfer of needed employees to the U.S. This would, however, require careful investigation and might be best handled through reciprocal arrangements in income tax treaties.

The coordination of retirement benefits for mobile employees is a complicated topic. We do not claim to have all the answers. We do believe, however, that it is an issue that will affect the competitiveness of U.S. companies, particularly as other regions of the world tackle this issue. We follow with interest the movement in the European Union toward pan-European pensions and the ability of workers to move among European countries without adversely affecting their pensions. While Europe has not yet achieved these goals, there are forces committed to their achievement. If and when this happens, companies may have one more reason to site operations in Europe rather than the United States. With this in mind, we believe that the U.S. should pay serious attention to the tax problems confronting U.S. citizens and residents working abroad.

Other Important Items

Additional items that we, in our experience, would classify as anti-competitive from a U.S. perspective include:

- the complexity of the foreign tax credit rules, which place an undue administrative burden on U.S. taxpayers;
- the alternative minimum tax;
- the inequity of the rules under which unused foreign tax credits can be carried forward only five years and backward only one year, while overall foreign losses (which operate to reduce the credits) are carried forward without limit;
- lack of a "deemed paid" foreign tax credit for non-corporate taxpayers, with the result that U.S. corporations can take a U.S. tax credit for foreign taxes paid directly by corporate subsidiaries, while non-corporate U.S. taxpayers (such as partnerships) are denied such a credit;

- the mind-numbingly complex deemed dividend rules (e.g., under Subpart F), which are effectively tax traps for the unwary; and
- the requirement to file costly and extremely burdensome annual "Information Returns" (e.g., Form 5471) for certain foreign corporate and partnership subsidiaries—forms, in our view, of which the cost to taxpayers far outweighs the benefit of their contents to the government.

CONCLUSION

We thank the Committee for giving us the opportunity to express our views on this subject. We would be happy to work with the Committee in further understanding the ramification of the issues discussed in this statement.

Statement of Timothy A. Brown, President, International Organization of Masters, Mates & Pilots, Linthicum, MD and Lawrence H. O'Toole, President, Marine Engineers' Beneficial Association

Mr. Chairman and Members of the Committee: On behalf of the International Organization of Masters, Mates & Pilots (MM&P) and the Marine Engineers' Beneficial Association (MEBA), we thank you for the opportunity to submit this statement specifically addressing our proposal to make section 911 of the Internal Revenue Code applicable to certain American merchant mariners. The MM&P primarily represents Masters and Licensed Deck Officers working aboard commercial vessels operating in our nation's foreign and domestic shipping trades. The MEBA primarily represents Licensed Engineers working aboard commercial vessels also operating in our nation's foreign and domestic shipping trades.

We would first like to emphasize our support for the views presented at the June 30 hearing by Mr. Peter Finnerty, Vice President for SeaLand Service, Inc., in support of H.R. 2159, the "United States-flag Merchant Marine Revitalization Act of 1999." We agree wholeheartedly that changes to the existing Capital Construction Fund as embodied in H.R. 2159 will help increase the competitiveness of the United States-flag merchant marine by facilitating the accumulation of capital necessary for the construction of new, modern commercial vessels in American shipyards for operation under the United States-flag. We similarly urge its favorable consideration by the Committee.

At the same time, we believe it is equally important that Congress examine ways to increase the employment of American merchant mariners aboard commercial vessels in the foreign and international trades. We are convinced that extending the same foreign earned income exclusion available to other American workers to American mariners working aboard commercial vessels operating outside the United States will help American merchant mariners compete more equally with comparably qualified non-American mariners for these jobs.

As the Committee is well aware, under section 911 of the Internal Revenue Code, American citizens employed outside the United States may exclude from their gross income for Federal income tax purposes up to $74,000 of their foreign-earned income. American merchant mariners, working aboard United States-flag or foreign flag commercial vessels in the foreign or international trades, are not qualified to take advantage of the foreign earned income exclusion primarily because they are not deemed to be working in a foreign country as defined in Internal Revenue Service regulations.

We strongly believe that changing the definition of "foreign country" and altering the "foreign residence" test for merchant mariners to better reflect the true nature of their employment, and making section 911 applicable to merchant mariners, will be consistent with the important purposes and objectives of the foreign earned income exclusion.

Clearly, one of the primary goals of section 911 is to promote America's national interests through the employment of American citizens outside the United States. Ensuring that the United States has a sufficient number of loyal, trained American merchant mariners to crew the government-owned and private vessels needed during war or other national or international emergency is a key component of America's sealift capability. Making section 911 applicable to merchant mariners, and increasing the opportunity for Americans to compete for employment on commercial vessels, will augment America's available seapower force. As in the case of other Americans seeking employment in the international marketplace, it is extremely difficult for American mariners, who are subject to the full range of American tax law, to secure employment opportunities outside the United States.

Similarly, extending section 911 to American mariners will have a direct and positive impact, not only on the ability of Americans to secure employment on foreign vessels, but also on American companies operating vessels in the international shipping arena. Presently, vessel owners must pay an American mariner more than they would pay mariners from other nations so that American mariners may retain a comparable after-tax income. All too often, in the maritime industry as in other industries, the employer is unwilling to pay this premium, even when the American mariner is more qualified, more professional and more productive than his foreign counterparts.

Today, privately-owned United States-flag commercial vessels are forced to compete for cargoes in an environment largely dominated by heavily subsidized and foreign state-owned fleets, and fleets registered in tax-haven countries, such as Liberia, Honduras, and Vanuatu. These fleets have significant economic and tax advantages as compared to American shipping companies. In reality, some of these discrepancies will continue to exist for the foreseeable future. For example, American companies extend health and welfare benefits that foreign governments rather than foreign companies provide to their nationals, and Americans are subject to a wide range of U.S. government-imposed rules and regulations generally not applicable to their foreign competitors. Extending section 911 to American mariners is one thing that Congress can do so that it will no longer mean an economic penalty or burden if a vessel operator—American or foreign—chooses to employ American mariners.

Today, despite the efforts of our organizations and other maritime labor organizations, American mariners are at a significant competitive disadvantage and are being priced out of their foreign markets—employment on commercial vessels operating outside the United States in the foreign or international trades—because prospective employers must provide more income to American mariners to compensate them for the tax burden that is not faced by foreign mariners.

We would point out that other nations are pursuing changes in their tax laws to increase employment opportunities for their merchant mariners. It has been reported that the Government of Ireland has decided to make concessions in its taxation of seafarers to make it more attractive to use Irish seafarers on Irish vessels and that a draft Government of India shipping policy includes, among other things, a proposal to provide "income tax exemptions for Indian seafarers, to attract talent to the field."

Similarly, both Great Britain and Germany announced at the end of 1998 that they were each exploring a variety of tax-related measures and incentives, including those relating to their merchant mariners, in order to revitalize their fleets and increase employment for their nationals. Germany is specifically addressing whether they can attract more young Germans to seafaring jobs by further exempting from taxes a portion of the wages of new seafarers.

Indeed, it is also worth noting that some foreign nations have already exempted their mariners from their national income tax, including Cyprus, Denmark, the Netherlands, Norway, and Spain.

We believe that Congress can help achieve the dual objective of enhancing the competitiveness of United States-flag commercial vessels operating in international and foreign commerce, and increasing the opportunity for American merchant mariners to secure employment aboard foreign and American commercial vessels. We recommend that Congress make section 911 applicable to American mariners working aboard either a United States-flag commercial vessel or aboard a vessel documented under the laws of a foreign country, to the extent the income earned by the American mariner is attributable to employment performed outside the territorial waters of the United States.

We thank you and your Committee for your consideration of this proposal and we stand ready to provide whatever additional information you or your staff may require.

Statement of the Interstate Natural Gas Association of America

The Interstate Natural Gas Association of America ("INGAA") is a non-profit national trade association that represents virtually all of the major interstate natural gas transmission companies operating in the United States. These companies handle over 90 percent of all natural gas transported and sold in interstate commerce. INGAA's United States members are regulated by the Federal Energy Regulatory Commission pursuant to the Natural Gas Act, 15 U.S.C. §§ 717–717w, and the Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301–3432.

In recent years a number of INGAA's members have become engaged in the design, construction, engineering, ownership and operation of major pipeline and power plant projects outside the United States. Investments are made in these foreign projects generally by foreign subsidiaries of the U.S. companies. These projects, which are highly capital-intensive, often involve construction of a natural gas pipeline and related facilities to transport gas from its point of extraction within one or more foreign countries for industrial uses, gas distribution and to electric generating facilities for use as fuel in the generation of power. The pipeline construction project may include the electric generating plant, and in some cases may also include an interest in the gas wells which provide the gas supply. The gas being transported in the pipeline may or may not be owned by the pipeline owner. Most of these projects are being undertaken in countries in Latin America, such as Argentina, Bolivia and Chile, in countries in Asia, such as India, Oman, and Abu Dhabi and in less developed countries in other parts of the world.

Generally, large energy projects are awarded through a bidding process. The bidding is highly competitive, and the economics of such projects are extremely tax sensitive. In many cases, the country or countries where the project is based impose substantial taxes on the project. U.S. tax law currently disadvantages U.S. companies vis-a-vis their foreign competitors, including particularly those based in Canada, Australia, or Europe.

In announcing this hearing, Chairman Archer stated: "I strongly believe that our tax rules must help, rather than hinder, the competitiveness of American businesses." INGAA urges Congress to reform the taxation of foreign oil and gas income to eliminate the clear inequities of current law as applicable to foreign pipeline projects. It is INGAA's position that the ownership and operation of gas pipelines and other immovable assets in foreign countries as described herein should *never* result in Subpart F income, whether or not the activities occur in a country where the gas was extracted or consumed, and whether or not the controlled foreign corporation takes title to the gas being transported, because these activities do not produce income which is passive or manipulable. Accordingly, we urge the Committee to support H.R. 1127, introduced by Representatives McCrery and Watkins, which clarifies the treatment of pipeline transportation income, and section 105 of H.R. 2018, "International Tax Simplification for American Competitiveness Act of 1999," introduced by Representatives Houghton and Levin. Both bills would exclude income from the transportation of oil and gas by pipeline from subpart F income. Companion bills in the Senate, S. 1116 introduced by Senator Nickles and section 105 of S. 1164 introduced by Senators Hatch and Baucus, would similarly exclude active oil and gas pipeline income from subpart F income. At a minimum, current law should be amended: (i) to apply both the current law "consumption" and "extraction" exceptions to subpart F treatment in the same manner, *i.e.*, their application should not be dependent upon whether the controlled foreign corporation takes title to the gas it is transporting; and (ii) to apply the high-tax exception to foreign base company income to foreign base company oil related income.

Moreover, the Administration's proposal to revise the tax treatment of foreign oil and gas income (the "Proposal") should be rejected. The Proposal would, if enacted, exacerbate the current law bias against INGAA members in competing for these projects, and would drastically affect the economics of projects already undertaken. Accordingly, INGAA also urges Congress to reject the Proposal.

This statement describes current law, illustrates the inequity of current law to INGAA members, and then further illustrates how the Proposal would greatly exacerbate this inequity.

I. U.S. Taxation of Foreign Pipelines Under Current Law

A. Subpart F

Under the Subpart F rules, U.S. "10 percent shareholders"[1] of a "controlled foreign corporation" ("CFC")[2] are subject to U.S. tax currently on their proportionate shares of "Subpart F income" earned by the CFC, whether or not it is distributed to the U.S. shareholders.[3] Included among the categories of Subpart F income is "foreign base company oil related income."[4] Foreign base company oil related income is income derived outside the United States from the processing of minerals extracted from oil or gas wells into their primary products; the transportation, distribution or sale of such mineral or primary products; the disposition of assets used

[1] *See* section 951(b).
[2] *See* section 957(a).
[3] Section 951(a).
[4] *See* section 954(g).

in a trade or business involving the foregoing; or the performance of any related services.

There are two significant exceptions to the foreign base oil related income class:

1. *The extraction exception:* income, including income from operating a pipeline, derived from a source within a foreign country in connection with oil or gas which was extracted by any person from a well located in such foreign country is not treated as foreign base company oil related income;[5] and

2. *The consumption exception:* income, including income from operating a pipeline, derived from a source within a foreign country in connection with oil or gas (or a primary product thereof) which is sold *by the CFC or a related person* for use or consumption within the foreign country is not foreign base company oil related income.[6]

In addition, there is a general exception for CFCs which do not produce 1,000 barrels per day of foreign crude oil and natural gas.[7] This exception, however, often is not available because for this purpose all related persons are aggregated, and many significant investors in natural gas pipelines and power projects around the world own foreign production which exceeds 1,000 barrels per day. Indeed, this limited exception is particularly non-competitive as it applies to production in Canada.

All types of foreign base company income *except foreign oil related income* may be excluded from current taxation under Subpart F if the income is subject to an effective rate of local income tax greater than 90 percent of the U.S. corporate rate.[8] No reason is given in the legislative history as to why this high tax exception is not applicable to foreign oil related income.

The Subpart F taxation of foreign oil related income was enacted in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), P.L. 97–248, September 3, 1982. The legislative history explaining the tax policy rationale for the Subpart F treatment of foreign oil and gas income is as follows:

> [B]ecause of the fungible nature of oil and because of the complex structures involved, oil income is particularly suited to tax haven type operations.

S. Rep. No. 494, 97th Cong., 2d Sess. 150 (1982).

The only other reference made in the legislative history of TEFRA to any reason for including foreign oil related income in Subpart F is the general statement of the Finance Committee that "the petroleum companies have paid little or no U.S. tax on their foreign subsidiaries' operations despite their extremely high revenue." *Id.* Accordingly, Subpart F taxation was imposed on all foreign oil related income without analysis of whether such income fit the criteria of Subpart F, *i.e.,* was passive in nature or moveable. Income from the ownership and operation of foreign gas pipelines is neither passive or moveable. Moreover, it is unlikely that such income could have been a target of TEFRA because INGAA members only began building pipelines outside the United States in the 1990s.

As described above, CFCs owned by INGAA members participate in large foreign projects which typically involve the construction and operation of gas pipelines and related facilities, sometimes include the participation in power plants, and occasionally also include investment in gas wells. These are all active business activities which have become common only in recent years. This foreign income of CFCs owned by INGAA members is no more "particularly suited to tax haven operations" (as the Senate Finance Committee Report states) than is any foreign manufacturing or processing activity conducted by a CFC, such as the manufacture of consumer or industrial goods. Surely it is not possible to "manipulate" income earned by a CFC from operating a gas pipeline permanently installed in a particular foreign country.

Most U.S. bidders have generally only won projects where either the "extraction" or "consumption" exceptions to Subpart F treatment applied. If a pipeline project does not qualify for one of these exceptions to Subpart F it is unlikely that a U.S. bidder could successfully win a bid for that project against foreign competitors. Indeed, such a U.S. bidder is at a competitive disadvantage even for projects with local income taxes higher than the U.S. corporate rate because the Subpart F exception for high-tax income does not apply.

Moreover, the exceptions to Subpart F for foreign oil related income apply irrationally. Consider the example where gas is extracted and processed by persons unrelated to the CFC in country A. The CFC constructs a pipeline from country A through country B and into country C where the gas is delivered to a power plant.

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[5] Section 954(g)(1)(A).
[6] Section 954(g)(1)(B).
[7] Section 954(g)(2).
[8] Section 954(b)(4).

Assume that the CFC receives $100 for transportation of the gas in each of countries A, B, and C, and that each country imposes tax on the CFC of $35. The U.S. taxation of the $300 of income is as follows:

Country A—The $100 is not subpart F income because the extraction exception applies—the income is derived from country A where the gas was extracted.

Country B—The $100 is Subpart F income, currently taxed in United States because the income is not earned either in a country where the gas was extracted (Country A) or consumed (Country C).

Country C—The $100 is Subpart F income if the CFC does not own the gas but instead charges a tariff for transportation. However, if the CFC takes title to the gas and sells it in country C, the consumption exception applies and the $100 is not Subpart F income.

As a matter of tax policy, different tax treatment of each separate $100 of income cannot be justified. None of this $300 of income should be Subpart F income because it is not passive or moveable. Moreover, because, as explained below, INGAA members are frequently in an excess foreign tax credit position, there are many instances in which a foreign tax credit is not available to offset the current U.S. tax on subpart F income from the operation of foreign pipelines by a CFC, with the result that international double taxation occurs.

B. Foreign Tax Credit

U.S. persons are subject to U.S. income tax on their worldwide income. To eliminate international double taxation, *i.e.*, the taxation of the same income by more than one tax authority, the United States allows a credit against the U.S. tax on foreign source income for foreign income taxes paid.[9] The amount of credits that a taxpayer may claim for foreign taxes paid is subject to a limitation intended to prevent taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income.[10] The foreign tax credit limitation is calculated separately for specific categories of income.[11] Generally speaking, the foreign income activities conducted by INGAA members, such as operating pipelines to transport natural gas in foreign countries, produce "active basket" (sometimes referred to as "general basket") foreign source income. Income from the extraction of oil and gas is also generally "active basket" income, although foreign oil and gas extraction income taxes are creditable only to the extent that they do not exceed 35 percent of the extraction income.[12]

The "separate basket" approach of current law was instituted in the Tax Reform Act of 1986. In 1986 Congress expressed a concern that the overall foreign tax credit limitation permitted a "cross crediting" or averaging of taxes so that high foreign taxes on one stream of income could be offset against U.S. tax otherwise due on only lightly taxed foreign income. Nevertheless, in 1986 Congress endorsed the overall limitation as being "consistent with the integrated nature of U.S. multi-national operations abroad," and therefore concluded that averaging credits for taxes paid on active income earned anywhere in the world should generally be allowed to continue.[13] Congress limited the cross crediting of foreign taxes when it would "distort the purpose of the foreign tax credit limitation."[14] For example, one identified concern was the use of portfolio investments in stock in publicly-traded companies, which could quickly and easily be made in foreign countries rather than in the United States. In order to limit the opportunities for cross-crediting, Congress added additional baskets for income that frequently either bore little foreign tax or abnormally high foreign tax, or was readily manipulable as to source. The baskets enacted in 1986 included passive income, financial services income, shipping income, high withholding tax interest, and dividends from non-controlled section 902 corporations.[15]

Current law, which treats all income from the transportation of natural gas through a foreign pipeline as active basket income, is clearly the correct result. INGAA members, however, are frequently in an excess foreign tax credit position because of the substantial interest expense on debt incurred to finance domestic capital expenditures which is apportioned to foreign source income, reducing the numerator of the foreign tax credit limitation which in turn reduces the amount of the

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[9] Section 901(a).
[10] Section 904(a).
[11] Section 904(d).
[12] Section 907.
[13] General Explanation of the Tax Reform Act of 1986, 99th Cong., 2d Sess. 862 (1986) ("1986 Blue Book").
[14] *Id.*
[15] H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 564–66 (1986).

foreign tax credit. Thus, as a practical matter it is difficult for a U.S. pipeline company to obtain foreign tax credits with respect to the income earned from its foreign operations.[16] Such companies, however, should not be precluded from using available credits.

II. The Administration's Proposal

On February 1, 1999, the Administration put forth the Proposal which would result in a substantial change in the taxation of foreign oil and gas income. The Proposal would treat all foreign income taxes paid by a CFC relating to oil and gas income, including income from the transportation of gas through a pipeline, as being subject to a separate foreign tax credit limitation instead of being included as part of the "general basket" of active income.

In the General Explanation of the Proposal, the Treasury Department does not articulate any reason for creating a separate basket for foreign oil and gas income under the foreign tax credit limitation. In its "Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal," issued February 22, 1999, the Staff of the Joint Committee on Taxation stated that the proposal "may provide some simplification by eliminating issues that arise under present law in distinguishing between income that qualifies as extraction income and income that qualifies as oil related income."[17]

The policy rationale of simplification does not apply to pipeline companies, which do not have extraction income. Accordingly, there is no policy justification for separating foreign oil and gas transportation income from other active income for purposes of the foreign tax credit limitation. Moreover, separating foreign oil and gas income into a separate foreign tax credit limitation basket would be contrary to the general principle of the separate basket regime enacted by Congress in 1986 that all active business income should be included in one foreign tax credit limitation basket to enable the cross-crediting of all taxes on such income.[18]

The Proposal would materially harm U.S. businesses, affecting U.S. jobs and U.S. competitiveness in the global economy. The effect of the Proposal would be to limit further the amount of foreign tax credits available to INGAA members and preclude most U.S. investors from successfully bidding for the capital-intensive foreign pipeline projects. This would significantly hinder a thriving business currently available to INGAA members. This business creates a demand for U.S. jobs, particularly engineering and support services. Elimination of most U.S. pipeline companies from participating in foreign pipeline projects seems to INGAA to be wholly counterproductive and misguided tax policy which would cost U.S. jobs.

In addition, the Proposal would apply to projects already completed and in operation. U.S. investors would therefore realize returns different from their economic projections, with materially adverse financial statement impacts. In short, enactment of the Proposal would create profound economic harm for INGAA members with foreign pipeline activities.

III. Recommendations

A. Reform the Subpart F Taxation of Foreign Oil-Related Income As It Applies to Gas Pipelines

Current law includes all foreign oil related income in Subpart F income. It is INGAA's position that the ownership and operation of gas pipelines and other immovable assets in foreign countries as described herein should *never* result in Subpart F income, whether or not the activities occur in a country where the gas was extracted or consumed, and whether or not the CFC takes title to the gas being transported, because these activities do not produce income which is passive or manipulable. Accordingly, we urge the Committee to support H.R. 1127, introduced by Representatives McCrery and Watkins which clarifies the treatment of pipeline transportation income, and section 105 of H.R. 2018, "International Tax Simplifica-

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[16] In the example described above, although the $200 of income frm Countries B and C would be subject to U.S. tax under Subpart F, it is unlikely that the $70 of foreign income taxes paid to Countries B and C would be available as a foreign tax credit to offset the U.S. tax on such income. As a result, there would be international double taxation of the $200 of income.

[17] Staff of the Jt. Com. on Tax., 106th Cong., 1st Sess., Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal, 310 (Comm. Print 1999).

[18] Shipping and financial services income, which are both active income, were subjected to separate basket treatment in 1986, either because the income "frequently" bore little foreign tax or abnormally high foreign tax or was manipulable as to source. 1986 Blue Book at 863–64. The income from operating foreign gas pipelines is not more frequently subject to either abnormally high or low foreign tax than manufacturing income, nor is it manipulable as to source.

tion for American Competitiveness Act of 1999" introduced by Representatives Houghton and Levin. Both bills would exclude income from the transportation of oil and gas by pipeline from subpart F income. At a minimum, (i) the consumption exception should be amended to apply in the same manner as the extraction exception, *i.e.,* its application should not be dependent upon whether the CFC takes title to the gas it is transporting, and (ii) the high-tax exception to foreign base company income should be amended so that it applies to foreign base company oil related income as it does to all other foreign base company income.

B. Reject the Administration Proposal

The Proposal should be rejected. As applied to foreign gas pipelines, there is no tax policy justification for the Proposal. It is inconsistent with the separate basket approach of current law and would preclude most U.S. investors from successfully bidding for the capital-intensive foreign pipeline projects. It also could result in a substantial "tax increase" for INGAA members that own foreign gas pipelines.

* * * * *

INGAA appreciates the opportunity to provide this statement and would be pleased to furnish any information requested by the Committee.

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.

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 investment[3] 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

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[1] The 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.

[2] The 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.

[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.

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.

* * * * *

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.

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[4] Introduced by Representatives Crane, Dunn and McDermott as the "Investment Competitiveness Act of 1999."

[5] The 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.

JOINT VENTURE: SILICON VALLEY NETWORK
SAN JOSE, CALIFORNIA, 95113–1605
July 6, 1999

A.L. Singleton, *Chief of Staff,*
Committee on Ways and Means
U.S. House of Representatives
Washington, DC.

Re: Hearing on the Impact of U.S. Tax Rules on International Competitiveness

The following comments are being submitted on behalf of Joint Venture: Silicon Valley Network. Joint Venture: Silicon Valley Network is a non-profit dynamic model for regional rejuvenation. Our vision is to build a sustainable community collaborating to compete globally. Joint Venture brings people together from business, government, education, and the community to identify and act on regional issues affecting economic vitality and quality of life.[1]

THE IMPORTANCE OF THE GLOBAL MARKETPLACE

In order for companies in the high-tech sector to thrive, including those in Silicon Valley, they must expand their business outside the United States. One critical reason for developing worldwide markets is to spread large R&D and other developmental costs over the largest possible product base in order to keep prices low in a highly competitive global economy. Perhaps the most important message that Congress can give businesses in the United States is through the tax provisions relating to the treatment of international operations of U.S.-based companies. Congress can encourage or discourage the expansion of U.S. companies outside the United States. Congressional action will make a great deal of difference with regard to whether U.S. businesses will thrive in the 21st century. Tax policy needs to be formulated on a long-term basis and it needs to encourage U.S. businesses, especially those in the high-tech sector, to expand outside the United States. Any efforts to modify international tax rules should consider how tax policy—can support trade policy, international competitiveness, simplification, and the reality that today's global economy is not the one that existed when some of these international rules were created years ago.

U.S. TAX POLICY IS U.S. TRADE POLICY

Tax policy should not impede trade policy. To that end, changes in U.S. tax policy should consider global tax trends, such as converging corporate income tax rates, and strive for reducing complexity. Converging corporate income tax rates around the world make a strong case for territorial-based tax systems, which reduce complexity. U.S. tax policy should encourage "headquarters" activities, such as research and development and non-commodity manufacturing, that will in turn produce higher profits in the future and higher U.S. wages. If changes to the current international tax rules are made without full consideration of all factors of today's global economy, economic growth in the United States could be adversely affected. Finally, U.S. international tax reform should occur within the context of global business and economic trends with a goal of designing tax policy that does not impede trade policy or is inconsistent with tax trends around the world.

ECONOMIC TAX MODELS

An appropriate starting point to understanding international taxation related to foreign transactions is to compare the current U.S. system to classic economic tax

[1] This letter represents the collective views of the Tax Policy Group within the Council on Tax & Fiscal Policy of Joint Venture: Silicon Valley Network (described on the last page of this letter), and not necessarily the views of any individual member of the Tax Policy Group. This letter is a summary of a larger Tax Policy Group position paper on International Tax Reform, which is expected to be published soon. The primary draftsperson of this letter was William C. Barrett (Applied Materials, Inc.). The ideas expressed in this letter represent the joint efforts of the following members of the Tax Policy Group: Jim Cigler (PricewaterhouseCoopers, LLP), Harry Cox (Aspec Technology Corporation), Randy George (Adaptec Corporation), Dan Kostenhauder (Hewlett Packard, Inc.), Larry Langdon (Hewlett Packard, Inc.), Suzanne Luttman (Santa Clara University), Annette Nellen (San Jose State University), Sandra Olsen (Solectron Corporation), and Don Scott (Oracle Corporation).

models. There are two classic economic models in the area of foreign taxation: capital export neutrality (CEN) and capital import neutrality (CIN).

The CEN concept holds that an item of income, regardless of where it is earned, should bear a global rate of tax equivalent to the home country tax rate. As applied in the U.S., the CEN model allows a foreign tax credit to a U.S. corporation facing U.S. taxation on it's worldwide income in order to reduce the risk of double taxation of the foreign earnings. Under the CEN model, tax rates are equivalent for investors residing in the same country.

Under a CIN model, tax rates are equivalent for all investment located in the same country. If such a model were used in the U.S., foreign income would not be taxed in the United States in the year in which it is earned or when received as a dividend. Territorial-based tax systems (e.g., The Netherlands and France) are patterned after the CIN concept where a country only taxes income earned within its borders. Under CIN, income would be allocated between U.S. and foreign operations based on functions and risks performed in the respective geographic locations.

The U.S. tax system is a hybrid approach with characteristics of both the classic CEN and CIN models. Except for certain proscribed activities (e.g., subpart F), the U.S. tax system is best described as a system based on deferral, where income earned offshore in a separate legal entity is not taxed until distributed (paid as a dividend of the foreign earnings) back to the U.S. The U.S. hybrid system includes incentives to encourage U.S.-based research, manufacturing, and export.

Numerous studies exist that debate the relative merits of the CEN vs. CIN economic models.[2] However, fewer studies exist that debate the [practical] distinctions between the two models. Practical considerations would include the following:

1. Global tax rates around the world for major trading partners are converging.[3] This global tax trend leads to the conclusion that, net of foreign tax credit, the U.S. government gains little by taxing foreign earnings.

2. Studies have shown that the amount of foreign taxes paid by U.S. multinationals are matched closely with the amount of foreign tax credit claimed on their U.S. returns.[4] Therefore, the amount of U.S. tax revenue generated by taxing foreign earned income may be insignificant. In the interest of simplicity, the extremely complex provisions in the Internal Revenue Code that trigger 'deemed' income inclusions make little sense.

3. Global mergers involving U.S. companies (e.g., Daimler/Chrysler) are becoming more common. Integration of the global marketplace and financial markets portends of an increase in these global mergers. These mergers provide an opportunity for the parties to re-evaluate their global tax structure and as a result, U.S. companies may have the opportunity to create a 'territorial' tax base for U.S. operations when the foreign party becomes the parent company of the newly merged global operation. Again, policy makers should seriously re-evaluate whether the taxation of foreign earned income makes any sense (1) when a territorial tax base is possible through global restructuring, and (2) under our worldwide-based taxation system with a foreign tax credit operating in a world with converging corporate tax rates.

4. The IRS and the U.S. Treasury adopted extensive transfer pricing regulations, and Congress enacted related penalty provisions, in 1993. Foreign governments in turn have adopted many of the concepts in these U.S. regulations. In addition, the 'Advanced Pricing Agreement' program has been used extensively by U.S. multinationals and the IRS where the IRS and U.S. multinational agree prospectively to transfer pricing methodologies. Consistency in global transfer pricing practices por-

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[2] For example, Overview of Present-Law Rules and Economic Issues in International Taxation, Joint Committee on Taxation, March 9, 1999, JCX–13–99.

[3] For example, see Jeffrey Owens, "Emerging Issues in Tax Reform: The Perspective of an International Bureaucrat," Tax Notes International, December 22, 1997. Nominal tax rates tend to converge around 30–40%.

[4] In an article written by Sarah Nutter, Assistant Professor at George Mason University, and attached to the 1997 IRS Statistics of Income Bulletin, Prof. Nutter points out that U.S. multinationals paid $23.7 billion of foreign taxes in 1993 and claimed $22.9 billion of foreign tax credits (see Tax Notes International, January 12, 1998, p. 89). The $600 million differential raises interesting observations, which seem to lead to the conclusion that the U.S. fiscal gains little by taxing foreign earned income of U.S. multinationals. For example, if the assumption is made that the $600 million differential are taxes associated with 'low-tax' offshore earnings (e.g., 10% tax rate earnings), the base income 'deferred' offshore would be $6 billion. The tax rate differential between the 10% and 35% U.S. tax rate would lead one to the conclusion that only $1.5 billion tax was deferred by U.S. multinationals. If these conclusions are correct, Congress should seriously question whether it makes sense to retain unnecessarily complex provisions of the U.S. Tax Code, such as subpart F, that tax these foreign earnings. Eliminating subpart F provisions of the Code, with the possible exception for incorporation of 'offshore pocket books', or adopting a 'territorial' based tax system are equally compelling and would eliminate unnecessary complication without sacrificing significant tax revenue.

tends of more efficient transfer pricing audit resolution. These very significant developments to proper allocation of cross-border income eliminate many of the concerns the Kennedy administration had in 1962 when subpart F, and other anti-deferral provisions, were enacted.

These practical observations lead to a very compelling argument that when there are minimal [practical] distinctions between CEN, CIN, or the U.S. hybrid method, the U.S. government should align international tax reform with a model that is the easiest to administer. From a U.S. tax revenue perspective, it matters little whether foreign earned income is taxed at all in the United States when U.S. tax on this income is offset by foreign tax credits that on average, are very close to the U.S. statutory tax rate. Repealing anti-deferral provisions in the U.S. tax code would be a tremendous tax simplification step with minimal downside tax revenue loss. Aspiring towards international tax simplification is an attainable pursuit in this increasingly integrated global economy and convergence of tax rates around the world.

Global Economic and Business Trends

The Brookings Institution analyzed the impact that trade barriers have on trade balance and export-related jobs.[5] The report concludes that trade barriers increase the cost of an exported product and, as a result, reduce the number of high-paying jobs in export-related industries. Therefore, it stands to reason that by reducing trade barriers, U.S. companies are able to support a higher wage base and focus on new product innovation that accompanies these higher-paying and export-related jobs. Extending the Brookings report logic, U.S. tax policy that increases the tax cost of export-related products will suppress high wage U.S. export-related jobs.

Global business consolidation is a trend seen across numerous industries. This trend hints of a more subtle evolution which is the consolidation of core "headquarters" functions. Core "headquarters" functions encompass research and development; centralized corporate functions, such as office of the Chief Executive Officer wherein global policy setting occurs for multinationals; and non-commodity manufacturing related to new product development. These functions are primary profit drivers for a multinational company and are critical to product innovation.[6] For many companies, there is one centralized headquarters location. Understanding the "headquarters" relationship is important in developing tax policy because a tax policy that encourages locating these functions in the U.S. will reap a higher U.S. profit base, higher wages, a stronger local economy, and future U.S. innovation that perpetuates the cycle.

Calls to Abolish "Corporate Welfare" Miss the Point

"Anti-deferral" legislation (e.g., "runaway plant" type legislation) is popular within protectionist camps.[7] The concern from these groups is that when U.S. multinational corporations invest in offshore manufacturing locations it is being done solely to reduce U.S. labor costs. The protectionist fears are largely unfounded considering the global trends discussed above and should be resisted. Multinationals will locate major income-producing functions (i.e., "headquarters" functions) where they can achieve the highest rate of return in terms of both human capability and

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[5] Globaphobia: The Wrong Debate Over Trade Policy, by Robert Z. Lawrence and Robert E. Litan, September 1997, *http://www.brook.edu/comm/policybriefs/pbO24/pb24.htm*. The Brookings report states that export related jobs on average pay 15% more than the average U.S. wage. The Bank of Montreal published a survey (Trade And Investment In The Americas, Survey of North American Businesses, Bank of Montreal/Harris Bank) revealing that after implementation of NAFTA, 47% of all North American businesses have gained employees while another 41% employ about the same number of employees. Only 11% of the surveyed firms lost employees. Further, the Hudson Institute has published a sequel to its study Workforce 2000 that reinforces many of these conclusions (Workforce 2020, Work and Workers in the 21st Century, Hudson Institute, Indianapolis Indiana, 1997).

[6] Gary Hufbauer, U.S. Taxation of International Income, Blueprint for Reform, Institute for International Economics, October 1992, characterizes "headquarters" activities as "incubators of human capital." "Non-commodity manufacturing" is used in this context to distinguish between lower profit "commodity" manufacturing. In an increasingly global marketplace, sound business governance dictates that to remain competitive in selling commodity products, business must seek lower cost production sites, leaving higher profit and higher paying wage jobs associated with "non-commodity" high-tech products in the United States.

[7] See for example, S. 1597 as proposed by Senator John Dorgan (R–S. Dakota.) in March 1996 and Amendment No. 5223 (Sept. 11, 1996). S. 1597 would have taxed offshore income associated with the sale of goods back into the U.S. The Asian economic crisis has heightened concerns from economists and business leaders that politicians may respond to price reductions with protectionist legislation which might in turn lead to deterioration of the global economy (see for example Wall Street Journal, January 5, 1998, editorial page).

financial return on investment and it is these "headquarters" functions that attract economic income. Concerns about losing low-wage/low-tech jobs misinterpret global trends and the factors that promote economic growth and improve wages in the United States.

The ongoing debate about whether to further restrict deferral is engaged in by parties that view the world from different perspectives. There are those who believe that eliminating deferral for the foreign earnings of U.S.-based companies while the foreign earnings of foreign-based competitors obtain the advantages of tax-sparing treaties or territorial tax systems puts U.S. companies at a major competitive disadvantage that works to the detriment of the entire U.S. economy. On the other side are those who focus on the potential loss of U.S. manufacturing jobs that could occur because U.S. companies would be attracted to foreign, low-tax jurisdictions.

Perhaps the most interesting way to think of these alternative views is through the prism of trade policy. The U.S. has been a leader since the middle of this century in dropping barriers to the free flow of goods and services across international boundaries. It is generally recognized that such a liberal trade policy has provided great economic benefits to all the countries of the world, including the Unites States. In the same vein, it is likely that allowing capital to flow more freely across borders will have a beneficial impact on U.S. and global economies. If some of the proposed anti-deferral legislation were adopted, the United States would be the first major country to eliminate deferral of income from active business activity. This would make U.S. companies less competitive without providing significant offsetting benefits.

CONTACT INFORMATION

Any questions on our comments should be directed to either Bill Barrett, Chair of the Tax Policy Group's International Tax Reform Subcommittee at (408) 235–4389 or barrett—bill@AMAT.com, or Annette Nellen, Chair of the Tax Policy Group, at (408) 924–3508 or anellen@ynn.com.

Sincerely,

LARRY LANGDON
Vice President: Tax, Licensing, & Customs
Hewlett Packard
Co-Chairs, Council on Tax and Fiscal Policy

JANE DECKER
Deputy County Executive
County of Santa Clara

Joint Venture: Silicon Valley Network (www.jointventure.org) is a non-profit dynamic model for regional rejuvenation. Our vision is to build a sustainable community collaborating to compete globally. Joint Venture brings people together from business, government, education, and the community to identify and act on regional issues affecting economic vitality and quality of life. One of OUI initiatives is the Council on Tax and Fiscal Policy.

Council on Tax & Fiscal Policy and the Tax Policy Group: The mission of the Council on Tax and Fiscal Policy is to bring together Silicon Valley's public and private sectors to identify common tax and fiscal needs and to work for mutually beneficial policy change at the regional, state, and federal levels. The Council champions reform by crafting legislation, supporting legislation, conducting special analysis, and serving as an educational forum. The Council's Tax Policy Group consists of individuals from high tech industry, government, and academia who analyze various state and federal tax rules and proposals to consider the impact to local governments and high tech industries. The Group's current work encompasses international tax reform, worker classification, R&D incentives, major federal tax reform, incentives for donations of technology to K–14, and sales tax issues of electronic commerce. The Group works to promote better understanding of tax and fiscal issues of significance to the Silicon Valley economy, through distribution of its reports and quarterly tax and fiscal newsletter, sponsorship of seminars and discussion forums, and submission of testimony to legislators and tax administrators.

NEU HOLDINGS CORPORATION
WHIPPANY, NJ, 07981
June 28, 1999

The Honorable Bill Archer, *Chairman*
Committee on Ways and Means
U.S. House of Representatives
Washington, DC.

Re: Hearing on International Tax Rules, June 30, 1999

Dear Representatives Archer and Rangel:

We greatly appreciate your efforts to examine the United States' international tax policy and its impact on U.S.-controlled shipping companies. Your attention to this matter, as well as the Shaw-Jefferson bill, H.R. 265, which is pending before the Committee, are the first vital steps toward strengthening the U.S.-controlled foreign-flag shipping industry and restoring the United States' competitive opportunities internationally.

General Ore International Corporation Limited (GOIC Ltd.) is one of the largest American-controlled industrial shippers of iron ore and liquid petroleum products in world markets, and it is one of the last corporations, privately-owned by U.S. citizens, that operates foreign-flag vessels. Nevertheless, GOIC Ltd. is a very small operator compared to its international competitors.

Our continued success is dependent upon our ability to compete fairly and openly in the international market. However, burdensome U.S. tax policies have hindered our ability to compete. Shipping income earned by GOIC Ltd. is subject to taxation under Subpart F of the Internal Revenue Code regardless of whether that income is reinvested in the business.

Subpart F, enacted in 1962, imposes taxes on certain U.S.-owned businesses operating abroad that are more onerous than if those businesses were operating in the United States. As originally enacted, U.S.-controlled foreign shipping companies were not subject to Subpart F and were taxed no differently than their competitors—their earnings were not taxed until they were repatriated. In 1975, this changed. Congress amended Subpart F to limit the deferral of foreign flag shipping income so that income not reinvested into shipping operations was taxed currently. As a result, the industry and the tax revenues it produced began to decline.

In 1986, Congress eliminated the deferral for reinvested income. Now the income from the U.S.-controlled foreign fleet is subject to U.S. tax whether or not those revenues are realized. This places companies like ours at a competitive disadvantage relative to our competitors, which are not subject to these taxes. Further, the United States cannot compete effectively in international markets with its major trading partners that have adopted tax policies and incentives to support their international shipping industries and, through them, their exports.

Extending Subpart F to shipping income has devastated the U.S.-controlled foreign shipping industry. Before 1975, U.S.-owned foreign-flag shipping companies controlled 25 percent of the world's fleet. Because of the tax burdens imposed by Subpart F, that number has declined to less than 5 percent today. This anti-competitive tax regime has reduced new ship acquisition, and it has resulted in U.S. owners becoming minority owners in the vessels they once owned and operated.

The U.S. government has gained nothing from extending Subpart F to shipping income. While the tax imposed upon this industry was originally designed to generate revenues, it has cost the U.S. Treasury millions of dollars. Please see the enclosed analysis by KPMG Company. In addition, U.S. national security is eroding with the declining sealift capability.

The U.S. Congress must take action to restore the industry's competitive opportunities with its foreign trading partners. We encourage the Ways and Means Committee to move H.R. 265 through the House. Under the proposed legislation, taxes would be deferred, not exempted, and would be paid into the U.S. Treasury when repatriated. The bill allows growth in the U.S.-controlled fleet and restores the ability of U.S citizens to be active competitors in the global market. Without immediate action, the United States risks losing the few remaining U.S.-controlled shipping companies to countries whosetax laws are more favorable.

Thank you for your attention to this matter. We look forward to working with you and the Ways and Means Committee to address this important issue. If you or your

staff would like any additional information, please contact my Washington counsel, Warren L. Dean of Thompson Coburn LLP, at (202) 508–1004.

Very truly yours,

RICHARD W. NEU

[Attachment is being retained in Committee files.]

SEABOARD CORPORATION
WASHINGTON, DC, 20006
July 7, 1999.

Hon. Bill Archer, *Chairman,*
House Ways & Means Committee,
Washington, DC

Re: June 30, 1999 Committee Hearing on the Impact of U.S. Tax Rules on International Competitiveness

Dear Chairman Archer:

Seaboard Marine commends the Chairman and Committee for holding its recent hearing on the international tax regime. We appreciate the opportunity to submit this statement regarding critical changes that are necessary in the U.S. tax code. Seaboard is in agreement with the testimony that Prof. Warren Dean provided June 30 on behalf of the Subpart F Shipping Coalition, of which we are part, and provides this separate statement because of the urgency and significance of these issues.

Seaboard Marine, based in Miami, is a wholly-owned subsidiary of Seaboard Corporation. It is one of the few remaining U.S.-owned shipping lines. Our company is one of the nation's premier carriers to the Carribean Basin, Central America and the west coast of South America. Additionally, Seaboard Marine is the largest carrier operating out of the Port of Miami, the world's leading shipping port to the Carribean Basin and Central America.

Seaboard Marine competes internationally with carriers from around the world. Our ability to compete, however, is significantly hampered because of oppressive and repressive U.S. tax and regulatory policy. These rules and regulations favor foreign shippers at the expense of the U.S. maritime industry, creating a lopsided playing field. The imposition of punitive taxes on U.S.-owned international shipping companies has decimated the maritime industry. Specifically, the current provisions of Subpart F of the Internal Revenue Code have made it virtually impossible for Seaboard Marine and other U.S.-owned shipping companies to remain competitive in the global marketplace.

As one of the last remaining U.S.-owned shipping lines, we urge the Committee to approve H.R. 265, sponsored by Congressmen Clay Shaw (R–Fla.) and William Jefferson. (D–La.) This proposed legislation would restore the competitive opportunities for U.S.-controlled foreign-flag corporations by excluding shipping income from Subpart F of the Internal Revenue Code. Under H.R. 265, taxes would be deferred, not exempted, and would eventually be paid into the U.S. Treasury when repatriated. If the current provisions of Subpart F are not amended and corrected, the American maritime industry faces extinction.

Besides employing more than 500 U.S. citizens and generating revenues in excess of $300 million, Seaboard Marine tangentially affects the employment of thousands of other American workers who are necessary to the inherent capital-intensive nature of the marine shipping industry. These ancillary businesses include trucking, warehousing, banking and manufacturing industries, and freight forwarders. Moreover, the vast portion of the capital assets that Seaboard Marine utilizes in its business are produced in the United States, such as flat racks, refrigeration equipment, chassis and forklifts. For Seaboard Marine, the loss of Subpart F protection has meant not only decreased revenues, but also a disincentive to reinvest and expand.

If this disincentive were eliminated, the industries upon which the maritime industry depends for goods and services also would benefit. Finally, Seaboard Marine provides a critical trade link to key countries in Latin America, such as Guatemala, Honduras, El Salvador, Nicaragua and the Dominican Republic. For these countries, the United States is the principal source of trade, of which Seaboard Marine plays a major role. The U.S.' ability to maintain its dominance in this important trade zone will be enhanced by the reinstitution of Subpart F protections for our industry.

Besides the specific implications for Seaboard Marine, the ramifications of current Subpart F provisions are far-reaching for the U.S. maritime industry. It is not incor-

rect or an exaggeration to say that the American maritime industry faces extinction if the current provisions of Subpart F are not amended and corrected.

Alarmingly, the U.S.-controlled fleet has declined from representing more than twenty-five (25) percent of the world fleet in 1975, when Subpart F was first altered, to less than five (5) percent today. American carriers' share of the market of the U.S. import/export cargoes fell by *half* between 1990 and 1996, according to the U.S. Maritime Administration. Equally striking is that in 1975, U.S. carriers owned nearly 22 million of the 85 million gross registered tonnage in the world flag-of-convenience fleet. This accounted to approximately 26 percent of the world fleet. By 1996, however, the world-flag-of-convenience fleet had almost tripled, to 241 million tons, while U.S. carrier ownership fell almost by half.

The downfall of the American shipping industry is directly attributable to the devastating income tax burden that the U.S. government imposes upon it. American carriers pay income tax at a base rate of 36 percent. Most foreign carriers, however, pay little or no income tax.

A study conducted by Crowley Maritime Corp., which also submitted a statement to the Committee regarding its June 30 hearing, illustrates the disparity of the tax ramifications between U.S. and foreign shippers. The Crowley study found that on average, the foreign carriers sampled received a net tax *credit* in 1996, while American carriers sampled paid more than 45 percent of their profits to the U.S. government in taxes in 1996; 43 percent in 1997.

With this tax disparity in mind, there is little wonder why the American shipping industry is struggling for survival.

Before the protection of Subpart F was stripped away, the once-proud U.S.-owned fleet controlled a quarter of the world's fleet. Hundreds of millions of dollars were generated in annual tax revenues as a result of the voluntary repatriation of earnings. The associated infrastructure generated billions of additional dollars of taxable economic activity. After the 1975 alteration to Subpart F, the once significant U.S.-owned fleet was forced to expatriate to remain competitive. Related industries, such as insurance brokerage, ship management, surveying, chartering, technical consultancies, etc., who serviced the maritime industry, followed.

Conversely, foreign shippers have taken advantage of a favorable tax regime both in the U.S. and abroad. This has a given them a great advantage and thus a stranglehold on the industry. Consequently, the economic leadership of the United States in this critical sector of the economy has been lost. This has been painfully demonstrated and made obvious by recent international maritime transactions.

In 1997, for example, the American President Lines, a bastion of the American maritime industry for more than 100 years, was sold to Neptune Orient Lines Ltd. of Singapore. Shortly thereafter, Lykes Steamship Company, another prominent old-line shipper, sold its assets to Canadian Pacific Ltd. In short, these venerable lines fell into foreign hands because of the repressive and noncompetitive tax burdens the U.S. government placed on the lines' American owners.

The elimination of the exclusion for shipping income from Subpart F of the Internal Revenue Code is thus illogical. The current provisions of Subpart F *do not* achieve the objective for which they were created. This repressive tax burden has not generated the tax revenues which were expected. Instead of increasing the tax revenue from the 1975 level of slightly more than $200 million to a projected revenue of almost $800 million in 1998, the revenue has, in fact, plummeted to (approx.) a meager $50 million.

The decline of the maritime industry has additionally weakened the national defense, threatened existing maritime jobs and prevented the creation of new job opportunities. America's national defense is weakened because the military has historically relied upon the U.S. fleet to meet its marine transportation requirements. We must now depend upon ships under foreign ownership.

The current provisions of Subpart F threaten thousands of U.S. maritime jobs, and prevent the creation of countless others because of the disincentive for American investment or reinvestment in shipping enterprises. Relieving the onerous burden that Subpart F presently imposes on the U.S. maritime industry not only would secure existing American jobs, but would no doubt be conducive to the creation of new job opportunities.

As one of the last surviving players in the American maritime industry, Seaboard Marine urges you to give close and careful scrutiny to the ramifications of H.R. 265. Without the repeal of the repressive provisions of the current Subpart F legislation, the extinction of the U.S. maritime industry is inevitable.

Seaboard Marine appreciates the opportunity to contribute to this vital tax debate. Our industry has been made to suffer by repressive taxation. It is time to halt and correct this crippling of a vital American industry.

Sincerely,

RALPH L. MOSS
Director, Government Affairs

Statement of the Section 904(g) Coalition

Mr. Chairman, the Section 904(g) Coalition commends you for holding this hearing on the impact of U.S. tax rules on the international competitiveness of U.S. businesses. Foreign competition faced by U.S. businesses has intensified with the acceleration of globalization. Over the years, Congress has revised the Internal Revenue Code to address the expanding activities of U.S. businesses in overseas markets. Unfortunately, a number of those revisions have negatively impacted the ability of U.S. businesses to compete in the global marketplace. One such provision, Section 904(g), enacted as part of the Deficit Reduction Act of 1984, can result in double taxation of income earned by a foreign subsidiary of a U.S. company. This testimony describes the situation in which double taxation can arise under Section 904(g) and proposes a narrow amendment to prevent such a result.

1. BACKGROUND

The members of the Section 904(g) Coalition are fully integrated U.S.-based multinational companies that engage directly and through domestic and foreign subsidiary corporations in the discovery, development, manufacture, marketing and sale of products. The foreign subsidiaries manufacture finished products from materials supplied by the U.S. parent company ("Parent") or other affiliates, and market, sell and distribute such products in their local markets. A number of these foreign subsidiaries also conduct research and development activities locally through their own research staffs, while others may fund research by third parties or affiliates on their behalf or pursuant to bona-fide cost sharing agreements within or outside their home countries. These foreign subsidiaries are incorporated in developed countries with which the U.S. has a tax treaty. All locally funded research and development expenses are deducted in their home country, foreign tax returns and expensed for local statutory accounting purposes. Consequently, worldwide patent rights that result from these efforts and expenses are owned by the foreign subsidiary.

Quite often the foreign patent owner does not have a manufacturing plant. The decision about where to locate such a plant is based on a variety of business, legal and political considerations. Building a manufacturing plant often requires a very significant investment in capital, and approval of the local government is often required for the siting, design and construction of the plant. In addition, manufacturing often involves specialized manufacturing know-how that the subsidiary may not possess. The foreign subsidiary would also need to recruit and train a manufacturing work force, which could require a significant investment of time, expense and management effort. In many cases, even if the subsidiary were willing to expend the time, expense and effort to acquire this capability itself, it could not construct a new manufacturing plant in time to meet the anticipated launch date for a particular product.

For these reasons, worldwide patent rights owned by a foreign subsidiary ("Licensor") may be licensed at an arm's-length royalty rate to another affiliate ("Licensee") that already owns and operates a manufacturing plant and has the capacity and know-how to manufacture the patented product.

2. INTERNAL REVENUE CODE SECTION 904(G)

Under Code section 861 (a)(4) of the Internal Revenue Code ("Code"), royalties received for the use of a patent in the U.S. are U.S. source income. As a result, royalties paid by Licensee to Licensor for sales of product in the U.S. will generally be considered U.S. source income to Licensor. Moreover, under Code section 904(g), when Licensor pays an actual or deemed dividend to Parent, the dividend will be U.S. source income to the extent Licensor's earnings and profits are attributable to the U.S. source royalties. Any such dividend paid by Licensor will carry foreign tax credits at rates that may equal or exceed the U.S. statutory rate, but none of the royalty component of the dividend will be foreign source income.

Alternatively, Section 904(g)(10) would permit Parent to avoid Section 904(g) resourcing if such resourcing would be inconsistent with an income tax treaty between the U.S. and Licensor's country of residence. Two requirements must be satisfied for Section 904(g)(10) to apply: (i) the treaty must give the foreign jurisdiction the right to tax dividends paid by Licensor to Parent (notwithstanding the dividend's domestic source under U.S. law), and (ii) the treaty must contain a special source rule that treats dividends that Licensor's jurisdiction may tax as arising in Licensor's jurisdiction for U.S. foreign tax credit purposes (see, e.g., Article 23 of the U.S.-UK Income Tax Treaty). Section 904(g)(10) relief, therefore, is contingent on the right of Licensor's country to impose withholding tax on dividends paid to Parent, rather than its right under the treaty to tax Licensor on its U.S. source income. Thus, for example, if the new U.S.-UK treaty (now under renegotiation) should no longer permit the U.K. to tax dividends paid to Parent (or, alternatively, no longer contain a special sourcing rule), Section 904(g)(10) relief would be unavailable even though Licensor has paid full U.K. corporate income tax on its royalty income. Loss of Section 904(g)(10) relief is a very real possibility in the U.K. because dividend withholding tax may be entirely eliminated under U.K. internal law. Moreover, resourcing provisions are now contained in only a limited number of treaties (perhaps a dozen), and United States treaty policy has generally been to reserve for the U. S. the right to apply Section 904(g) in post-enactment treaties (see, e.g. Treasury Department Explanation to Article 25 of the new U.S.-Luxembourg treaty). As newer treaties supersede older treaties, Section 904(g)(10) relief will become increasingly rare. Section 904(g)(10) also requires that the dividend income attributable to the resourced royalty be placed in a separate foreign tax credit limitation basket.[1]

Thus, the choices available to Parent under current law are: (1) to rely on the possibility of cross-crediting all the foreign income taxes in the five-year carry-forward period in its general limitation basket, or (2) to choose the benefits of a treaty, where available, and credit foreign taxes paid up to the effective U.S. tax rate but permanently lose the ability to credit local taxes in excess of the U.S. rate.[2] If the product is generating substantial U.S. royalty income that is subject to tax in the foreign jurisdiction, it is extremely unlikely that Parent would be able to cross-credit the foreign taxes in its general limitation basket. Thus, either choice will result in serious double taxation for Parent. The separate basket approach also unfairly prevents a taxpayer from using other available credits to satisfy any residual U.S. tax liability on U S. source royalties taxed at a foreign rate below the U.S. statutory rate.

As discussed below, the Coalition believes, based on the legislative history of Code section 904(g), that Congress did not intend this result. Conceding for purposes of argument that Congress did intend when it enacted Section 904(g) in 1984 that dividends paid by Licensor to Parent be treated as U.S. source income to the extent Licensor's earnings and profits were attributable to U.S. source royalties, evolving foreign business requirements during the intervening 14 years and the need for U.S. companies to compete in foreign markets should cause Congress to revisit and revise subsection (g).

3. Legislative History

The legislative history to the Deficit Reduction Act of 1984 ("the 1984 Act") expresses concern that, under existing law, a corporation could receive U.S. source income and subsequently repatriate the income as foreign source by flowing the income through an intermediate foreign corporation. By thus inflating foreign source income, U.S. companies with excess foreign tax credits could reduce U.S. tax on what would otherwise be U.S. source income and thus distort the foreign tax credit limitation. Congress also wanted to eliminate any competitive advantage to U.S. taxpayers that exported capital to be invested in the United States to foreign subsidiaries rather than investing it directly. Joint Committee Print, H.R. 4170, 98th Congress, Public Law 98–369, pp. 346–54.

Examples in the Joint Committee Print make it clear that the abuse Congress was targeting was the conversion of U.S. source income to foreign source income by routing the income through a foreign subsidiary set up for that purpose: where, in other words, there was no business reason for the activities in question to be carried

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[1] Section 904(g)(10) is further limited where Parent has dividend income under Subpart F by requiring treaty protection at each level of ownership where there are intermediary holding companies. Section 904(g)(10)B.

[2] In practice the capacity to credit taxes within a separate 904(g)(10) basket will be limited to rates below the U.S. statutory rate because of the allocation of expenses under Reg. Sec. 1.861–8.

on by a foreign subsidiary instead of a U.S. subsidiary or the U.S. parent itself, and the primary reason for the establishment of a foreign subsidiary was tax avoidance. The example given by the Joint Committee is a foreign insurance subsidiary of a U.S. company that earns all its income from insuring U.S. risks of U.S. companies and distributes its profits to its parent as foreign source income.

4. Application Of Code Section 904(g) Appears Contrary To Congressional Intent

As discussed above, Congress had two concerns when it enacted Code section 904(g) in 1984: the export of capital and the manipulation of the foreign tax credit. Neither of these concerns applies to the activities of Licensor in the circumstances described above.

First, there is no export of capital involved in the ownership and commercialization of product by a foreign subsidiary where the patent is either discovered in the foreign jurisdiction and/or funded from Licensor's local business profits,[3] and all the R&D expenses are deducted in its local tax return. In these circumstances, no U.S. capital is exported, directly or indirectly, to Licensor for the discovery and development of the product. The patent rights to the product are clearly the property of Licensor, and Licensor therefore has no choice but to report the full profits from exploiting the patent in its local tax return. In any event, Code section 367(d), also enacted in 1984, put an end to the practice of transferring appreciated intangibles from a U.S. parent to a foreign subsidiary in a tax-free exchange. Under Code section 367(d), the intangible is treated as having been transferred in exchange for a royalty or other payment commensurate with the income earned on the intangible. Since the royalty would be U.S.-source if the intangible were used in the U.S., the outbound transfer would no longer result in either a deferral of income or a conversion of income from U.S. to foreign source.

Second, there is no manipulation of the foreign tax credit. If Licensor had manufactured the product itself, Licensor's income from sales of product into the U.S. would be foreign source income. Because Licensor has no manufacturing plant, it will license worldwide patent rights to an affiliate that does have such a plant in return for an arm's length royalty. Thus, the decision to license to an affiliate is made for sound business reasons. Moreover, all of Licensor's income, including royalties, is subject to full local taxation in its jurisdiction of residence. Even if Parent had a choice about where to report the income from exploiting the patent, it could not obtain a foreign tax credit benefit by routing U.S. source income through a full tax-paying foreign jurisdiction. On the contrary, Parent's foreign tax credit capacity is reduced to the extent it incurs local tax in excess of the U.S. tax rate. Because the Licensor that the Coalition is focused upon is incorporated and residing in a developed country with which the U.S. has a tax treaty, there is little or no opportunity for manipulation of the foreign tax credit rules.

Finally, it appears that Code section 904(g) would apply even if Licensor had actually imported capital into the U.S. by manufacturing product and selling it in the U.S. through a U.S. branch—a structure clearly not designed either to export capital or distort the foreign tax credit limitation. In that case, Licensor would be subject to a 35% U.S. federal tax on its income, plus a 5% branch profits tax. Licensor would also be subject to full local income tax less a credit for U.S. taxes incurred. A dividend from Licensor under these circumstances would likewise be subject to Code section 904(g), and, thus, a pro rata portion would be U.S. source income. Consequently, Parent would face the same foreign tax credit problem discussed above.

In sum, Parent has not attempted to transfer a U.S. asset or business to a foreign jurisdiction to convert U.S. source income into foreign source income. The capital to create the asset is of foreign origin, all R&D expenses are deducted in Licensor's local tax return, and Parent has never owned the asset. The foreign subsidiary that owns the patent is incorporated and residing in a country with which the U. S. has a tax treaty. The foreign tax jurisdiction, moreover, has very reasonable expectations that any profit resulting from commercialization of the patent will be subject to full income taxation in that jurisdiction. U.S. tax policy actually endorses this expectation through income tax treaties by ceding primary taxing jurisdiction to that other country on royalty income that is U.S. source income under Section 861 principles. There is no valid U.S. tax policy objective in these circumstances for limiting utilization of foreign tax credits under Section 904(g).

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[3] A formula can be developed to assure that funds expended for R&D were derived from Licensor's own profits rather than from capital contributions made by Parent.

5. Evolving Foreign Business Conditions Necessitate Modifications to Section 904(g)

There is language in the attached Joint Committee Print to the effect that Congress intended to preserve full U.S. tax on U.S. source income earned by foreign subsidiaries of U.S. corporations upon repatriation to the U.S. regardless of the rate of tax paid by the foreign subsidiary on the income.[4] Thus, the Committee Print appears to reflect U.S. tax policy concern even where the U.S. source income is subject to high rates of foreign taxes, the cost of which the taxpayer then seeks to shift to the U.S. government through the foreign tax credit mechanism. The Coalition believes, however, as discussed earlier, that Congress was principally concerned with situations where the high rate of local tax results from the U.S. parent company having either transferred a U.S. source-income-generating-asset to the foreign subsidiary or having allowed the subsidiary to conduct business in the U.S., rather than engaging in the U.S. business activity itself.

Clearly, Congress was not focused on a foreign subsidiary that was developing worldwide patent rights to a product and would eventually license such patent to another foreign affiliate. In today's global economy, U.S. parent companies are increasingly designating foreign subsidiaries as centers to undertake a portion of their research. These decisions are dictated by business necessity in today's international business climate. Increasingly, foreign governments are looking for strengthened local business ties as a prerequisite for important local business opportunities. These may include enhanced patent protection under local law, expedited review of new product applications, and pricing decisions in countries where these decisions are controlled largely by local governments.

The increased "nexus" local governments are more increasingly focused on is the funding of research costs for particular products. This requirement is based on the expectation that increased R&D will lead to the recruiting of local scientists and ultimate ownership of worldwide patent rights if the research efforts should prove successful. It is imperative that U.S. companies be free to compete with their foreign counterparts in meeting these local business requirements without subjecting themselves to the potential risk of future double taxation. The Coalition believes that this result is clearly inconsistent with broader goals of U.S. tax policy.

6. Code Section 904(a) Discourages Repatriation, Resulting In Net Revenue Loss

Because repatriation of earnings could put Parent in an excess foreign tax credit position, Licensor could reasonably decide not to pay a dividend to Parent. Retaining earnings in the foreign jurisdiction would defer the repatriation of local tax credits. Profits from reinvested capital would be subject to tax in the foreign jurisdiction but not in the U.S., with a corresponding loss of U.S. tax revenue. The loser in this scenario is the U.S. government because capital imports are diminished, and profits from reinvested capital are subject only to foreign tax, not to U.S. tax.

7. Recommendation

It is recommended that Code section 904(g) be amended to prevent its application when the owner who has funded development of a patent or other intangible receives a royalty or other income from exploiting an intangible and such income is subject to tax in a country with which the U.S. has an income tax treaty, which treaty permits the foreign country to tax such U.S. source income. The fact that the United States has entered into an income tax treaty with that other country is indicative that a tax haven jurisdiction is not being availed of and foreign tax credit manipulation is not involved (compare, e.g., Bermuda captive insurance or finance companies). The royalty income would, in any event, be subject to U.S. tax under subpart F if it is taxed at a rate that is less than 90% of the U.S. rate. See Section 954(b)(4).

The Coalition believes that if Code section 904(g) is amended as suggested above, there will be no additional export of capital from the U.S. or manipulation of the-U.S. foreign tax credit rules.

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[4] *See* page 348 of the Joint Committee Print which states that: "The [pre 1984] source rules arguably allowed the circumvention of the foreign tax credit limitation. The creation of foreign income that either attracted high foreign taxes directly or absorbed foreign tax credits that arose from unrelated high-taxed foreign income passed the cost of high foreign taxes from the U.S. taxpayer to the U.S. government. The [Deficit Reduction] Act [of 1984] prevents that result by its general rule that ensures full U.S. tax when U.S. source income flows through a U.S.-owned foreign corporation."

[Attachment is being retained in Committee files.]

TAX COUNCIL
WASHINGTON, DC, 20005
July 7, 1999

The Honorable Bill Archer, *Chairman*
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C.

Dear Mr. Chairman:

On June 30, 1999 the Ways & Means Committee held a hearing on the Impact of U.S. Tax Rules on International Competitiveness. The Tax Council commends you and the other members of the committee for scheduling the hearing on this issue which is so important to American workers and businesses.

In addition to Representatives Houghton and Levin, you heard from 16 outstanding private sector witnesses who possess an unprecedented amount of expertise and knowledge regarding taxes and international business. All of the witnesses presented convincing and well thought out statements that justify the urgent need to reform and simplify the U.S. international tax laws. Over half of the witnesses you called to testify represent members of The Tax Council and we would like to state for the record that we, as an association, strongly support their collective call for international tax reform.

In particular, we support the provisions in H.R. 2018 that would accelerate the effective date for look-through treatment in applying the foreign tax credit baskets to dividends from 10/50 companies; repeal Section 907 with its excessively burdensome record keeping requirements; apply look-through rules on sales of foreign partnerships; and provide a permanent subpart F exemption for active financing income. In addition, we recommend the recently proposed legislation that would treat Advance Pricing Agreements as confidential return information. These provisions would help to simplify the tax code and assist U.S. companies to compete more effectively against foreign-based competitors.

The Tax Council is a nonprofit association that has been in existence since 1966 and has 110 major companies and businesses as members. In addition to providing an ongoing forum for the discussion of important tax policy questions, it supports efforts to assure that all federal tax laws are based on sound tax and budget policies.

The Tax Council, which has been actively involved in the debate on international tax reform for a long time, urges the Committee to move as quickly as possible on the recommendations that were presented during this hearing. If we can be of any assistance, please do not hesitate to call upon us.

Sincerely,

ROGER J. LEMASTER
Executive Director

TROPICAL SHIPPING
RIVIERA BEACH, FL, 33404–6902
July 6, 1999

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

Re: June 30, 1999 Committee Hearing on Impact of U.S. Tax Rules on International Competitiveness

Dear Mr. Singleton:

The current U.S. international tax regime is contributing to the de-Americanization of U.S. industry because the U.S. owned fleet is being forced 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 ports of call in 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 United States.

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 which is beneficial for Tropical Shipping's long term interests.

Our tax laws force U.S. companies to become acquired by foreigners because their countries have adopted tax policies to ensure that their international shipping industry is competitive in world markets. 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 mergers of U.S. companies with foreign companies will leave the resulting new company headquartered overseas. Examples of this are found in the decrease of the U.S. controlled fleet and the foreign acquisition of American President Lines and Lykes Steamship Co. Because of the adverse consequences resulting under the current U.S. international tax system, U.S. shipping companies are being forced out of the growing world market for the carriage of cargo.

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 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.

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 1998. 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 so that the U.S. will increase their global competitiveness, expand and stabilize itself in the international shipping industry and strengthen U.S. exports which would result in more U.S. based jobs. 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, introduced by Reps. Houghton and Levin), 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 en-

actment 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.

YOUNGSTEIN & GOULD
LONDON W1M 5FQ,
June 25, 1999

Ways and Means Committee
United States House of Representatives
Washington, D.C.

Dear Sirs:

In connection with hearings which are to be held this Wednesday, June 30, 1999, I enclose a letter by me on 11th December 1998 to the U.K. Inland Revenue and U.S. Treasury Department (the "Letter") in connection with negotiations which commenced early this year to modernize the US/UK income tax treaty. The points made there are highly relevant to any inquiry into the effect of U.S. tax law on the international competitiveness of U.S. workers who are working in countries which also impose worldwide taxation of income (e.g. the OECD countries).

As the Letter illustrates, U.S. citizens who are resident for tax purposes in another jurisdiction which imposes worldwide income taxation tend to be subject to the harshest aspects of the U.S. and foreign taxation systems without the benefit of either system's tax incentives/reliefs (tax exempt pensions, reduced taxation of capital gains, etc. etc.). The result is that such individuals pay much higher tax than either

U.S. citizens who remain in the U.S. or non U.S. citizens resident in the same foreign jurisdiction, as well as being subject to exponentially greater compliance burdens. The effect is nothing less than economic "second class citizenship."

The Letter notes that a solution to the most severe aspects of this problem would be simply to eliminate the "saving clause" which is inserted by the Treasury Department as a matter of rote in all U.S. double tax treaties, providing that U.S. citizens resident in the other treaty jurisdictions may not claim relief from U.S. tax under such treaties. It is unclear that the policy for inclusion of the saving clause in the U.S. treaties has ever been clearly considered, and certainly not by the House of Representatives which is not involved in the treaty process. As noted in the Letter, it is fallacious to argue that the saving clause is an extension of the policy of the U.S. to tax its citizens regardless of residence.

Also as noted in the Letter, the inclusion of the saving clause in treaties implies a level of responsibility of the Treasury Department to recommend and Congress to adopt domestic taxation provisions for U.S. citizens resident abroad which mitigate the harsh consequences of the denial of treaty relief, yet neither the Treasury Department nor Congress appear to appreciate that this responsibility exists. Clearly it has not been fulfilled.

The position of U.S. citizens resident in other countries imposing worldwide taxation deserves your urgent attention. It would undoubtedly improve the morale of expatriate Americans if your Committee would acknowledge the problems which exist and assume responsibility for developing and implementing a solution.

Yours sincerely,

JEFFREY L. GOULD

YOUNGSTEIN & GOULD
LONDON W1M 5FQ,
Dec. 11, 1998

Bob Wightman Esq
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Joseph H Guttentag Esq.
Deputy Assistant Secretary (International Tax Affairs)
U.S. Treasury Department
Washington, D.C.

Dear Mr. Wightman and Mr. Guttentag:

I understand from our tax publications that the Inland Revenue and IRS have announced plans to modernise the UK/US double taxation convention for income taxes.

I. BACKGROUND

A. As a U.S. lawyer who has practised in London for the past 20 years, specializing in taxation matters, I have had occasion to advise on many aspects of the current treaty. I am aware of many areas where "modernization" is certainly required, to take into account developments in the domestic taxation rules and commercial environments of the two countries since the present treaty was agreed. I would like to focus on one area in which I am aware of a desperate need for a more sensible approach, namely the taxation by the U.S. of its citizens who are resident in the U.K. without affording the benefit of "dual resident relief" provided, for example, in the OECD Model Income Tax Treaty.

B. As indicated below, the effect of the present treaty is a sort of "second class citizenship" for U.S. Expatriates resident in the U.K., who are unable to lead a fiscally "normal" life because they have to face the harshest aspects of both the U.K. and the U.S. systems without the mitigating effects of the reliefs offered in either country.

II. THE PROBLEM AREAS

A. The fact that the U.S. imposes taxation of the worldwide income of its nationals, regardless of residence, raise unique problems particularly for U.S. citizens who are resident in countries like the U.K. which impose their own worldwide taxation. The "International" solution to such problems, as exemplified by the OECD Model Income Tax Treaty, is found in the "dual resident" provisions under which in cases of an individual who is fiscally resident in both treaty countries, the country with the greater claim to imposing worldwide taxation is accorded the status of the country of residence for treaty purposes while the other country may impose worldwide taxation but subject to the reliefs given under the treaty. The U.S. rejects this solu-

tion in the case of its nationals residing overseas ("U.S. Expatriates") through requiring the inclusion in its double taxation treaties of "saving clauses" reserving to the U.S. the right to tax its nationals without regard to treaty reliefs.

B. Unfortunately, the U.S. domestic tax law offers nothing for U.S. Expatriates who are subject to worldwide taxation in another country to take the place of dual resident treaty relief. As a result, the only protection against double taxation of such U.S. Expatriates rests in claiming foreign credits. Relief from double taxation by way of credit or exemption is a feature of the domestic tax law in virtually every other OECD country as well, but such relief clearly has been considered inadequate to deal with the problems of worldwide double taxation, as evidenced by the almost uniform inclusion of "dual resident" provisions in treaties between OECD countries

C. The sometimes Draconian consequences to U.S. Expatriates of the U.S. approach are proof of the wisdom of the OECD approach. With only the foreign tax credit to rely upon, U.S. Expatriates residing in the U.K. are unable to obtain any benefit from tax-favored transactions in either country because of inconsistency in approach. For example:

1. While the U.S. offers a rate of capital gains tax which is one-half that of the U.K., the U.S. taxes capital gains which are exempt under U.K. rules, such as the annual exemption from U.K. capital gains tax, gain from the disposal of a principal residence and gain which would qualify for U.K. retirement relief. The U.S. Expatriate who is resident in the U.K. must pay U.K. capital gains tax at the U.K.'s higher rate on those gains which are not exempt, and U.S. capital gains tax at the U.S.'s lower rate on gains which are exempt from the U.K. capital gains tax. Thus the U.S. Expatriate obtains the benefit of neither system's taxation of capital gains.

The difference in tax treatment of gain from the sale of a residence is exacerbated by an unenlightened U.S. tax policy regarding currency gains and losses realized on foreign currency (e.g. pound sterling) mortgages.

2. The U.S. and U.K. rules for tax-deferred pension and profit sharing plans are similar, but each impose different specific requirements as a result of which no U.K. exempt approved pension scheme will meet U.S. requirements for a qualified plan, and vice-versa. The U.K. at least offers the possibility of "corresponding relief" for certain U.K. residents who are covered by U.S. plans, but the vast majority of U.S. Expatriates who are resident in the U.K. are unable to avail themselves of such relief.

U.S. Expatriates participating in U.K. pension plans may be liable to U.S. tax not only on employer contributions but also on a pro rata share of any income and gain realized in the pension fund. As this income is not liable to tax in the U.K., no credits for U.K. tax are available to offset the U.S. liability, while on the other hand when benefits are received, they will be largely tax-free in the U.S. (having already been taxed) while U.K. tax will then be due. The result is that in the extremely important area of pension planning U.S. Expatriates uniquely are unable to benefit from tax deferred pensions and are likely to suffer true double taxation if they are so ill-advised as to participate in a U.K. exempt approved scheme.

3. Tax incentives for charitable giving differ between the U.S. and U.K. and it is difficult to get them to match.

D. A similar problem has arisen from proliferation of U.S. anti-avoidance legislation, which is frequently focussed on overseas activities of U.S. taxpayers but always from the point of view of preventing avoidance by U.S. *resident* taxpayers. In fact, it is U.S. Expatriates who are most often affected by these rules, and in ways not intended by Congress.

1. For example, the "passive foreign investment company" ("PFIC") rules penalize minority investment in foreign companies which are organized to earn passive income. To prevent the last scintilla of avoidance, the term PFIC is so broadly defined as to include many purely active commercial ventures. Similarly, very restrictive tax credit provisions are embodied in the PFIC rules, which are inconsistent with the principles of double taxation relief as contained in Article 23 of the present UK/US treaty. The result is that U.S. Expatriates who are resident in U.K. are subject to anti-avoidance rules when making investments in U.K. companies in circumstances where there is no tax avoidance, resulting both in punitive rates of U.S. tax and denial of effective relief for U.K. taxation imposed on the same income/gain, i.e. true double taxation.

2. Other U.S. anti-avoidance provisions such as the "controlled foreign corporation" rules may result in attribution of income of a foreign entity to a U.S. Expatriate prior to the time when that income would be taxed to him in the U.K., creating a potential mismatch of credits and, once again, the possibility of true double taxation.

3. A further problem of certain anti-avoidance rules both in the U.K. and the U.S. is the attribution of income to someone other than he who has earned it. The fre-

quent result will be that income is taxed to one person by the U.K. and to another by the U.S., so that once again the foreign tax credit becomes an inadequate shield against double taxation.

E. Many of the above problems would be avoided if a U.S. Expatriate residing in the U.K. were able to claim relief from the U.S. taxation under the US/UK double tax treaty.

III. The Solution

A. The most comprehensive solution to these problems would be to eliminate the saving clause from the new US/UK income tax treaty. A U.S. Expatriate resident in the U.K. and eligible for relief from U.S. tax under the new treaty would, for the most part, be able to plan his affairs on the basis of being liable to tax on his income only in the U.K. and therefore have the same possibility as any other U.K. resident to mitigate his tax liability through adoption of acceptable forms of planning such as pensions. It is true that, because of the absence of a provision which deals with capital gain, the present treaty would not afford U.S. Expatriates relief from inconsistent treatment of capital gains even if there were no saving clause. However, the U.S.'s unilateral approach to treaty claims by U.S. resident aliens (pursuant to Treasury Regulations Section 301.7701 (b) −7) would satisfactorily address this problem.

B. It therefore seems to me high time for the IRS to reexamine the wisdom of incorporating the saving clause into its treaties. So far as I am aware, the saving clause has no congressional sanction. Presumably, the rationale for requiring the saving clause is to serve the U.S. policy of taxing its citizens on a worldwide basis, but there is no reason why this policy should be any stronger than U.S. policy of taxing its resident aliens on a worldwide basis, yet resident aliens are freely able to claim the benefit of "dual resident" provisions of U.S. treaties when applicable. The difficulties faced by a U.S. Expatriate residing in a country like the U.K. amply demonstrate that the U.S. has not taken responsibility in the drafting of its domestic legislation for the impact of the saving clause on such individuals.

C. Another reason to reconsider the saving clause is that, in practice, the saving clause operates to the disadvantage of the U.S.'s treaty partners. Although typically (as in present US/UK treaty) the saving clause is drafted so as to afford either treaty partner the ability to tax its own nationals as if the treaty had not come into effect, it is only the U.S. which reaps a fiscal benefit from the saving clause because:

1. the U.S. is the only country which impose worldwide taxation of its nationals; and
2. in those cases where a country such as the U.K. could avail itself of the saving clause to deny treaty relief (i.e. in relation to claims of U.K. nationals resident in the U.S.), in practice it does not do so, either because it is not geared to enforce a "one-off" provision which is inconsistent with its normal treaty obligations or for cultural reasons.

D. If the Treasury Department is not persuaded that it should take a fresh look at this issue, an alternative which certainly should be considered is a series of specific treaty provisions to deal with specific problems (e.g. pensions, capital gains, charitable contributions). This is less than ideal, both because of the difficulty of drafting all the provisions that ought to be included and because of the risk of rapid obsolescence. Nonetheless, "half a loaf" would be far better than none.

IV. Conclusion

It would be a very positive development if the re-negotiation of theUS/UK income tax treaty could pave the way for a more considered treatment of U.S. Expatriates in future treaty negotiations (or indeed, unilateral relief through U.S. domestic legislation wholly or partly overriding saving clauses in existing U.S. treaties).

I would be very interested in assisting the Inland Revenue and /or the IRS during the course of these discussions, both in relation to the problem of U.S. Expatriates and generally. Please do not hesitate to contact me if I may be of service.

Yours sincerely,

Jeffrey L. Gould

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