# HEARING ON THE IMPACT OF INTERNATIONAL TAX REFORM ON U.S. COMPETITIVENESS

## HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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**THURSDAY, JUNE 22, 2006**

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

The Subcommittee met, pursuant to notice, at 10:00 a.m., in room B–318, Rayburn House Office Building, Hon. David Camp (Chairman of the Subcommittee) presiding.

[The advisory and revised advisories announcing the hearing follow:]

# *ADVISORY*

FROM THE COMMITTEE ON WAYS AND MEANS

## SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE
March 15, 2006
No. SRM–7

CONTACT: (202) 226–5911

# Camp Announces Hearing on the Impact of International Tax Reform on U.S. Competitiveness

Congressman Dave Camp (R–MI), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the impact of international tax reform on U.S. competitiveness. This hearing will be part of a series of hearings on tax reform. **The hearing will take place on Tuesday, May 23, 2006, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 2:00 p.m.**

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

**BACKGROUND:**

In its November 2005 report, the President's Advisory Panel on Federal Tax Reform (the Panel) criticized the current U.S. international tax system as one that "distorts business decisions, treats different multinationals differently, and encourages wasteful tax planning." As a result, the Panel's report contained a number of international tax reform proposals that are intended "to reduce economic distortions and improve the fairness of the U.S. international tax regime by creating a more level playing field that supports U.S. competitiveness." Lawmakers, taxpayers, practitioners and academics have similarly criticized the U.S. international tax system and have also proposed reforms.

In announcing the hearing, Chairman Camp stated, "This hearing will provide us the opportunity to understand how the current U.S. international tax system impacts the competitiveness of U.S. multinational corporations and to evaluate how this system can be reformed to enhance our competitiveness abroad and stimulate job creation at home."

**FOCUS OF THE HEARING:**

The purpose of this hearing is to understand how the current U.S. international tax system impacts the competitiveness of U.S. multinational corporations and to evaluate how this system can be reformed to enhance our competitiveness abroad and stimulate job creation at home.

**DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:**

**Please Note:** Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "*109th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=17*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record.*" Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Tuesday, June

6, 2006. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

**FORMATTING REQUIREMENTS:**

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item 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 submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies 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. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

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

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

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*** * * CHANGE IN DATE AND TIME * * ***

# *ADVISORY*

FROM THE COMMITTEE ON WAYS AND MEANS

**SUBCOMMITTEE ON SELECT REVENUE MEASURES**

FOR IMMEDIATE RELEASE
April 24, 2006
SRM–7 Revised

CONTACT: (202) 226–5911

## Change in Date and Time for Hearing on the Impact of International Tax Reform on U.S. Competitiveness

Congressman Dave Camp (R–MI), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee hearing on the Impact of International Tax Reform on U.S. Competitiveness, previously scheduled for Tuesday, May 23, 2006, at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building, **will now be held on Thursday, June 22, 2006, at 10:30 a.m.**

**The deadline to provide a submission for the record will now be close of business, Friday, July 7, 2006.** All other details for the hearing remain the same.

(See Subcommittee Advisory No. SRM–7, dated March 15, 2006).

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*** * * CHANGE IN TIME AND LOCATION * * ***

# *ADVISORY*

**FROM THE COMMITTEE ON WAYS AND MEANS**

**SUBCOMMITTEE ON SELECT REVENUE MEASURES**

FOR IMMEDIATE RELEASE
June 20, 2006
SRM–7 Revised #2

CONTACT: (202) 226–5911

## Change in Time and Location for Hearing on the Impact of International Tax Reform on U.S. Competitiveness

Congressman Dave Camp (R–MI), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee hearing on the Impact of International Tax Reform on U.S. Competitiveness, previously scheduled for Thursday, June 22, 2006, at 10:30 a.m., in the main Committee hearing room, 1100 Longworth House Office Building, **will now be held at 10:00 a.m. in B–318, Rayburn House Office Building.**

All other details for the hearing remain the same. (See Subcommittee Advisories No. SRM–7 and SRM–7 Revised, dated March 15, 2006 and April 24, 2006, respectively.)

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Chairman CAMP. Good morning. The Select Revenue Subcommittee of the Committee on Ways and Means hearing on the impact of the international tax reform on U.S. competitiveness will begin.

Everyone has found their seats. Good morning. At our recent hearing on corporate tax reform, a number of witnesses testified on the importance of international tax reform. The current U.S. international tax system has been characterized as one that distorts business decisions and inhibits the competitiveness of U.S. business abroad. This hearing will provide us the opportunity to understand how the current international tax system impacts the competitiveness of U.S. companies operating abroad and to evaluate how this system can be reformed and to stimulate job creation at home.

International tax reform will be an important consideration in the full Committee's evaluation of the many options to reform the Federal Tax Code, and I want to welcome our visitors and witnesses, and I look forward to hearing your views on these important issues.

I now recognize the Ranking Member, Mr. McNulty of New York, for his statement.

Mr. MCNULTY. Thank you, Mr. Chairman.

I recognize our witnesses, and thank you, Mr. Chairman.

In 2002, this Subcommittee held a series of hearings specifically on international corporate tax reform. In 2004, the American Jobs Creation Act was enacted into law and substantially revised our international tax system.

Even with those changes, few believe our international tax rules have been perfected and have reached the proper balance. There is no question that our current international tax structure remains very complex and in need of reform. It is clear that our tax system often carries incentives for U.S. companies to locate or move their operations overseas. Hopefully, our discussion today will focus on realistic options to simplify and restructure our international tax system.

Our country's economic growth requires that U.S. companies be competitive both at home and in the expanding markets of the world. I must emphasize that our country continues to face record Federal deficits: The national debt has ballooned to more than $8.3 trillion. The goal of any future international tax reform measures should not be to merely provide additional corporate tax breaks to U.S. multinationals nor should it result in the shifting of U.S. jobs overseas. Our goal must be to modernize our tax system in a way that ensures economic growth in the United States and provides long-term financial stability for our children and grandchildren.

Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman CAMP. Thank you very much.

Again, I want to welcome our panel. We have with us Dr. Glenn Hubbard, Dean and Russell R. Carson Professor of Finance and Economics at Columbia Business School in New York; Dr. James R. Hines, Professor of Business Economics and Public Policy at the University of Michigan in Ann Arbor; and Dr. Craig Barrett, Director of the Intel Corporation in Santa Clara, California.

Each of you will have 5 minutes to summarize your testimony, and after each of you gives your testimony, we will have time for questioning.

I will begin with Dr. Hubbard. Again, welcome. Thank you for coming. You have 5 minutes.

**STATEMENT OF R. GLENN HUBBARD, DEAN AND RUSSELL L. CARSON PROFESSOR OF FINANCE AND ECONOMICS, COLUMBIA BUSINESS SCHOOL, NEW YORK, NEW YORK**

Dr. HUBBARD. Thank you, Mr. Chairman and Mr. McNulty. I think that this is an incredibly important subject that you have chosen for this hearing. As a way of putting it in context, I think the subject today touches on the vital issue of competitiveness. Our economy's success absolutely and relative to our trading partners over the past decade has depended on flexibility and productivity, and growth of multinational companies. I think it is imperative that we not tie the hands behind the backs of these successful businesses. Today I wanted to note two points, one, that multinationals play a very large role in the American economy. Second, the tax policy toward multinationals matters, and reform is needed—or reform is needed and overall corporate tax reforms should remain a priority for your consideration.

On the issue of multinationals, recent research among economists suggests that in a highly open economy, highly successful multinationals can boost both brand value of our companies and productivity. This is driven by multinationals who capture for all of us, essentially, the benefits of globalization.

Interestingly, in thinking about where these multinationals are, most overseas investment by American multinationals is for market access and remains in higher-wage, higher-tax countries.

On the issue of tax policy, this matters a lot. Empirical work by myself and many other people over many years suggests that the way we tax multinationals importantly affects their investment decisions, their location decisions, and how they finance themselves. Our overall norms that we have traditionally used in this country for judging tax policies toward multinationals strike me as outdated. They are based on models of perfectly competitive firms which are not the way multinationals operate. They are based on norms of looking at worldwide well-being, which is not something we do in the rest of policy. In any event, the usual norm of capital export neutrality is not even applied in practice.

I think more contemporary treatment of multinationals would suggest that, at a minimum, cash flow taxation deferral in this case or an exemption system of territorial taxation is far more defensible. As an economy, we have a strong incentive to get this right to maintain the productivity advantage that we have. A territorial tax proposal, in my view, deserves very serious considerations and will not affect investment or jobs.

The corporate tax, though, remains the elephant in the room. This morning's Wall Street Journal referred to the action that has been proposed in Germany for a corporate rate cut. The United States has the second highest rate in the Organization for Economic Co-operation and Development (OECD). The corporate tax discourages capital formation. More recent work suggests it actually discourages innovation, risk-taking and, in fact, wage growth.

But, importantly, to close, fundamental tax reform, whether you choose to examine it as an income tax or a consumption tax, would remove investor level taxes on corporate income. This necessarily implies a territorial tax. Almost any version of tax reform gets you there.

Thank you again, Mr. Chairman. I look forward to your questions later.

[The prepared statement of Dr. Hubbard follows:]

**Statement of R. Glenn Hubbard, Ph.D., Dean and Russell L. Carson Professor of Finance and Economics, Columbia Business School, New York, New York**

Mr. Chairman, Ranking Member McNulty, and members, it is a pleasure to have the opportunity to discuss with you the role of tax policy in improving the international competitiveness of the United States.

Increasingly, the markets for U.S. companies have become global, and foreign-based competitor companies operate under tax rules that are often more favorable than our own. The existing U.S. tax law governing the activities of multinational companies has been developed in a patchwork fashion, with the result that current law can result in circumstances that harm the competitiveness of U.S. companies. In addition to their economic implications, the international tax rules are among the most complex in the code, with the result that they are both costly and difficult for companies to comply with and challenging for the Internal Revenue Service to administer. Current U.S. international tax rules should be reviewed with an eye to reducing their complexity and removing impediments to U.S. international competitiveness.

The U.S. economy is increasingly linked to the world economy through trade and investment. U.S.-based multinationals and their foreign investment help bring the benefits of global markets back to the United States by providing jobs and income.

The profitability and long-term viability of U.S.-based multinationals is influenced by U.S. tax policy.

Like all firms, multinationals are faced with a number of business decisions, including how much to invest and where. Because multinationals by definition operate in a number of countries, they also have to decide in which country to locate their headquarters which in turn affects which countries reap the majority of benefits from the multinational's operations. Each of these business decisions is influenced by tax policy, particularly how countries tax income from foreign investment.

The U.S. tax system, in the past, has chosen to tax income from foreign investment at the same rate as it taxes domestic income under a principle called capital-export neutrality. The principle is based on the idea that investment abroad is a substitute for investment (and jobs) at home, and is founded on the assumption that global markets are perfectly competitive. As I describe later, capital-export neutrality was seen as a laudable objective in the 1960s, when the United States was the primary source of capital investment, and dominated world markets. Both the global economic setting and the accepted view of global markets have changed dramatically since the 1960s. In the past few decades, other countries have come to challenge the United States' preeminent position in the global market, and the United States has become a net recipient of foreign investment as opposed to the largest source. There is mounting evidence that foreign affiliates are in fact complements to domestic investment and employment, and therefore should, if anything be encouraged.

The U.S. system of taxing income from foreign investment should be reconsidered in the light of the new global setting. The tax system should enhance the competitiveness of the U.S. position in global markets, and ensure that Americans reap the full benefits of increasing trade and investment flows.

## THE UNITED STATES IN THE GLOBAL ECONOMY

Over the past few decades, the global economy has become increasingly integrated. For the United States, this integration is reflected by the fact that more than ten percent of the U.S. gross domestic product (GDP) in 2005 about $1.2 trillion was derived from U.S. exports of goods and services. Roughly eight percent of American workers produce goods and services that will be sold in foreign markets. In addition, imports of foreign raw materials and capital goods help the U.S. economy run smoothly and efficiently.

The mirror image of increased trade in goods and services is the enormous rise in international capital flows over the past thirty years. These flows represent funds channeled from savers in one country to borrowers in another. The International Monetary Fund estimates that since 1970, gross capital flows capital flows into and out of a country as a percentage of GDP have risen more than tenfold for developed countries and fivefold for developing countries. In the last decade alone, estimated capital flows in developed countries have more than quadrupled.

Americans have benefited from liberalized of trade and capital flows. Trade enhances productivity, which is reflected in the fact that workers in exporting firms and industries typically earn about 10 to 15 percent more than the average U.S. worker. More generally, enhanced global trade by further reducing world barriers to trade by one-third would be equivalent to a $2,500 per-year increase in the annual income of the average family of four. It is in our economic interest to enhance market forces and capture the benefits of international movements of goods and capital.

### Multinational Corporations and the U.S. Economy

Multinationals are an intrinsic part of globalization. To begin, they represent a substantial portion of cross-border economic activity. Almost two-thirds of U.S. exports take place through U.S. multinationals. And the involvement of the United States in global trade has impacts on income and employment in the U.S. economy. Multinationals are an intrinsic part of global integration because they represent an alternative means by which nations conduct cross-border transactions. That is, the economic costs of production, transportation, distribution, and final sale may be lower of conducted within a single firm than via a series of market transactions. Accordingly, the rise in global integration carries along with an increased volume of transactions for which multinationals have a particular advantage.

To pursue their market opportunities, multinationals must make a number of business decisions. Like all firms, they must determine the scale and character of their capital expenditures, the size and skill composition of their labor force, and which technologies are the most promising. However, in each case, multinationals' decisions have a locational dimension as well. That is, they must determine not only

the amount of each of these activities, but also where they will take place. Indeed, in the extreme, they must choose where they will call 'home.'

**Why Do Multinationals Invest Abroad?**

The starting point for multinationals' investment in foreign countries is the same as domestic investment: profitability. As in other circumstances, firms will seek out profit opportunities as a means to provide firm growth in output, employment, revenues, and shareholder returns. Indeed, the research literature suggests that there are significant profit opportunities in this area—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.

What opportunities are provided by foreign investment? Foreign investment by multinationals is often classified into two types, each type associated with a different motivation. In horizontal investment a firm invests in a similar production process in various countries. Building a facility abroad that is similar to domestic operations is one way to access foreign markets in the face of barriers (tariff or non-tariff barriers) to trade in goods. If a market is protected by trade barriers, one way for a firm to get access to the market is to set up a subsidiary in the country, and produce the product locally (perhaps with foreign technology, inputs, brand names etc). Or, it may simply be too expensive to transport domestically-produced goods and remain competitive. Economic research has highlighted that trade and capital movements can be substitutes, and horizontal investment has this character. Alternatively, in vertical investment, a firm invests in different input processes in different countries. This kind of investment is often driven by different costs of operation (including different taxation levels). And trade flow data generally support the horizontal theory: The primary market for foreign plants is their host country.

The distinction between horizontal and vertical incentives for investment informs the concern that multinationals will move production to the location with the lowest cost of production. To the extent that simple versions of vertical investment dominate, this concern has greater significance.

Empirical research by economists has also concluded that foreign direct investment is more often horizontal than vertical. A number of recent empirical papers support this theory. As noted above, most foreign investment flows from large, rich countries to other large, rich countries. Thus investment is not flowing to the lowest-cost (or at least lowest-wage) countries. Second, sales by foreign affiliates of U.S. multinationals are higher in countries with higher tariffs and transport costs on U.S. goods. Third, U.S. firms serve foreign markets more through foreign investment and less through exports the larger is the scale of corporate operations relative to the scale of production. This fact is consistent with the idea that multinationals arise when there are economies of scale in headquarters (or parent) activities relative to scale economies in production.

Even when foreign investment is vertical, there is little evidence that it affects wages in the home country. For example, a number of empirical studies show that increased capital mobility, including the "outsourcing" of production to low-wage countries, as well as immigration from developing countries to the advanced economies, have only a small effects on wages in OECD countries. And the vast majority of U.S. multinational foreign investment is in other developed, high-wage countries.

A particularly important location decision is the location of the headquarters of the multinational. Although multinationals, by definition, operate in a number of countries, the Department of Commerce reports that the bulk of the revenue, investment, and employment of U.S.-based multinationals are located in the United States, and this has not changed over time. At the beginning of this decade, U.S. parents accounted for about three-fourths of the multinationals' sales, capital expenditures and employment. These shares have been relatively stable for the last decade. Therefore where a firm chooses to place its headquarters will have a large influence on how much that country benefits from its domestic and international operations.

The foreign operations of U.S. multinationals also benefit the U.S. economy because they increase the demands for services from the firm's headquarters. A recent OECD study based on 14 developed countries found that "each dollar of outward foreign investment is associated with $2 of additional exports and with a bilateral trade surplus of $1.70." In addition, U.S. multinationals perform the overwhelming majority of their research and development at home. Physical capital assets often dominate the discussion of multinationals' investment decisions. However, among the assets of U. S. companies are their scientific expertise. Foreign physical capital investments are avenue to increase their use of this expertise, thereby raising the rate of return on firm specific assets such as patents, skills, and technologies. Not

surprisingly, raising the rate of return provides enhanced incentives for investment in research and development. Foreign and domestic operations of multinationals appear to be complements, not substitutes.

**International Tax Policy**

*Looking Back: Capital-Export Neutrality*

The U.S. approach to international taxation dates to the 1960s, a time in which the U.S. was the source of one half of all multinational investment in the world, produced about 40 percent of the world's output, and was the largest capital exporter in the world.

In this circumstance, it was appealing to construct a tax system that was "neutral" with respect to the location of foreign investment by taxing income from all foreign investments at the same overall rate. This approach to taxing income from foreign sources is known as capital-export neutrality. Capital-export neutrality carries with it the appealing notion that taxes will not distort location decisions and that a company will invest wherever the return is greatest, maximizing efficiency. Thus a firm would be taxed at the same marginal rate on income from foreign or domestic investments. In one example of a fully capital export neutral system, domestic corporations have their foreign-source income taxed as if earned in the United States, but with an unlimited credit for foreign income taxes. Under such a system, domestic corporations presumably would locate investments where they are most productive.

As an example of the mechanics of such a system, with a U.S. corporate tax rate of 35 percent, firms earning $100 abroad would owe $35 on the income. To offset foreign taxes, American multinationals can claim foreign tax credits for income taxes (and related taxes) paid to foreign governments. If the U.S.-based firm paid $25 in tax to the foreign government, the firm would be given a tax credit of $25 against its $35 owing to the U.S. government. The United States would receive net taxes of $10, and the overall tax of $35 would be the same for both domestic and any foreign investment.

Capital-export neutrality as a tax policy objective received intellectual support from the "perfect" competition paradigm that dominated economics at the time. In this characterization of market competition, aggressive pricing and ease of entry, and multitudes of competitors yielded no brand-name loyalty, economies of scale, or other sources of extra profits.

*Looking Forward: Capital-Export Neutrality Reconsidered*

A variety of considerations suggest a reconsideration of capital export neutrality as a tax policy objective. To begin, it is useful to note that the United States never fully adhered to the principle in practice, suggesting the presence of alternative incentives. Two features of the U.S. system deferral and incomplete crediting serve to place an important gap between the principle of capital-export neutrality and tax practice.

To understand the impact of deferral, consider an example. Assume a foreign subsidiary of a firm makes a profit of $100 which is taxed by the foreign country at a rate of 25 percent. The firm then reinvests $55 of the profit into its operations and pays the other $20 as dividends to its shareholders in the United States. Therefore, the firm has to pay U.S. tax on that $20, but gets a credit for the 25 percent tax on the $20 (amounting to $5). If the firm pulls the $55 out of the firm the following year and repatriates it to the United States, it will have to pay U.S. taxes on that profit at that time.

The rules surrounding deferral are the source of considerable complexity. Deferral is only available on the active business profits of American-owned foreign subsidiaries, and the profits of unincorporated foreign businesses such as American owned branch banks, are immediately taxed by the United States. As well, under "Subpart F" of U.S. tax law, certain income (called Subpart F income) from foreign investments is "deemed distributed" and is therefore immediately taxable by the United States.

In other ways, the current tax system departs from capital-export neutrality by making foreign investment less attractive than domestic investment. For example, a firm that faces higher taxes in its host country than at home will receive excess foreign tax credits, which it may or may not be able to use. The firm can either apply its excess to foreign tax credits against taxes paid in the previous two years, or in future years. However, if the host country consistently has a higher tax than the United States, it will end up paying the higher of the two tax rates on its foreign income, and pay the lower U.S. tax on its domestic income, counter to the principle of capital-export neutrality. A second example in which the tax system acts to discourage foreign investment is one in which activities are carried out in a foreign

corporation; the U.S. tax rules will accelerate any income, but defer any losses. If those activities were instead placed in a U.S. corporation, both income and loses would be recognized for U.S. tax purposes. Therefore, given the uncertainty of any initial investment, the current system actually biases investment toward the domestic market and away from foreign ventures.

In addition to some trepidation with fully implementing capital-export neutrality, the underpinnings of the international tax regime have shifted on both the theoretical front and the economic landscape. On the theoretical front, it is now recognized that most multinationals produce differentiated products and compete in industries where there are some economies of scale. Indeed, in the absence of economies of scale, it would not make sense to have the foreign plants affiliated with the parent firm at all. Therefore, the model of perfect competition that drives the principle of capital-export neutrality merits reconsideration.

The traditional theory supporting capital-export neutrality is based on a stylized view of multinational companies. Under this view, foreign direct investment is indistinguishable from portfolio investment and there are no economic rents that is, there is perfect competition. Michael Devereux of the University of Warwick and I reexamined the theory of optimal tax policy taking into account that foreign investment is different from portfolio investment in that the returns that exceed the cost of capital (that is, there are economic rents) due to factors such as intangibles (for example, brands, or patents) and company-specific cost advantages.

As noted above, the returns on foreign investment are higher than those on domestic investment, implying that there are rents. Also noted above, there are economies of scale associated with headquarter activities, further putting the assumption of perfect competition in question. Devereux and I note that research in industrial organization on multinational corporations in fact emphasizes the presence of economic rents and that empirical studies of foreign direct investment find that investment location decisions are more closely related to average rather than marginal tax rates. These empirical observations support the view that foreign direct investment differs fundamentally from portfolio investment.

When Devereux and I take into account more realistic assumptions about the economic characteristics of foreign direct investment, we predict that the residence-based tax system fails to achieve domestic welfare maximization. Deferral of taxation of foreign income generally results in higher national welfare than current taxation (ignoring foreign country taxation). At low rates of foreign income tax, a limited foreign tax credit with deferral of foreign income generally dominates current taxation with a deduction for foreign income taxes paid.

In terms of the economic setting, the United States is now the world's largest importer of capital. This observation highlights the fact that capital export neutrality ignores that the firm can decide where to call "home." Unless the domestic tax rate is the same in both countries, under a scheme of capital-export neutrality, the decision of where to place the firm's headquarters will be affected by the countries' tax systems.

Effects of home-country tax policy on location of economic activity and investment have been investigated by economists, with the basic insight that a move toward a more territorial system will be unlikely to generate a large shift in investment locations. Other analysis has examined positive externalities created for a country by being the home of multinational headquarters, implying that economic activity of foreign affiliates is complementary to the economy of the "home base."

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

## TAX POLICY AND U.S. INTERNATIONAL COMPETITIVENESS

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

### *Why Tax Policy Matters*

If U.S. businesses are to succeed in the global economy, the U.S. tax system must not generate a bias against their ability to compete effectively against foreign-based companies especially in foreign markets. Viewed from the narrow perspective of in-

come taxation, however, there is concern that the United States has become a less attractive location for the headquarters of a multinational corporation. This concern arises from several major respects in which U.S. tax law differs from that of most of our trading partners.

First, about half of the OECD countries have a territorial tax system (either by statute or treaty), under which a parent company is not subject to tax on the active income earned by a foreign subsidiary. By contrast, the United States taxes income earned through a foreign corporation, either when the income is repatriated or deemed to be repatriated under the rules of the tax code. The United States should examine closely the merits of a more territorial approach, a move that would be consistent with most commonly discussed fundamental tax reforms.

Second, even among countries that tax income on a worldwide basis, the active business income of a foreign subsidiary is generally not subject to tax before it is remitted to the parent. In some circumstances, for example income arising from "base country sales or service" sources, the active business income is deemed to be repatriated and taxed immediately. Indeed, one reading of tax history is that the former FSC regime originally developed at least in part in response to the pressures generated by the absence of deferral on these income sources.

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

Fourth, the United States only recently departed from the handful of industrialized countries that fail to provide some form of integration of the corporate and individual income tax systems. Partial integration since 2003 has reduced double taxation of corporate income, but the lack of permanent integration makes it more difficult for U.S. companies to compete against foreign imports at home, or in foreign markets through exports from the United States, or through foreign direct investment.

*Revisiting Principles of Neutrality*

Strict concern for the competitiveness of a U.S. multinational operating in a foreign country would dictate an approach to taxation that results in the same tax as a foreign-based multinational operating in that country. This competitiveness principle is also known as capital-import neutrality, as it results in the same rate of return for all capital flowing into a country.

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

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

A direct application of the alternative notion of neutrality, capital-import neutrality, can be equivalent to a territorial tax system. As noted above, it is unlikely that any single, pure theory of international tax rules will provide direct and universal policy guidance. However, it is interesting to note that this recent research tends to support the tax strategies of competitive nations. Nevertheless, concerns have been raised over the possibility that using capital-import neutrality to guide tax policy will result in a narrower tax base and a shift in the structure of production for multinational firms.

One concern with moving to a more territorial approach to taxing foreign income is that U.S.-based firms will relocate domestic operations to the country with the lowest taxes. This concern stems from the same assumption noted above that investment abroad and investment domestically is substitutes. Although firms take the cost of production of their affiliates into account, there is little reason to believe that increased investment abroad necessarily implies less economic activity at home.

As noted earlier, the vast majority of U.S. foreign investment is located in other industrialized countries, with taxes not out of line from those in the United States. Because taxes typically are only a small part of total costs of production, the change in taxation level alone is unlikely to induce a plant to move from the United States. The OECD found that where tax policy is identified as a major issue, transparency in the tax law and administration will often be ranked by investors ahead of special tax relief. Uncertainty over tax consequences of foreign direct investment increases the perception of risk and discourages capital flows, a fact particularly important for long-term, capital—intensive direct investment that most host countries are eager to attract.

A related concern is the loss of the tax base. The argument goes that if the United States does not tax income from foreign investment, it will lose substantial revenue. However, this argument presupposes two facts: (1) foreign tax credits received by foreign subsidiaries are less than the tax owing to the U.S. government; and (2) there is not another way to tax that same profit. Although the U.S. corporate tax rate is one of the highest among industrial economies, a number of firms have excess foreign tax credits. There is also evidence that the United States can capture taxes from foreign subsidiaries from personal income taxation. Because foreign subsidiaries tend to pay out more dividends (due perhaps to the greater need to signal profitability), profits can be taxed. In a recent study, James Hines estimates that, among American firms, one dollar of reported foreign profitability is associated with the same level of dividend payments to common shareholders as is three dollars of reported domestic profitability. In fact, the United States receives greater tax revenue from the foreign operations of American companies by taxing individual dividend income that it does by taxing corporate income. For example, Hines finds that for $100 of after-tax foreign profits generates $50 more dividends to domestic shareholders than does $100 of after-tax domestic profits.

While fears of runaway plants or a runaway tax base are overblown, runaway headquarters is a real concern. Measured by deal value, over the 1998 to 2000 period, 73 to 86 percent of large cross-border mergers and acquisitions involving U.S. companies have been structured so that the merged company has its headquarters abroad. In the case of Daimler-Chrysler, U.S. taxes were specifically identified as a significant factor in determining the location of the new parent firm. U.S.-based multinationals have most of their jobs and funds invested in their parent firms, losing the parents becomes more of a concern than simply increasing the amount of investment in foreign-owned affiliates.

And Reform Likely Requires Corporate Tax Reform While reform of the tax treatment of U.S. multinationals remains important for tax policymakers, real reform almost surely leads to a consideration of the corporate income tax. The United States has the second highest corporate tax rate among OECD economies, and many large OECD economies have been cutting corporate tax rates, while broadening the tax base. For the United States to remain competitive, we should consider reducing corporate tax rates substantially. While some of the lost revenue could be made up through corporate base broadening, a better approach would be to address corporate tax changes (and international tax changes) in the context of fundamental tax reform. Recent research by economists suggests that such changes could improve economic efficiency, improve the climate for innovation, and raise wages.

**CONCLUSIONS**

Multinational corporations are an integral part of the U.S. economy, and their foreign activities are part of their domestic success. Accordingly, we must ensure that U.S. tax rules do not impact the ability of U.S. multinationals to compete successfully around the world. Policymakers should continue to review carefully the U.S. international tax system (and the corporate tax generally), including fundamental reforms like a territorial system, with a view to removing biases against the ability of U.S. multinationals to compete globally. Such reforms would enhance the well-being of American families and allow the United States to retain its world economic leadership. These gains should contribute to the growing interest in fundamental tax reform.

Thank you, Mr. Chairman, and I look forward to your questions.

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Chairman CAMP. Thank you very much, Dr. Hubbard. Dr. Hines, you have 5 minutes.

**STATEMENT OF JAMES R. HINES, JR., PH.D., PROFESSOR OF BUSINESS ECONOMICS AND PUBLIC POLICY, UNIVERSITY OF MICHIGAN, ANN ARBOR, MICHIGAN**

Dr. HINES. Thank you. There are two primary channels by which residence-based international taxation as practiced currently by the United States affects the competitiveness of American business operations. The first channel is that residence taxation creates incentives that distort the behavior of American firms.

The second channel is that residence taxation affects the total tax burdens of companies that are residents in the United States. Both of these channels are important, but they are distinct.

U.S. residence-based taxation influences after-tax returns by imposing home-country taxation that is a function of actions undertaken at home and abroad. The incentive problem is that the actions that the system encourages are often inconsistent with maximizing investment returns net of foreign taxes, in that what American firms are encouraged instead to do is maximize returns net of foreign plus domestic taxes. These incentives impair the competitiveness of American firms operating abroad, specifically, the U.S. tax system encourages American firms with deficit foreign tax credits to discount the cost of foreign taxes since the payment of foreign taxes produces an off-setting foreign tax credit that can be used to reduce U.S. tax liability. For American firms with excess foreign tax credits, the U.S. expense allocation rules discourage profitable investments in the United States that can trigger additional tax liabilities by reducing the foreign tax credit limit and may thereby also discourage profitable foreign investments.

In both cases, the system sacrifices the competitiveness of American firms, doing so in pursuit of an unclear objective.

Taxation on the basis of residence not only creates inefficient incentives for American firms with foreign operations but imposes a pattern of tax liabilities that separately impairs competitiveness. The most obvious feature of this residence-based taxation is that a firm that is an American resident owes tax to the United States on its worldwide income whereas a firm that is a resident in another country does not. This system effectively imposes what can be a very large tax on U.S. residents, thereby discouraging multinational firms from establishing U.S. residency and encouraging firms that are already residents in the United States to relocate elsewhere.

The wave of corporate inversions from 1996 to 2002 reflects these incentives as a number of American firms thought it worthwhile to incur the tax and other costs associated with relocating to foreign residence in order to avoid U.S. taxation of their worldwide incomes.

The corporate inversion phenomenon is not quantitatively huge in and of itself. Only 25 large firms inverted. It is instead a signal of the magnitude of incentives created by the U.S. residence taxation. For every firm that changes its nationality by inverting, there were several others whose U.S. tax liabilities or potential tax liabilities on foreign income were significant enough to make them contemplate inverting or else never establishing U.S. residency in the first place.

Taxation on the basis of residence makes most sense when residence is an immutable characteristic of a person or a firm. In the global economy, residence is a matter of choice not only because people and companies can move but also because the weight of economic activity is itself responsive to tax burdens, even in circumstances in which people in firms never change their tax residences.

If the United States imposes a heavy tax on the foreign incomes of firms resident in the United States, then over time, American firms will not flourish to the same extent as firms resident in other countries. The after-tax incomes of American firms will be depressed by heavy tax-burdens and investors will not commit the funds they would to an otherwise equivalent firm that was not subject to the same tax-burdens. United States adoption of territorial taxation offers the prospect of addressing these problems, providing incentives and tax burdens for global businesses that would enhance the competitiveness of American firms.

Even if the goal of American policy were to enhance World and not U.S. welfare, this is achieved by reducing U.S. taxation of foreign income to bring it better into line with world norms. One might ask why it matters to the United States, or for that matter the world, that a company's residence to the United States operates under a tax system that maintains their competitiveness.

If the goal of U.S. policy is to advance the living standards of Americans, then policies should be designed to promote the efficiency of businesses located in the United States. This most definitely includes their international competitiveness. In a market system, the wages of American workers are determined by the productivity of labor in the United States. In maximizing the efficiency of business operations, sound policy also maximizes the productivity of American labor and capital. Since labor represents most of the United States' economy, labor receives most of the benefits of productive efficiency in the United States with these benefits coming in the form of higher compensation and greater employment.

Viewed through a modern lens, residence-based taxation as practiced by the United States appears very curious in that it serves neither the interests of the United States nor of the world as a whole.

Thank you.

[The prepared statement of Dr. Hines follows:]

**Statement of James R. Hines Jr., Ph.D., Professor of Business Economics and Public Policy, University of Michigan, Ann Arbor, Michigan**

Mr. Chairman and Members of this distinguished Subcommittee, it is an honor to participate in these hearings on the impact of international tax reform on U.S. competitiveness. I am a Professor of Economics at the University of Michigan, where I am also Research Director of the Office of Tax Policy Research. I am a Research Associate of the National Bureau of Economic Research, and Research Director of the International Tax Policy Forum.

There can be little doubt that the United States would benefit from international tax reform. Advocates of all stripes urge reform, many of them stressing the need for reform as a matter of some urgency. As so often happens with such complex issues, however, the advocates are not of a single mind. I hope to clarify the sources of differences of opinion, and to sketch a sensible way to think about the impact of U.S. tax reform on the international competitiveness of the American economy. This exercise serves the double function of assisting in the evaluation of what are by now familiar arguments, and suggesting directions of beneficial reform.

*The Residence Principle*

The residence principle has long been the basis of U.S. international tax policy. Its concept is that income earned by American persons anywhere in the world should be taxed by the United States at the same rate as other income. In practice, U.S. tax policy deviates significantly from the residence principle in several ways, most notably in permitting taxpayers to claim credits for certain taxes paid to foreign governments, and in deferring U.S. taxation of certain types of foreign income. Despite these deviations, the residence principle remains the cornerstone of U.S. international tax policy, and the primary way in which U.S. tax policy influences the competitiveness of American-owned operations abroad.

There are two primary channels by which residence-based taxation, as practiced by the United States, affects the competitiveness of American business operations. The first channel is that residence taxation creates incentives that distort the behavior of American firms. The second channel is that residence taxation affects the total tax burdens of companies that are resident in the United States. Both of these channels are important, but they are distinct, and there is considerable confusion about their roles and relative importance.

*Incentives Created by Residence Taxation*

The first way in which residence taxation impairs the competitiveness of American firms is by creating incentives that are inconsistent with maximizing economic value as judged from the standpoint of the United States. This is not to say that the system fails to create incentives. The market system in the international setting, as in every other setting, encourages taxpayers to allocate resources in a way that maximizes after-tax returns. Importantly, from the standpoint of American businesses operating abroad, U.S. residence-based taxation influences after-tax returns by imposing home-country taxation that is a function of actions undertaken at home and abroad. The incentive problem is that the actions that the system encourages are often inconsistent with competitiveness and efficiency.

Consider a very simple example in which an American firm operates abroad in two countries, one that taxes corporate income at a 15% rate, and another that taxes corporate income at a 30% rate. Let us assume that the firm does not have excess foreign tax credits from other foreign operations, and is unable to find sufficiently attractive foreign investment opportunities that would permit it to benefit from deferring repatriation of foreign profits. Then if the firm earns income of $100 in the first country, it owes $15 in taxes to the foreign government and $20 of residual taxes to the United States, since its U.S. tax liability of $35 (35% of $100) is reduced to $20 by virtue of the $15 foreign tax credit that it receives for taxes paid to the foreign government. If the firm earns income of $100 in the second country, then by the same reasoning it owes $30 in taxes to the foreign government and $5 of residual taxes to the United States.

What is wrong with this picture? The problem, from the standpoint of the United States, is that taxpayers seeking to maximize after-tax profits will be indifferent between earning $100 in the first country and earning $100 in the second country. In either case the taxpayer walks away with $65 of after-tax profits; the only difference between the two cases is the allocation of tax payments between the foreign government and the U.S. government. From the standpoint of the United States, however, these two outcomes are far from equivalent, since in the first case Americans (the taxpayer and the U.S. government together) earn $85 after payment of foreign taxes, whereas in the second case Americans earn $70 after foreign taxes.

To modify the example slightly, an American who maximizes after-tax income would prefer to earn $100 before tax in a foreign jurisdiction with a 30% tax rate than to earn $90 before tax in a foreign jurisdiction with a 15% tax rate, since in the first case the taxpayer receives $65 (65% of $100), whereas in the second case the taxpayer receives $58.50 (65% of $90). Yet from the standpoint of the U.S. government and the American taxpayer taken together, the first investment produces a return of $70 (70% of $100), and the second investment produces a return of $76.50 (85% of $90). Hence the U.S. tax system encourages exactly the wrong choice between these two foreign investment opportunities.

As the examples illustrate, residence taxation interferes with incentives to maximize investment returns net of foreign taxes. Since maximizing such returns is the essence of competitiveness, U.S. residence taxation impairs the competitiveness of American firms operating abroad.

In fact, the problems created by U.S. residence-based taxation are considerably worse than those suggested by the example, since the detailed aspects of the foreign tax credit limit calculation and the operation of deferral contribute to reducing the competitiveness of American firms operating abroad. The foreign tax credit is limited to (roughly) the U.S. tax that would have been due on foreign source income.

The previous example suggests that U.S. residence taxation creates anticompetitive incentives only for firms with deficit foreign tax credits, that is, for firms whose average foreign tax rates fall below the U.S. rate—but that conclusion is incorrect. Instead, the practical operation of the U.S. foreign tax credit limit implies that firms with excess foreign tax credits—those whose average foreign tax rates exceed the U.S. tax rate—also have incentives not to maximize profits net of foreign taxes.

Consider the case of a firm with excess foreign tax credits. This taxpayer may face serious problems that stem from U.S. expense allocation rules that apportion domestic expenses between U.S. and foreign source. Any domestic expenses allocated to foreign source reduce the foreign tax credit limit and thereby increase the taxpayer's U.S. tax liability on foreign-source income. This allocation method thereby affects incentives for both foreign and domestic activities, doing so in a way that is inconsistent with the goal of maximizing returns net of foreign taxes.

Consider, for example, a firm that earns $100 in foreign location with a 40% tax rate. The firm pays $40 of taxes to the foreign government, and, in the absence of domestic expense allocation, would have no U.S. tax liability on its foreign income, since it would be entitled to claim a $35 foreign tax credit with which to offset its U.S. taxes on the $100 of foreign profits. Suppose that the same firm spends $50 on domestic administration designed to improve domestic efficiency and thereby generate $55 of additional domestic output. From an efficiency standpoint this is clearly a worthwhile expenditure, since it produces more value ($55) than it costs ($50). If, however, the allocation rules require the firm to allocate $20 of this expenditure to foreign source, then the firm's foreign tax credit limit will be reduced by $7 (35% of $20), and the firm will be obliged to pay $7 of additional U.S. tax on its foreign source income. As a result, the firm will have an incentive to forego the economically beneficial domestic efficiency improvement, since doing so triggers additional tax due on foreign income.

There is a second possibility, of course, which is that the American firm might maintain its domestic operations and simply forego its foreign operations altogether. With this option there is clearly no problem with the foreign tax credit limit, since the firm would have no foreign income. But this is hardly an efficient, or competitive, alternative.

The general problem with the expense allocation rules is that they make U.S. tax liabilities complex functions of domestic and foreign activities, and do so in a manner that is inconsistent with maximizing profits. Under normal circumstances taxpayers have incentives to spend $100 to earn $110, even though the $10 profit is taxed, and the same taxpayers will prefer investments that return $110 to investments that return $105. The system of residence taxation together with foreign tax credit limits and expense allocation rules interferes with these incentives, and can create situations in which economically inefficient transactions are preferred.

The current international tax system is designed to defend the U.S. tax base by preventing taxpayers from reducing their U.S. tax liabilities on domestic income with credits for taxes paid to foreign governments, and to prevent taxpayers from incurring deductible expenses in the United States that produce foreign income that is taxed lightly, or taxed not at all, by the United States. These are reasonable motivations. A major difficulty with the current solution is that, as we have seen, the methods used to defend the tax base themselves create incentives that are inconsistent with economic efficiency. A second difficulty, to which I will turn shortly, is that the absence of similar provisions in the tax laws of other nations raises the possibility that U.S. policy needlessly impairs the competitiveness of American business and thereby actually reduces the size of the total U.S. tax base.

The deferral of U.S. taxation of unrepatriated income earned by foreign subsidiaries is designed to attenuate some of the costs of U.S. residence taxation. Unfortunately, deferral itself creates incentives to delay returning investment proceeds to the United States, encouraging firms to retain funds in foreign investments, even though the same firms might better deploy their money in the United States than they do abroad. Mihir Desai, Fritz Foley and I have estimated (Desai, Foley, and Hines, 2001) that, in an average year, the existence of U.S. repatriation taxes reduces total repatriations by 12.8%. Of course for some firms, and particular foreign operations, the effect is much larger than that. We estimate the efficiency loss associated with merely the incentives to time dividend repatriations around tax considerations is equal to approximately 2.5% of the dividends received, a figure that grows greatly once financing and investment effects are included.

*Residence Taxation and Tax Burdens*

Taxation on the basis of residence not only creates inefficient incentives for American firms with foreign operations, but also imposes a pattern of tax liabilities that separately impairs competitiveness.

The most obvious feature of U.S. residence based taxation is that a firm that is an American resident owes tax to the United States on its worldwide income, whereas a firm that is resident in another country does not. This system effectively imposes what can be a very large tax on U.S. residence, thereby discouraging multinational firms from establishing U.S. residency, and encouraging firms that are already resident in the United States to relocate elsewhere. The wave of corporate inversions from 1996–2002 (documented in Desai and Hines, 2002) reflects these incentives, as a number of American firms found it worthwhile to incur the tax and other costs associated with relocating to foreign residence in order to avoid U.S. taxation of their worldwide incomes. The corporate inversion phenomenon is not quantitatively huge in and of itself—only 25 large firms inverted—but is instead a signal of the magnitude of the incentives created by U.S. residence based taxation. For every firm that changed its nationality by inverting, there were several whose U.S. tax liabilities, or potential U.S. tax liabilities, on foreign income were significant enough to make them contemplate inverting or else never establishing U.S. residency in the first place.

Taxation on the basis of residence makes the most sense when residence is an immutable characteristic of a person or a firm. In the global economy residence is a matter of choice, not only because people and companies can move, but also because the weight of economic activity is itself responsive to tax burdens, even in circumstances in which people and firms never change their tax residences. If the United States imposes a heavy tax on the foreign incomes of firms resident in the United States, then over time American firms will not flourish to the same extent as firms resident in other countries. The after-tax incomes of American firms will be depressed by heavy tax burdens, and investors will not commit the funds that they would to an otherwise equivalent firm that was not subject to the same tax burdens.

How large a burden does the U.S. tax system impose on the foreign incomes of American firms? In addressing this issue it is important to distinguish the taxes that American firms pay from the burdens they incur, since taxpayers can, and do, avoid paying taxes by foregoing valuable investments. These foregone opportunities are very real burdens, which taxpayers would not face if the tax system were redesigned to promote efficiency. Mihir Desai and I have estimated (Desai and Hines, 2004) that U.S. taxation of foreign income prior to 2005 imposed burdens of approximately $50 billion a year on American firms. Certainly the subsequent legislative reforms have reduced this burden, but it remains substantial both as a fraction of foreign income and when compared to the home country tax burdens of firms with which Americans compete.

*Who Taxes on the Basis of Residence?*

Most countries do not attempt to tax substantially any of the active foreign incomes of their resident companies. Of the 30 high-income countries that are members of the OECD, only nine, the Czech Republic, Iceland, Japan, Korea, Mexico, New Zealand, Poland, the United Kingdom, and the United States, impose taxes on any significant fraction of active foreign income. Non-OECD countries are even less likely than OECD countries to tax the foreign incomes of resident companies. Among the countries that tax foreign incomes, the United States has a particularly complex system of income determination and a very advanced method of ensuring compliance, all designed to prevent income from escaping the U.S. tax net.

Should it matter to the United States that other countries use tax systems that differ from the American system? This matters not only because firms can choose their locations of residence, but also because Americans compete in global product markets, and the market for corporate control, with firms located in other countries. If the U.S. tax system fails to promote efficiency, then the burden is borne by American firms in the form of reduced international competitiveness. The significance of the resulting cost to American firms, and the U.S. economy, is apparent from consideration of the welfare economics of taxing foreign income.

*Should Taxation be Based on Residence?*

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

Capital export neutrality (CEN) is the doctrine that the return to capital should be taxed at the same total rate regardless of the location in which it is earned. If a home country tax system satisfies CEN, then a firm seeking to maximize after-tax returns has an incentive to locate investments in a way that maximizes pre-tax returns. This allocation of investment is thought to correspond to global economic efficiency under certain circumstances. The CEN concept is frequently invoked as a normative justification for the design of tax systems similar to that used by the United States, since the taxation of worldwide income with provision of unlimited foreign tax credits would satisfy CEN.

The standard analysis further implies that governments acting on their own, without regard to world welfare, should tax the foreign incomes of their resident companies while permitting only a deduction for foreign taxes paid. Such taxation satisfies what is known as national neutrality (NN), discouraging foreign investment by imposing a form of double taxation, but doing so in the interest of the home country that disregards the value of tax revenue collected by foreign governments. From the standpoint of the home country, foreign taxes are simply costs of doing business abroad, and therefore warrant the same treatment as other costs. The home country's desired allocation of capital is one in which its firms equate marginal after-tax foreign returns with marginal pretax domestic returns, a condition that is satisfied by full taxation of foreign income after deduction of foreign taxes. This line of thinking suggests that the American policy of taxing foreign income while granting foreign tax credits fails to advance American interests because it treats foreign income too generously. In this view there is a tension between tax policies that advance national welfare (NN) by taxing after-tax foreign income, and those that advance global welfare (CEN) by taxing foreign income while permitting taxpayers to claim foreign tax credits. The practice of much of the world, including Germany, France, Canada, and the Netherlands, that effectively exempts foreign income from taxation, is, by this reasoning, difficult to understand, since it is inconsistent with either national or global interests.

It is important to clarify that there are important assumptions built into the standard normative framework that delivers CEN and NN as global and national welfare criteria, and in particular, it is critical that foreign firms are assumed not to respond to changes induced by home-country taxation. Realistically, however, investment by domestic firms at home and abroad may very well influence investment by foreign firms, a scenario that is inconsistent with the logic underlying CEN and NN. If greater investment abroad by home-country firms triggers greater investment by foreign firms in the home country, then it no longer follows that the home country maximizes its welfare by taxing foreign income while permitting only a deduction for foreign taxes paid. From the standpoint of global welfare, if home and foreign firms compete for the ownership of capital around the world, and the productivity of an investment depends on its ownership, then it is no longer the case that the taxation of foreign income together with the provision of foreign tax credits necessarily contributes to productive efficiency.

Modern analysis of international tax systems tend to focus much more on tax-induced ownership changes than do the older views on the subject. Tax systems satisfy what is known as capital ownership neutrality (CON) if they do not distort ownership patterns. It is easiest to understand the welfare properties of CON by considering the extreme case in which the total stock of physical capital in each country is unaffected by international tax rules. In this setting, the function of foreign direct investment is simply to reassign asset ownership among domestic and foreign investors. If the productivity of capital depends on the identities of its owners (and there is considerable reason to think that it does), then the efficient allocation of capital is one that maximizes output given the stocks of capital in each country. It follows that tax systems promote efficiency if they encourage the most productive ownership of assets within the set of feasible investors.

Consider the case in which all countries exempt foreign income from taxation. Then the tax treatment of foreign investment income is the same for all investors, and competition between potential buyers allocates assets to their most productive owners. Note that what matters for asset ownership is comparative advantage rather than absolute advantage: if French firms are always the most productive owners of capital, but they do not have the resources necessary to own everything, then efficiency requires that French firms own the capital for which their rate of return difference with the rest of the world is the greatest. The United States would reduce world welfare by taxing foreign income while permitting taxpayers to claim foreign tax credits, since such a system encourages American firms to purchase assets in high-tax countries and foreign firms to purchase assets in low-tax countries. These tax incentives distort the allocation of ownership away from one that is strictly associated with underlying productivity differences.

In order for the allocation of capital ownership to be efficient it must be the case that it is impossible to increase output by trading capital ownership among investors. This efficiency condition requires not necessarily that capital be equally productive in the hands of each investor, but that the potential gain of reallocating ownership to a higher-productivity owner be exactly equal to the cost of such a reallocation by offsetting ownership changes elsewhere. Since taxpayers allocate their investments to maximize after-tax returns, the marginal dollar spent on new investments by any given investor must yield the same (expected, risk-adjusted) after-tax return everywhere. It follows that, if net (host country plus home country) tax rates differ between investments located in different countries, marginal investments in high-tax locations must generate higher pre-tax returns than do marginal investments in low-tax locations. Selling an asset in a low-tax location and purchasing an investment in a high-tax location increases output by the firm engaging in the transaction, but (generally) reduces output by the firm on the other side of this transaction. If both parties face the same tax rates, or face taxes that differ in fixed proportions from each other, then CON is satisfied, ownership reallocation would have no effect on total productivity, and the outcome is therefore efficient. If some countries tax foreign income while others do not, then it is impossible to restore CON without bringing them all into alignment, though individual countries have the potential to improve global welfare by moving their taxation of foreign income into conformity with an average global norm.

The same circumstances that make CON desirable from the standpoint of world welfare also imply that countries acting on their own, without regard to world welfare, have incentives to exempt foreign income from taxation no matter what other countries do. The reason is that additional outbound foreign investment does not reduce domestic tax revenue, since any reduction in home-country investment by domestic firms is offset by greater investment by foreign firms. With unchanging domestic tax revenue, home-country welfare increases in the after-tax profitability of domestic companies, which is maximized if foreign profits are exempt from taxation. Tax systems that exempt foreign income from taxation can therefore be said to satisfy "national ownership neutrality" (NON). Hence it is possible to understand why so many countries exempt foreign income from taxation, and it follows that, if every country did so, capital ownership would be allocated efficiently and global output thereby maximized.

*Competitiveness and American Affluence*

One might ask why it matters to the United States—or for that matter, the world—that companies resident in the United States operate under a tax system that maintains their competitiveness in a global environment. If the goal of U.S. policy is to maintain and advance the living standards of Americans, then policies should be designed to promote the efficiency of businesses located in the United States, and this most definitely includes their international competitiveness. In a market system, the wages of American workers are determined by the productivity of labor in the United States. In maximizing the efficiency of business operations, sound policy also maximizes the productivity of American labor and capital. Since labor represents most of the U.S. economy, labor receives most of the benefits of productive efficiency in the United States, with these benefits coming in the form of higher compensation and greater employment.

There is extensive evidence that tax systems influence the magnitude and composition of international economic activity, and there is good reason to believe that improved tax design has the potential to enhance the performance of national economies. The welfare principles that underlie current U.S. taxation of foreign income rely on the premise that direct investment abroad by American firms reduces the level of investment in the United States, since foreign competitors are assumed not to react to new investments by Americans. It follows from this premise that the opportunity cost of investment abroad includes foregone domestic economic activity and tax revenue, so national welfare is maximized by taxing the foreign incomes of American companies, whereas global welfare is maximized by providing foreign tax credits. If, instead, direct investment abroad by American companies triggers additional investment in the United States by foreign companies, which is likely in a globally competitive market, then entirely different prescriptions follow. The national welfare of the United States is then maximized by exempting foreign income from taxation (NON), and global welfare is maximized by conformity in the systems of taxing foreign income among capital-exporting countries (CON).

The contribution of the U.S. tax system to the competitiveness of American multinational firms and the performance of the U.S. economy has been the subject of extensive analysis and rethinking in recent years. What we have learned can be summarized in two points. The first is that the ownership and activities of multinational

corporations are highly sensitive to taxation, much more so than what was previously believed to be the case. The second is that the competitiveness of the world economy has the potential to change everything we think about the features that characterize tax systems that promote economic efficiency. Together, these two findings carry dramatic implications for the kinds of tax policies that advance the competitiveness of U.S.-owned firms, the well-being of Americans, and the productivity of the world economy. Viewed through a modern lens, residence based taxation, as practiced by the United States, appears very curious, in that it serves the interests neither of the United States nor of other countries.

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Chairman CAMP. Thank you very much, Dr. Hines. Dr. Barrett.

## STATEMENT OF CRAIG R. BARRETT, PH.D., CHAIRMAN OF THE BOARD, INTEL CORPORATION, SANTA CLARA, CALIFORNIA

Dr. BARRETT. Chairman Camp, Members of the Subcommittee, thank you for this opportunity.

My name is Craig Barrett. I am Chairman of Intel, and just to give you a few pertinent facts about Intel, we are the world's largest semiconductor company. Revenues last year were approximately $38 billion; 80-plus percent of that revenue came from outside of the United States. We are mainly an export-oriented company. We spend over $5 billion a year in research and development (R&D), and last year, we spent over $6 billion dollars on capital investment for manufacturing.

There has been a lot of discussion recently about competitiveness and our company, and others have spoken on this topic. Competitiveness, in my definition, is really the ability to have a highly educated workforce, the investment in research and development to generate ideas for the next generation of products, and the role of the government is in establishing an environment for investment and innovation.

With regard to my own company and my own industry, it is not really an issue of whether tax policy will cause us to invest or not invest in R&D and capital. We will invest. The only question is where we will invest and where the jobs will be created by our investment.

I would like to address briefly two topics. One, investment in manufacturing, the sort of manufacturing facilities that we have which are very capital intensive. They are roughly $3 billion facilities. They are probably the poster child for the sort of manufacturing the United States should have. They are capital intensive. They are high tech. They have a highly educated workforce. They are profitable.

The other area that I would like to address is research and development. We currently do most of our research and development in

the United States, but there are forces tending to pull that way to other countries.

Let me address the manufacturing issue first and the impact of tax policy.

The $3 billion facilities that we have, if you do a net present value or net present cost of those facilities over a 10-year period and you compare them to being located in the United States or being located in certain foreign environments where tax policies are different, you see that the range in net present value is approximately a billion dollars plus or minus a few hundred million over a 10-year period, so roughly one hundred million dollar-per-year, penalty to put those facilities in the United States because of our tax policy. That hundred million dollar a year deficit or penalty comes about from our high corporate tax rate, which as mentioned earlier, is the highest in the OECD. It is also the lack of investment tax credits and the lack of what I would call competitive depreciation schedules for our facilities.

Interestingly, labor plays a very, very small role in that penalty. Cost of materials and capital are about the same everywhere in the world. So, of the billion dollar over 10-year penalty, roughly 70 percent of it is tax-related, 20 percent of it is investment credit or investment incentive related. So roughly, 90 percent of it is, then, tax-related.

To briefly compare that to a few other countries and their attitudes. In Malaysia, for example, for similar investments, that might make in the United States, would give a 10-year tax holiday. That is 10 years of zero percent tax; accelerated depreciation schedules; and depreciation schedules of well over a hundred percent of the actual capital costs.

In Israel, you will see a 20 percent capital grant and basically a 10 percent corporate tax rate. In Ireland, you would see a 12.5 percent tax rate, and a 20 percent R&D tax credit. The list would go on and on. Other countries are using their tax policy as an incentive to promote investments in their countries, whereas the United States is not.

The solution to this I think is complicated, obviously, but it embodies corporate tax rates. It embodies depreciation schedules. It involves investment tax credit. It is as my first Chief Financial Officer that I worked with at Intel told me, a buck is a buck no matter how it gets to the bottom line. Not being a tax expert, I can't tell you how to get that dollar to the bottom line, but getting it there is incredibly important.

Just a few comments on R&D tax credit.

The R&D tax credits started in 1981. It has not been uniformly applied during that period. There have been lapses in it. The tax rate that it gets is approved for a short period of time. When our horizon for R&D spending is much longer than the approval period for that R&D tax credit, it makes it less of an incentive in the United States than it could be.

A brief example in conclusion, France, which is not known for its progressive tax policy in promoting investments, has a 50 percent incremental R&D tax credit which applies not only to salaries but also to capital investments in R&D.

Thank you for the chance to testify, and I look forward to questions.

[The prepared statement of Dr. Barrett follows:]

**Statement of Craig R. Barrett, Ph.D., Chairman of the Board, Intel Corporation, Santa Clara, California**

Chairman Camp and members of the Subcommittee on Select Revenue Measures:

My name is Craig Barrett and I am the Chairman of the Board of Intel Corporation.

Intel, since its founding in 1968, has become the world's largest semiconductor chip maker. We employ over 100,000 people worldwide (54% of whom are in the U.S.). For 2005, Intel's revenue was over $38 billion dollars. Also, in 2005, Intel spent nearly $6 billion dollars on capital facilities and equipment, and over $5 billion on research and development. Intel consistently delivers architectural innovation along with world-class, high-volume manufacturing.

Intel is a global company—over 80% of Intel's consolidated sales revenue in 2005 was from non-U.S. sources—clearly, we are an export-intensive company. The marketplace is global, and so is our competition. Intel must compete with companies based all over the world.

I've spoken out frequently over the last few years about U.S. competitiveness and its many facets, such as the state of the U.S. K–12 education system, government research funding, and increases in the number of U.S. visas for highly talented high-tech employees. These are all important areas that need to be addressed in a comprehensive and effective U.S. competitiveness policy. However, the subject of today's hearing is tax policy, tax reform, and the United States' international tax rules. U.S. tax policy is, and should be, another important element in keeping the U.S. economy and U.S. multinational companies as competitive as possible.

To be competitive in the global marketplace, U.S. tax policy needs to focus on offering tax treatment that is comparable, if not more favorable, than that which is offered by other nations competing for the investments and operations of U.S. multinationals. Taxes are a cost of doing business, but not a consistent one across jurisdictions.

My colleague, Paul Otellini, Intel's CEO, testified last year before the President's Tax Advisory Panel. He was invited to consider, and address, how the U.S. Tax Code affects business decision-making, and in turn, affects our competitiveness. Intel's intensive spending on capital, labor, and R&D, as well as its focus on exports, has significant tax implications. Decisions by U.S. companies as to the location of their production facilities and the location and extent of their R&D are critical to U.S. competitiveness—especially as the U.S. economy becomes increasingly knowledge-based in nature. The impact of the Tax Code on business decision-making was the focus of Paul's presentation; my testimony today will have a similar focus.

I am aware that it has been said before (most recently during your tax reform hearing last month) that the Tax Code should not include tax preferences to reward a behavior that would happen anyway. That statement raises a valid point, but it misses a more critical question: you should not only ask yourselves *whether* the behavior would happen anyway; you should also ask yourselves *where* it would happen. In our case, Intel will continue to spend on production facilities and R&D as our business grows and prospers, but the relevant question for Intel is, as it should be for U.S. policy-makers, not whether we would spend as we grow in the future, but instead where that spending and growth will occur.

Semiconductor manufacturing is extremely capital intensive. The cost to build and equip a new wafer fabrication facility today is $3 billion or more. Where, and when, to build a fabrication plant is the largest ongoing financial decision a semiconductor CEO must make. However, the initial cost of a factory is just the beginning. Intel introduces a new generation of more advanced chip-making technology as frequently as every 18 months—and to make the more advanced products in one of our existing factories, we have to again invest very substantial sums in advanced production equipment.

Historically, about 70% of Intel's capital expenditures have been in the U.S. because that is where most of our advanced factories have been located. Currently, we have wafer fabrication plants in six U.S. states (Arizona, California, Colorado, Massachusetts, Oregon, and New Mexico), and in two other countries (Israel and Ireland). Five of our seven most sophisticated (300 millimeter) wafer facilities now completed or under construction are located in the U.S.

The impact of these facilities is considerable. For example, in Arizona where we have multiple facilities, we employ almost 11,000, with an annual payroll exceeding

a billion dollars. Taking into account our effect on other businesses in Arizona, Intel's impact translates into over 27,000 jobs, and the overall impact of Intel's Arizona operations on the gross state product is estimated to be $2.6 billion. As a point of reference, about 228,000

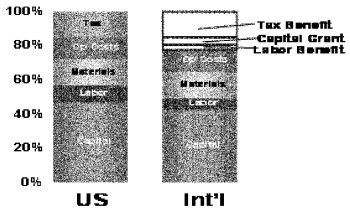
Americans work directly in the semiconductor industry. Additionally, many more work for companies supplying the industry with materials and equipment. Gartner recently forecast that the market for semiconductor chips will reach $259.5 billion in 2006, and in recent years U.S semiconductor companies have had slightly less than half of the industry's total sales.

As I mentioned before, many countries compete intensely to attract Intel's facilities, although this has also changed in recent years. More nations very intent on attracting high-tech state-of-the-art factories, such as Intel's, now also have the requisite infrastructure and well-trained workforce they lacked in years past. Many countries offer very significant incentive packages and have highly favorable tax systems. While in the past we focused on comparing Europe to the U.S., we now increasingly focus on comparing Asia to the U.S.

As a result of this change in the competitive environment, a critical issue we must now consider when deciding where to locate a new wafer fabrication plant is that it costs $1 billion dollars more to build, equip, and operate a factory in the U.S. than it does outside the U.S. The *largest* portion of this cost difference is attributable to taxes. The billion dollars is the difference between the net present cost over ten years of building and operating the wafer fabrication facility in the U.S., estimated to be as much as $6.8 billion, compared to the net present cost over ten years of building and operating the same facility outside the U.S., estimated to be as little as $5.6 billion. The following chart illustrates this cost difference:

## Wafer FAB Cost Model: Key Assumptions & Drivers

- **Cost model compares alternatives based on a 10 year NPC**
  - Production starting in year 3
    - Ramp with "current generation" technology products and transition to next gen products after 5 years
- **What factors drive analysis ?**
  - Cost differences driven by tax treatment, capital grants, other local factors
    - Other local factors: utilities, labor, logistics




| | Conceptual 300mm FAB 10yr NPC |
|---|---|
| Int'l | $5.6B-$6.1B |
| US | $6.7B-$6.8B |

The chart shows that costs can be lower internationally due, in part, to capital grants from foreign governments. These grants can be very sizable, and may also be received up-front, thereby suffering no decline in their nominal value due to the time value of money. Labor can be somewhat less costly internationally, but labor cost is not a large relative difference in Intel's case because advanced chip factories are highly automated and the employees are well—trained and well-paid in all locations. Materials and operating costs are essentially the same worldwide.

Consequently, most of the $1 billion cost difference (about 70%) is the result of lower taxes; also, if taxes are combined with capital grants, then as much as 90% of the cost difference occurs.

Among the taxes and incentives in foreign countries we have observed are:

- Malaysia—providing a 10-year tax holiday, and tax depreciation for capital building and equipment costs equal to 160% of their cost;
- Ireland—with a 12.5% corporate tax rate, and a 20% research tax credit;
- Israel—paying up to a 20% capital grant, with a 10% tax rate and a two-year tax holiday; and
- China—granting a 5-year tax holiday, followed by 50% of the normal tax rate for 5 more years.

These are in comparison to the U.S., with its 35% corporate tax rate, lack of investment incentives, and relatively uneconomic and uncompetitive depreciation treatment.

Although state tax policies and incentives can be relevant and important in site decisions among potential domestic sites, they do not typically significantly decrease the billion dollar cost difference. However, recently, certain states are attempting to help address the U.S. competitive cost disadvantage through state capital grants, and these hold the potential to become a more significant cost reduction factor.

To help put the magnitude of a $1 billion cost difference into perspective, it equals about one-third of the cost of a wafer fabrication facility or about 20% of Intel's yearly U.S. R&D expenditures.

From just this sample of tax systems and incentives available in other countries, you can see that the U.S. compares relatively poorly, and effectively an economic penalty on investment in the U.S. is imposed.

With the global nature of Intel's business, a preference to locate production facilities near markets, and the increasing number of countries capable of meeting Intel's operating needs, considerable business reasons exist for locating a number of our wafer fabrication facilities in foreign locations. However, the $1 billion cost penalty serves as encouragement to do so even for those factories that may for good business reasons otherwise be preferably located in the U.S. In the semiconductor industry generally, most of the newest generation of factories are being built outside the U.S.; two-thirds of the new 300 millimeter wafer fabrication facilities under construction, being equipped, or in production are located in Asia, and if all types of plants (not only 300 millimeter) are considered, China leads with eighteen semiconductor plants.

What can be done through U.S. tax policy to address this serious competitive challenge?

Potential solutions to close the gap include a corporate rate reduction, an investment tax credit (ITC), full expensing of a factory in year one (or expensing plus a write-off of an additional percentage above and beyond the facility's cost), or a combination of these items. The solution could be broad-based or targeted (perhaps to capital-intensive industries, state-of-the-art technology, high growth potential, or some other criteria).

The U.S. statutory rate for corporations is clearly uncompetitive when compared with other nations, and a rate reduction would be helpful (depending upon its size). A recent comparison among OECD corporate income tax rates finds that the U.S. is tied for the highest federal rate among thirty OECD countries. A recent ad in the Harvard Business Review noted the favorable Irish 12.5% corporate tax rate, and its attractiveness to companies in the bio-tech and pharmaceutical sectors (specifically naming seven such world-class companies), so the relatively high rate in the U.S. and favorable rate in Ireland have been noted, and acted upon, by more than just the semiconductor industry.

The responsiveness of the business community to tax rates can also be seen from the recent measure in the American Jobs Creation Act that provided a temporary reduced tax rate on foreign dividends brought into the U.S. for investment in productive activities, including capital facilities and research. It has been estimated that as much as $300 billion entered the U.S. economy during the reduced rate period. Intel's $6 billion of "homeland investment" dividends helped in our decision to invest over $3 billion in a new wafer fabrication facility in Arizona.

An investment tax credit would help reduce the cost of productive assets, through its partial offset of income tax liability. Full expensing could be another option. Semiconductor manufacturing equipment becomes outmoded quickly, and its current 5-year "accelerated" tax depreciation no longer reflects its current economic usefulness or even its 4-year financial book life. Expensing, however, would only produce a timing difference; it simply accelerates the depreciation of the equipment to an earlier year. In contrast, a rate reduction, ITC, or expensing of the equipment beyond its original cost would generate greater value, producing permanent differences impacting the effective tax rate and bottom-line.

Another important aspect of competitiveness and U.S. tax policy should also be noted. Once a wafer fabrication facility is located at a foreign site, it is highly likely that earnings in the foreign country will be invested in additional plant expansions overseas, rather than being invested in the U.S. If brought back to the U.S., after the U.S. 35% corporate income tax, only 65 cents of each dollar of earnings would be available to be invested here, while in contrast as much as a full dollar (or 87.5 cents in Ireland, for example) would remain for investment in a foreign location after local tax. Having more money left to invest in production facilities is a competitive advantage. Consequently, an initial decision to invest in a foreign location, prompted by the $1 billion cost penalty, will then further disadvantage the U.S.

when earnings from the overseas location are also invested outside the U.S. The homeland investment provision of the American Jobs Creation, previously mentioned, addressed this detrimental aspect of our current tax system, but only as a temporary solution, not a sustaining one.

Research & development in the semiconductor business requires sustained and heavy commitments as well. In 2001 and 2002, during the sharpest downturn from a revenue standpoint in the history of the semiconductor industry, Intel nonetheless continued investing virtually the same amount in R&D (around $4 billion) as in the immediately preceding years, in order to ensure that new products would be ready when the downturn ended. About 80% of Intel's R&D has typically been performed in the U.S. (over $4 billion dollars, for example, in 2004)—and the balance of our research is performed in design centers located around the world, including in Israel, Russia, China, and India. Other countries greatly value research performed in their countries, and they offer very generous tax credits and incentives to attract research. U.S. research and U. S competitiveness are inextricably linked, as the President noted in his State of the Union competitiveness initiative. The U.S. should be encouraging as much U.S. private sector research as possible, as well as increasing government funding of basic research.

A Tax Credit for increased U.S. research was first enacted in 1981, but, despite its long history, the Credit thereafter has been subject to only limited extensions. The Credit also suffered a year-long gap in its history. Most recently, the Credit once again expired at the end of last year and is now awaiting another extension (but, as proposed, only for yet another limited period). A permanent Credit is long overdue. A recent Congressional Research Service study identified inadequacies in the Credit, and specifically noted its lack of permanence as a key detriment. The expiration of the Credit, the possibility of another gap, and repetitive short-term extensions dilute its potential impact. Research planning demands a long-term view, and project planning through implementation frequently spans several years. In addition, in order to maximize the Credit's impact, it should be made more effective by its extension to as many companies as possible performing U.S. research; to do so, the Credit must contemplate more varied factual circumstances, and pending proposals to further enhance the Credit to extend its reach also merit enactment.

I appreciate this opportunity to share Intel's views on tax policy and tax reform, specifically from the perspective of a business decision-maker, and with a focus on U.S. competitiveness. I welcome any questions you may have.

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Chairman CAMP. Thank you very much. I want to thank all of the panel Members for being here.

Dr. Barrett, the question I wanted to ask you was, how does the U.S. international tax system impact business investment decisions, but after hearing your testimony, I think I should ask you how do other countries' tax systems affect or impact business investment decisions. In deciding to locate a facility, what are the considerations that are most important to you?

Dr. BARRETT. Historically, the considerations were in the ability to do business. That is the presence of the infrastructure, and this is infrastructure of everything from transportation to power to educated workforce to the physical infrastructure.

Over the last 10 or 20 years, that limited the choices basically to countries in Western Europe and Japan and the United States, the only countries with really significant infrastructure. More recently, we have seen a dramatic switch as more and more countries come on line with strong educational infrastructure and also physical infrastructure.

So, Asia now is probably the most competitive environment. If you look at the sort of facilities I was describing, about 70 percent of all of facilities currently under construction are in Asia, and I don't mean Japan. I mean Asia proper. So, increasingly, it is a very, very competitive environment, and increasingly, those countries are using their tax policy and their other government invest-

ment policies to promote investments, to promote high-paying jobs and looking at that as an investment for the future. We have seen Western Europe, Japan and the United States more or less hold firm, with a few exceptions, on relatively high corporate tax rates, lack of investment tax credits and lack of competitive depreciation schedules.

Ireland might be the Western European exception when, approximately 15 years ago, they changed their corporate tax rate from 40 percent to its current 12.5 percent. You have seen what happened in Ireland in terms of investment and growth of their economy as they went from the bottom of the European Union in 1989 to currently the highest per capita income in the EU, driven primarily by strong educational infrastructure but more importantly by a very low corporate tax rate.

Chairman CAMP. Thank you.

Dr. Hubbard, this lower corporate tax rate, what effect—obviously, recent studies in the United States have shown we have one of the highest rates, as several of you have testified comparing us to our trading partners.

What effect does our U.S. tax rate have on the competitiveness of U.S. firms operating abroad?

Dr. HUBBARD. The U.S. tax rate affects U.S. firms in two ways. At home, it certainly affects investment decisions. In terms of their multinational firms' operations abroad, it affects their overall tax burden. The corporate tax also affects workers in our economy, whether it is from overseas operations or domestic operations, because much of the burden of the corporate tax is borne by workers so a rate cut would be good for labor.

Chairman CAMP. Dr. Hines, we had a lot of discussions over time about whether we should replace our worldwide U.S. taxation system with a territorial system, and if we did convert to a territorial tax system, again, on U.S. companies operating abroad, what effect would that have on their competitiveness?

Dr. HINES. Adoption of territorial taxation would immediately make U.S. firms more competitive in foreign markets and make them more efficient in the United States as well. The reason is that the current system, in which the United States is such an outliner compared to other countries, other rich countries and other countries that aren't rich, leads to an outcome where the tax system gives the American firms the wrong incentives to organize their production around the world. If we were to adopt a territorial system thereby becoming like most of the countries in the world, we would go back to having a tax system that doesn't distort ownership of assets the way that the current system does, and once you don't distort the ownership of assets, you will make business more productive, and that includes in the United States.

So, I agreed with Dr. Hubbard that the impact of that system would be to rationalize production and thereby increase the productivity of labor and other factors in the United States.

Chairman CAMP. Are there any incremental steps that you would suggest in the event that a comprehensive addressing of the issue is not done?

Dr. HINES. You mean, it won't be done? Just in case, it isn't, then there are partial steps. There are big steps in that direction.

France exempts 95 percent of foreign source dividends. For thecalendar year 2005 the United States exempted 85 percent of foreign source dividends from taxation, but that was a purely temporary gesture which is different from what we are talking about now.

But one could choose a number—currently, the number is zero, and you could exempt maybe 50 percent or more.

Chairman CAMP. So, you think the exemption of foreign source dividends would be one area that we have done in the past at least partially and for a short period of time would be something that we could do as an incremental step.

Dr. HINES. Yes, the concept being not as a temporary adjuster this time but instead permanently.

Chairman CAMP. Thank you.

Mr. McNulty.

Mr. MCNULTY. Thank you, Mr. Chairman. Since I came here in the late eighties, I have been increasingly concerned about the increasing Federal budget deficits. The growing national debt, which I mentioned in my opening statement, is now in excess of $8.3 trillion, and as someone who has four children and five grandchildren, I worry about that more and more with each passing day.

I was just wondering if you could state for the Committee how you believe your proposals today would positively impact that situation, or the bottom line as you would have it, for the United States of America?

Dr. HUBBARD. If I could begin, the U.S. fiscal picture over the medium to long run is almost entirely a story about our entitlement programs. In fact, the implicit debt in those programs is far larger than the numbers that you mentioned, by an order of magnitude, perhaps. The question is how we meet our obligations. We have to have the most efficient possible tax system to do this. The sorts of changes that are being talked about to make firms more productive I think will go in the right direction. We can't meet those obligations down the road by raising taxes on capital. We would be killing ourselves to do that. So, I think you have mentioned probably the big question, and I think it is another big reason for favoring tax reform along the lines that have been discussed this morning.

Dr. HINES. I share your concern with the deficit. I think it is not a sound way to run the economic policy to have huge debts and persistent government deficits, and it is simply a matter of the United States has to pay its bills, and the United States will pay its bills. The question is, how we are going to do that and whether we will do it in a sensible, I believe, a better manner or a less sensible manner.

You are much better positioned to be able to pay your bills if you have an efficient tax system, and the reason is, you collect money more effectively, and you will have a stronger economy to tax. So, the more efficient you can set up the system, the easier it will be to pay your bills.

Now, of course, this isn't going to be the whole solution because in order to—for the country to pay its bills, we are going to either cut spending or raise taxes. Those are the only two things you can do.

But in the processes——

Mr. MCNULTY. Or grow the economy.

Dr. HINES. Yes, absolutely. If you can grow the economy, that is a way of collecting more taxes because it would happen automatically.

But all of those things are going to happen most easily if you have an efficient system, and that is what we are describing this morning, I think, is that the current system is not efficient from the standpoint of taxing of multinational firms.

Dr. BARRETT. I only have four grandkids that I am worried about. The oldest one is a sophomore going into her junior year at Stanford. So, she's getting perilously close to the work environment.

This is a conundrum as far as a head of a major corporation is concerned in the United States My company, for example, could be very successful if it never hired another person in the United States. Most of our business is done out of the United States As a U.S. citizen, that is not an acceptable vision to me. So, I would like to see United States be as competitive as possible.

Using tax policy to promote investment and to promote the creation of high-paying jobs, I think, is the most critical thing the government can do. As I look around the world at these other countries that we are involved with that have progressive tax policies who promote investments they see a net positive flow into their country. Ireland perhaps is the classic example where with a corporate tax rate—and they did not rob the Treasury in Ireland, created the most prosperous, most dynamic economy in Western Europe and added to the growth of their economy and the growth of opportunity for their citizens.

So, my comments are targeted toward opportunity for citizens in the United States by tax policy which promotes investment in the United States in the creation of jobs in the United States.

The current policy, the numbers that I mentioned, are in fact exactly the opposite. They are promoting companies of the sort that Intel is to invest in R&D and to invest in manufacturing facilities out of the United States. They can't possibly be good for the budget deficit, but more importantly, they can't possibly be good for our children or grandchildren.

Mr. MCNULTY. Thank you.

Chairman CAMP. Thank you.

Mr. Chocola may inquire.

Mr. CHOCOLA. Thank you, Mr. Chairman.

Thank you all for being here this morning.

Dr. Hubbard, I appreciate your comments about the unfunded liabilities we face, which I think the Government Accountability Office puts at, at least at $36 trillion today.

I guess my first question would be for Dr. Hubbard, but all of you are more than welcome to respond. If the United States ended our tax deferral on overseas income, do you think the result would be more or less companies investing in the United States?

Dr. HUBBARD. If the United States repealed deferral, we would be raising tax on capital in the our country. Investment would become less attractive for American companies and, by weakening the economy, less attractive for companies generally.

Mr. CHOCOLA. Dr. Hines, do you have any comment?

Dr. HINES. Yes. I think there be would be less investment in the United States. Repealing deferral has a superficial appeal because it seems that you would remove the tax liability associated with repatriation and therefore trigger flows of funds from abroad to the United States. So, at first blush, it is easy to think of repealing deferral as a gesture that will create more investment funds for the United States.

However, in the medium run, after maybe a couple of months, repealing deferral would make the United States even more unusual compared to all other countries that are capital exporters. We would become unique in the sense of imposing such a heavy tax on outbound investments from the United States.

What that would do is weaken American companies, first of all, and second, make it much less attractive for foreigners to invest in the United States, which is another source of job creation and investment.

So, repealing deferral is not an adjustment which one would want to undertake, even though, it does have this apparent appeal.

Mr. CHOCOLA. Intel took advantage of the temporary low rates of repatriating earnings?

Dr. BARRETT. We did. Income, to the best of my knowledge, that temporary repeal in rates brought about $300 billion back to the United States. Intel contributed about $6 billion of that repatriation, and $3 billion of that went to build a new facility which is under construction in Arizona at this point in time.

In response to your question, I would reiterate that over 80 percent of our business is export business. Our competitors are international competitors. If you repeal the deferral of tax on foreign income, it would make Intel and companies like Intel less competitive in the international marketplace. Our competitors would prosper, and we would decline.

Mr. CHOCOLA. Yesterday I had a group of steelworkers in my office, and we had a spirited discussion about global trade issues. I used to run a public company, but we had some of the same issues. We had to make decisions about where we invested and not only on tax policy but on market forces, obviously. However, Dr. Hubbard, you said in your written testimony that although firms take the cost of production of their affiliates into account, there is little reason to believe that increased investment abroad necessarily implies less economic activity at home.

Would you like to explain or expound on that?

Dr. HUBBARD. Certainly. There is often a common view that if a multinational invests abroad, that investment displaces whatever it would have done in the United States. In fact, most multinational investment abroad has to do with market access, accessing lower costs of production as well, so it really is that the capital abroad and capital in the United States for many industries that are complementary. Certainly, multinational employment abroad can tend to raise high-wage employment here in the United States. So, this is something that isn't a matter of just theory. There have been a number of empirical studies by Martin Feldstein and others to suggest this very strong complementary relationship despite the facial appearance.

Mr. CHOCOLA. Dr. Barrett, in your written testimony, I think you said you agree with not giving companies incentives to do—to engage in behavior they were going to behave in anyway; it is just a question of where they are going to engage in the behavior.

In an earlier hearing, we had people say, don't give us tax incentives, give us a low rate. Has there been any research done on what an optimal rate would be here for corporate tax in the United States to make us as competitive as possible, and to be revenue appropriate? Have there been any studies of that?

Dr. BARRETT. I don't have an absolute number. I can only point you to countries that are aggressively attracting investment in the sort of innovative assessment that we would like to have more of in the United States. They are using either tax holidays or tax rates in the 10 percent range, so the 0 to 10 percent range compared to the United States 35 percent from the Federal standpoint and not adding state and other taxes on top of that. However, I certainly would not argue with a 10 percent corporate tax rate in the United States.

Mr. CHOCOLA. Do either of you have—are aware of any research done——

Chairman CAMP. The gentleman's time has expired. So, if you could answer briefly.

Dr. HUBBARD. The optimal tax on capital is zero, but I think more interestingly, the recent work suggests a revenue maximizing corporate rate would be only in the mid 20 percent for the United States

Chairman CAMP. All right. Thank you.

The gentleman from Texas, Mr. Doggett may inquire.

Mr. DOGGETT. Thank you, Mr. Chairman.

Picking up on Dr. Hubbard's comments, Dr. Hines, isn't that optimum tax rate of zero what you are advocating for all foreign source income?

Dr. HINES. No, because foreign source income is taxed by foreign governments.

Mr. DOGGETT. I am about talking about U.S. tax being be zero.

Dr. HINES. Yes.

Mr. DOGGETT. Do you agree with that? That we should apply the zero rate on all foreign source income of U.S. companies as far as the U.S. tax system is concerned?

Dr. HUBBARD. Yes, sir.

Mr. DOGGETT. Dr. Barrett, is that your position also?

Dr. BARRETT. My position is merely the United States should have a competitive policy on tax such that it doesn't inhibit companies like Intel from investing in the United States as well as investing in foreign countries.

Mr. DOGGETT. If we make—going right to that point then, if we make the rate zero on all foreign source income, don't we need to at the same time lower toward zero the rate on corporate income in this country in order to avoid an incentive for people to do all their investments where they pay no taxes, no U.S. taxes at all?

Dr. HUBBARD. Not quite, Congressman. The argument for the zero tax on foreign-source income is simply that it is in the interests of the United States; because of the well-being of multinationals and the effect that has on wages and capital formation

in the United States. There is a separate and bigger question that I mentioned in my opening remarks about the corporate tax generally, and yes, we should be lowering the corporate tax rate. However those are two different questions.

Mr. DOGGETT. Dr. Barrett has told us that there are countries like Malaysia that practically pay Intel to come. They are not paying any tax, perhaps at least for some period of a tax holiday, and are being given various and other incentives to be there to get the competition between the states and localities here to attract an Intel.

So, if there is no U.S. tax and, in some cases, for extended periods of tax holidays, there is no foreign tax there—if the U.S. corporate tax stays even in the twenties and it is—and there is no tax that you face to build new plants in Malaysia or some other country, then unless you lower the U.S. tax significantly, there will be a strong incentive to export jobs and plant equipment abroad.

Dr. HUBBARD. Be careful about generalizing that example because the bulk of multinational investment really is for market access. It is not to be in the Malaysias of the world but the high-tax, high-wage countries.

Dr. HINES. If the question is what effect would that have on business activity in the United States, and employment in the United States, the way to—exempting foreign income from taxation, there is a lot of theory and a lot of evidence now that that would improve business activity and increase employment in the United States. It seems paradoxical, but the way that it works is foreign governments have the opportunity to tax businesses located wherever they are, and they can choose to tax it wherever they are at whatever rate they want and some of them offer very low tax rates.

Mr. DOGGETT. Let me ask what I think is the converse of the question I posed. That is, if the rate for building a new plant and equipment is effectively 35 percent in Maryland and is zero in Malaysia under your plan, you don't think we need to make any adjustments in the rate for domestic income generation just because it is zero abroad?

Dr. HINES. Not on that question.

Mr. DOGGETT. Let me ask you as we move under your recommendations to a zero tax rate on foreign source income—we have heard comments from Dr. Barrett that we need to make adjustments, which I agree with in depreciation schedules for—certainly people who are in semiconductor and other kinds of new information technology production that we need to have more dependable research and development tax credit All of those things of course, take money from the treasury as would a zero tax rate on foreign source income. How do each of you propose that we make up that revenue? Or do you believe that the answer, as I thought Dr. Hubbard was saying, is that the deficit is all about entitlements, which is another way of saying, make it up by changes in Medicare and Social Security.

Dr. HUBBARD. To answer your question, we actually do not raise that much revenue from the taxation of foreign-source income. However such tax generates a lot of distortions. Happily, this is one that is not that costly to fix. It is, however, expensive to cut

the domestic corporate rate, though that should be part of an exercise of overall tax reform where I think most economists would recommend.

Mr. DOGGETT. Do either of you have any specific places that you would generate more revenue in order to compensate for any changes in the level of corporate taxation at home or abroad that you recommend?

Dr. HUBBARD. You should broaden the corporate tax base.

Dr. HINES. Might want to think about a value-added tax.

Chairman CAMP. All right. Thank you.

Dr. BARRETT. I was going to suggest that other countries look at this, as opposed to taxation, as to creating opportunity and creating jobs which then create a tax base on their own. When we look at different states in the U.S. where corporate tax rates are not an issue, but local taxes are, every analysis that has been done shows that creating the local jobs more than accommodates the decrease in property tax rates or whatever incentives states can provide.

As I travel around the world, I see countries investing for the future by creating jobs and creating the tax base and not worrying about taxing the corporation that creates the jobs.

Chairman CAMP. All right. Thank you.

I want to thank the panel Members for your excellent testimony and for your time for being here.

Thank you very much.

Our second panel I would ask to come forward is composed of Michael J. Graetz, who is the Justus S. Hotchkiss Professor of Law, Yale Law School in New Haven, Connecticut; Paul Oosterhuis, who is a partner in Skadden, Arps, Slate, Meagher & Flom; and Stephen Shay, who is a partner in Ropes & Gray in Boston, Massachusetts.

Thank you all for being here. You each have 5 minutes to summarize your testimony. Your written statements we have and will be made a full part of the record. We will begin with Mr. Oosterhuis. Thank you for being here.

**STATEMENT OF PAUL W. OOSTERHUIS, PARTNER, SKADDEN, ARPS, SLATE, MEAGHER & FLOM, LLP**

Mr. OOSTERHUIS. Thank you. It is my pleasure to be here. I received my first experience as a tax lawyer on the Joint Committee Staff beginning in 1973, and I spent a wonderful five and a half years working on international tax rules.

Since then, I have been working in private practice advising U.S.-based and foreign-based multinationals on the subject that we are talking about today. So, I am going to speak to you from the perspective of a practitioner.

I would like to focus my attention on the territorial proposal like that Jim Hines and Glen Hubbard discussed on the prior panel.

The first thing to make sure everybody understands is that a territorial system, a dividend exemption system as it has been proposed recently would raise revenues, not lose revenues. That is important for you to understand. That is because it is important to understand how it raises revenue when you are thinking about it, and whether the implications of those revenue-raising aspects

cause problems that need resolution before deciding whether territoriality is a good direction that we should move in or not.

Moving from our current deferral and foreign tax credit system to a territorial system raises revenues essentially for three reasons. The first, in our foreign tax credit system as it exists today, companies can use foreign taxes that they pay to high-tax countries and use those credits to reduce their U.S. tax on other items of income that are not heavily taxed. That, first of all, applies to exports. That is because our rules, going back to the 1986 Act, allow some portion of export income to be foreign source income whether or not the company has any presence abroad. If a company has substantial high-taxed earnings in foreign countries and also exports, it can reduce its rate of U.S. tax on exports by using its credits against its export income.

If we move to a territorial exemption system, excess credits go away. Because foreign income is exempt from a tax, no foreign tax credits are allowed, and therefore, for some companies, territoriality is going to raise the taxes on their export transactions.

You need to understand that and you need to evaluate whether increased taxes on exports is acceptable or whether there are serious issues involved in such an increase.

Second, companies that have high-tax foreign earnings can use those high foreign taxes to reduce the U.S. tax on their foreign royalty income given the way our rules work today. The royalties are principally from technology. It is also royalties from trademarks and consumer and marketing intangibles, but principally royalties from technology development activities that occur in the United States. So, if we switch to a territorial system, we are increasing the taxation of those technology companies that rely on high taxes in various foreign countries to reduce the tax on their royalties. You need to think about that. I think you could think about that in the context of the R&D tax credit legislation because one solution there might be to use some of the money that territorial would raise to expand and make permanent the R&D tax credit.

The third results because in the territorial exemption system, foreign dividends are exempting, and thus most people believe there are some expenses that also need to be disallowed as a deduction because they are expenses that relate to the generation of exempt income. In our foreign tax credit world, we don't need to disallow any deduction. We just treat those expenses as being foreign source expenses, and then give a foreign tax credit on net foreign source income, that is foreign income net of foreign source. In a territorial system, the logical analog is to disallow foreign source as deductions in the United States. That can have a very negative impact on the location of jobs in the United States to the extent the expenses of paying salaries, for example, are disallowed as deductions.

The Joint Committee suggested a territorial proposal over a year ago. They proposed that some R&D expenses might be disallowed as deductions. I think that is wrong. It is wrong as a technical matter, and I think it would be bad as a policy matter. Second, general and administrative (G&A) expenses are a big category of expenses potentially disallowed as deductions. Those are headquarters-type

expenses of people who are managing international businesses of U.S. based multinationals. There is an argument that some of those expenses should be disallowed, but I think you should consider whether or not that is necessary given the importance of these types of jobs in our country

So, these are some of the issues that you need to think about as you consider a territorial system. On balance, there is a lot to be said for territoriality, as Dr. Hubbard and Dr. Hines indicated in the prior panel, but there are some problems as well. It does raise revenue rather than lose revenue, so you need to be very careful as you analyze it.

[The prepared statement of Mr. Oosterhuis follows:]

**Statement of Paul W. Oosterhuis, Partner, Skadden, Arps, Slate, Meagher & Flom LLP**

Thank you for the invitation to testify today. It is a pleasure to appear before you to discuss the topic of reform of the U.S. international tax regime. I am appearing on my own behalf, and not on behalf of any client or organization. As such, the views I express here today are solely my own.

**I. Introduction**

The foundations for much of the current U.S. international tax regime were passed into law in 1962. Without belaboring the point, much has changed economically since the 1960s and 1970s. Our world is much more global. U.S. multinationals are much less dominant in the global economy. In 1960, 18 of the world's 20 largest companies ranked by sales were U.S. multinationals. By the mid-1990s, that number had fallen to 8.[1] In the early 1960s, the U.S. accounted for over forty percent of worldwide gross domestic product.[2] Today, the U.S. accounts for only approximately 28%[3] of worldwide output. Instead of being the world's largest exporter, of capital, the United States is now the world's largest importer of capital.

At the same time, the prosperity of the United States is increasingly tied to the global economy. Falling tax and regulatory barriers to the free flow of goods, services, and capital have created an integrated worldwide marketplace. Reductions in the cost of international transportation and communication, as well as technological advances, make it not only possible but essential for companies to operate efficiently across national boundaries. Half a century ago, multinational firms invested abroad to overcome tariff and transport costs. Today, global supply chains have gone from being the exception to being the norm. Foreign direct investment by U.S. multinationals is now part of an integrated production process that must be highly efficient to compete with other U.S. and foreign multinationals.

Adapting U.S. international tax policies to these business realities is a subject of considerable discussion. Most of that discussion over the last few years has revolved around establishing a territorial international tax regime or eliminating the deferral of taxation on certain foreign income that represents the heart of our current worldwide system of international taxation. In particular, both the Joint Committee on Taxation and the President's Advisory Panel on Federal Tax Reform have studied territorial approaches and produced outlines of the rules that might be used to implement such a system.

Of course both territorial and deferral systems require consideration of taxing currently some of the income earned by controlled foreign corporations. I believe there are important interactions between the nature of the rules that determine which foreign income will be taxed currently[4] in either a deferral system or a territorial system and the desirability or necessity of a territorial tax system. The competitive advantages of a territorial system could be thwarted by casting the remaining subpart F rules too wide, so that substantial active business income would be taxed cur-

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[1] SeeEconomic Report of the President 210 (2003).

[2] Fred F. Murray, ed., The NFTC Foreign Income Project: International Tax Policy for the 21st Century 95 (Dec. 15, 2001).

[3] The World Bank reported that for 2004, U.S. GDP was $11,712 billion and world GDP was $41,290 billion. *See* World Bank Data Query, http://devdata.worldbank.org/data-query/ (last visited June 16, 2006).

rently, or by casting that net too narrowly, so that substantial passive income of U.S. taxpayers would go untaxed anywhere in the world.

Subpart F of the Code contains the rules governing the current taxation of CFC income under our Code today. Thus, it would seem useful first to discuss issues relating to the scope of our current subpart F rules and then to discuss issues relating to the merits of moving to a territorial system.

## II. Issues Under Subpart F

### A. *Historical Rationale for Subpart F*

To understand the structure and rationale underlying the provisions of subpart F, it is helpful to return to the circumstances that led to its adoption during the Kennedy Administration. The country faced a large deficit and the Administration worried that U.S. economic growth was slowing relative to other industrialized countries. At the time, deferral was available for all foreign income earned by foreign affiliates, and administration policymakers became concerned that U.S. multinationals were shifting their operations offshore in response to the tax incentive provided thereby.[5] The Kennedy Administration proposed to impose current taxation on the foreign source income of foreign subsidiaries of U.S. multinationals operating in developed countries and simultaneously to provide investment tax credits and accelerated depreciation allowances intended to encourage investment and production in the United States.[6] The Kennedy Administration's intent was to make investment in U.S. facilities relatively more attractive in comparison to investment in foreign facilities.

Businesses and many in Congress believed, however, that ending deferral would unfairly disadvantage U.S. companies competing in foreign markets first by taxing them at a higher rate than their locally-owned competitors and second by eliminating their flexibility to utilize deferral to average their foreign tax credits over time to avoid double taxation. These concerns were understandably widespread despite the fact that at the time the United States was the source of half of all multinational investment worldwide, was the world's largest capital exporter, and basically dominated the nascent global marketplace.[7]

It soon became clear that the Kennedy Administration's proposal to end deferral entirely in developed countries could not pass the Congress. The compromise that emerged is what we all now know as subpart F. As one of its core concepts, subpart F attempts to eliminate deferral for third-party passive investment income. The 1962 version of subpart F retained deferral for most truly active businesses.[8]

Subpart F as enacted in 1962 was a classic example of a practical legislative solution to a perceived problem, as opposed to an attempt to achieve a theoretically perfect result. At the turn of the 1960s most developed countries had corporate income tax rates equal to or higher than the United States. Thus, over the long run deferral of income earned in those countries was not that valuable and did not provide that much of an incentive for U.S. companies to make investments abroad instead of in the United States. U.S. multinationals, however, had set up structures in which a foreign affiliate company located in a low-tax jurisdiction would lend, license or otherwise do business with operating company affiliates in high-tax foreign jurisdictions. Interest, royalties or other deductible intercompany payments were made by the high-taxed foreign affiliates, reducing income tax liability in those foreign jurisdictions and creating income for the low-taxed foreign affiliate. Due to deferral, that income could generally avoid U.S. tax until repatriation. Prior to subpart F, these simple "earnings stripping" arrangements represented the heart of U.S. corporate international tax planning.

Subpart F was designed in substantial part to address these earnings stripping transactions. It identifies specific categories of income, not principally their location or tax burden. At least in theory, subpart F attempts to identify the tax planning activities that can give U.S. multinationals an incentive to invest abroad independent of local tax rates. As enacted, it reduced any such incentive for U.S. multinationals to invest abroad without affecting their ability to compete with local foreign companies, which were unlikely to be able to engage in similar earnings stripping-transactions. In concept, subpart F could thus make it much more difficult for a U.S. multinational to lower its effective tax rate below the U.S. tax rate over

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[5] John F. Kennedy, President of the U. S., Annual Message to Congress on the State of the Union (Jan. 11, 1962), *in* 1 Pub. Papers at 13–14 (1963).

[6] *Id.*

[7] Fred F. Murray, ed., The NFTC Foreign Income Project: International Tax Policy for the 21st Century 95 (Dec. 15, 2001).

[8] I.R.C. §§ 951–960 (1962).

time.[9] Doing so required locating profitable manufacturing facilities in low-taxed jurisdictions, which for non-tax reasons was often more difficult to do.

But in its creation and particularly as it was expanded in the 1980s, subpart F applied to more than third-party passive income and earnings stripping transactions. It always applied to some active businesses, including in particular services businesses to the extent of services performed outside of a company's jurisdiction of incorporation, a topic to which I will return.[10] In the 1970s and 1980s other categories of active business income were added to subpart F, including shipping and active finance income.[11] Our experience with attempts to eliminate deferral on shipping income and active finance income indicates that eliminating deferral on active business income, even if it is low-taxed, may not strike the right balance between competitiveness and minimizing foreign investment incentives. In both cases after enactment the perceived impact on competitiveness was sufficient that Congress rethought its handiwork, enacting successive extensions of the temporary active finance exception since 1997[12] and eliminating the shipping income category in 2004.[13]

**B. *Subpart F in the Global Economy of the 21st Century***

Economic globalization in the forty-plus years since the 1962 Act greatly changed both the business model of multinationals and the way economists think about why multinationals invest across national borders. Today much U.S. multinational activity inevitably must take place abroad, and direct investment decisions may more often center on whether a U.S. or foreign-based multinational will own a pre-existing foreign operating facility or business than on where any new direct investment will be made. In 2001 over 96% of' foreign direct investment into the United States represented the acquisition of preexisting entities.[14] Although data for outbound investment is not as readily available, it is also likely that most current outbound direct investment by U.S. multinationals similarly represents transfers of' ownership rights rather than development of' new assets.[15] To many, this data suggests that often the question is no longer whether a U.S. company will build and operate a manufacturing plant in Des Moines, Stuttgart, or Kyoto. Instead, the question is whether a U.S.-based multinational, a European multinational, or a Japanese multinational will own a manufacturing plant in a location such as Shanghai, and as a result whether the headquarters and research and development jobs associated with that plant will be predominantly in the U.S., Europe or Japan.

As the competitive pressures associated with global product and services markets increase, the flaws embedded in various provisions of subpart F have become correspondingly more important. In that regard, I would direct the Congress' attention to perspectives like that articulated in an excellent 2001 National Foreign Trade Council ("NFTC") report on deferral issues.[16] That report concluded that more than forty years after its creation, the basic structure of the U.S. international tax system (including the general deferral principle) remains workable. The report articulated the principle that our subpart F rules should generally be in line with comparable rules of other major countries that serve as home to multinational competitors. It then benchmarked U.S. international tax rules against the rules imposed by many of our major trading partners and OECD counterparts, including Canada, France, Germany, Japan, and the United Kingdom.[17] The Report suggested that relative to the rules major foreign competitors of the U.S. impose on their multinationals, subpart F imposes a harsh regime with respect to certain types of active business income. To maintain our subpart F comparability, the report proposed liberalizing those parts of subpart F that accelerate tax on active business income of foreign affiliates of American companies.[18]

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[9] In the early years subpart F had a variety of exceptions and special rules which substantially reduced the scope of its application, but by 1976 it was reasonably effective in accomplishing its goals.

[10] I.R.C. § 954 (1962).

[11] Pub. L. No. 99–14 (1986); Pub. L. No. 94–12, § 602 (1975).

[12] *See, e.g.*, Pub. L. No. 106–170, § 503(a)(1)-(3) (1999); Pub. L. No. 107–147, § 614(a)(2) (2002).

[13] Pub. L. No. 108–357, § 415(C)(2)(a) (2004).

[14] *See* Mihir A. Desai & James R. Hines Jr., Economic Foundations of International Tax Rules 16 (2003) (citing Thomas Anderson, *Foreign Direct Investment in the United States: New Investment in 2001,* Surv. of Current Bus., June 1, 2002, p. 28–35.).

[15] Id.

[16] Fred F. Murray, ed., The NFTC Foreign Income Project: International Tax Policy for the 21st Century (Dec. 15, 2001).

[17] *Id.* at 67–88.

[18] *Id.* at 3.

The principle that our CFC rules should be reasonably in line with those of other major countries makes considerable sense; it is a useful exercise to focus on elements of our current subpart F rules from that perspective.

*1. Subpart F Services Income*

CFC income from services performed for, or on behalf of, a related person outside the country under the laws of which the CFC is organized is taxed currently under subpart F.[19] Treasury regulations have secured a broad scope for this provision by deeming services performed by a CFC with "substantial assistance" from a related party—defined by the regulations to include certain types of direction, supervision, services, know-how, financial assistance, equipment, material, or supplies—to be subpart F services income.[20]

With their considerable breadth, the subpart F services income rules have always encroached on active business income. Today, however, those rules are pervasively troublesome given the declining importance of physical location in the performance of services. As a result of the rules' reach, multinational corporations face the prospect of immediate taxation for otherwise deferrable active business income as the result of routine and otherwise efficient global staffing and resource allocation decisions. By contrast, the OECD countries surveyed in the NFTC report give their CFCs considerable flexibility to provide or receive services with assistance from a related CFC without losing deferral or exemption for the affected income (at least so long as the services are not provided from the parent's home country or by a CFC that is subject to tax in that country). The subpart F services rules thus represent a deviation from the general principle favoring deferral for active business income and a serious departure from consistency with the regimes of our major trading partners. They are also fundamentally antiquated (and frankly unenforced) in the modern business environment, where cross-border services projects using resources from multiple countries and affiliates are ubiquitous. For all these reasons, they would best be repealed.[21]

*2. Active Financing*

In 1986 subpart F was expanded to capture certain gains derived in the active conduct of a banking, financing, or similar business. A temporary exception to this provision was first passed by the Congress in 1997 (with certain rules to prevent the routing of income through foreign countries to maximize tax benefits). Currently, financial services firms enjoy an exception from subpart F for active financing income of their CFCs provided the CFC (or its qualified business unit) is both "predominantly engaged" and "conducts substantial activity" in an active banking, financing, or similar business.[22]

Allowing U.S. multinationals to face only the local tax rate until income is repatriated is clearly appropriate for financial services, which is in many respects the most globalized of all the service industries. Outside the United States, active financing income is almost universally recognized as active trade or business income and is consequently entitled to either deferral or exemption (depending on whether the home jurisdiction has a deferral-based or territorial tax system). To promote certainty and stability for U.S. financial corporations as well as to provide a level playing field, Congress should permanently extend a generous active financing exception.

Moreover, the active finance exception as it has existed since 1997 has a number of detailed requirements. For example, to qualify for the exception, substantially all of the activities in connection with which a relevant item of income is earned must be conducted directly by the eligible CFC in its home country.[23] In addition, a qualifying CFC that is not licensed to do business as a bank in the United States (and most are not so licensed) must derive more than 70 percent of its income from transactions with unrelated customers outside the United States.[24] Such CFCs must also derive more than 30% of their gross income from the active and regular conduct of a lending or finance business in transactions with unrelated customers that are lo-

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[19] I.R.C. § 954(e).

[20] Treas. Reg. § 1.954–4(b)(1)(iv).

[21] It also seems particularly anomalous that a U.S. CFC is taxed currently when it provides services to a related CFC, but is not taxed when it makes an intercompany loan to that same related CFC. That contrast results because the subpart F rules now allow foreign-to-foreign earnings stripping transactions, but continue to tax active business provision of services to related parties.

[22] I.R.C. § 954(h).

[23] Section 954(h)(3)(A)(ii).

[24] Section 954(h)(2)(B)(ii).

cated in the CFC's home country.[25] These requirements can intrude on sound business practices in an industry that is as globalized and multi-jurisdictional as financial services. Our financial institutions operate in a global, not local, business world. Limitations on cross-border lending and other active finance-type activities between foreign countries make little sense in today's world. To my knowledge, no other major foreign country imposes similar limitations on their resident banks under comparable CFC rules. Thus, a strong case can be made for liberalizing these rules as well as making them permanent.

*3. Subpart F Sales Income*

The U.S. subpart F sales income rules attempt to strike a balance between promoting competitiveness and preventing earnings stripping but, because they can apply to very real and substantial companies, can be less favorable than those of our OECD counterparts. Sales income subject to subpart F encompasses income earned in a variety of transactions—including (1) the purchase of personal property from a related person and sale to another person, (2) the sale of personal property to any person on behalf of a related person, (3) the purchase of personal property from any person and its sale to a related person, or (4) the purchase of personal property from any person on behalf of a related person—where the property purchased or sold is both produced outside and sold for use outside of the country under the laws of which the CFC is organized.[26] These rules apply very mechanically. Historically, they were intended to prevent multinationals from routing income through "re-invoicing" companies with little substance and strategically located in low-tax countries. However, as business models have adapted to the globalized economy and manufacturing and marketing of products is conducted across multiple national boundaries for legitimate business reasons, the mechanical nature of the rules results in many transactions creating subpart F sales income even though they involve very real and substantial business operations.

OECD countries surveyed by the NFTC impose deferral limitations with a similar goal to our subpart F sales rules, but in general—and particularly in the cases of Canada, German, and Japan—impose more flexible limits on dealing with related parties and operating outside the CFC country. The persuasive rationale for such flexibility rests on the recognition that in a world of multinational firms, many legitimate sales businesses may entail substantial sales to or purchases from related parties.

Thus, Congress should consider liberalizing the subpart F sales rules. As part of that effort, consideration should be given to clarifying those circumstances where contract manufacturing activities should be taken into account in determining the applicability of subpart F to sales income.[27]

*4. Application of Subpart F to Related Party Passive Income*

With relatively little debate Congress recently enacted on a temporary basis look-through rules to except from subpart F related party dividends, interest, royalties and rents.[28] This legislation effectively codifies the result that since 1998 most taxpayers had been able to achieve on their own through check-the-box planning techniques.

Applying a look-through rule for dividends may well be good policy. Taxing such dividends under subpart F raised little revenue but distorted multinational behavior by discouraging the payment of dividends from CFCs with low taxed income. Excluding from subpart F, however, related party payments that are deductible in foreign countries raises completely different policy issues. The exclusion allows U.S. multinationals to incur deductible expenses in a high-tax foreign jurisdiction payable to a related entity in a low-tax jurisdiction without generating subpart F income in the United States. It thus repeals one of the core concepts of subpart F. The result clearly improves the competitiveness of U.S. multinationals by reducing their foreign tax on foreign income. But it is not clear that the result strikes the right balance between that competitiveness and minimizing foreign investment incentives.

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[25] Section 954(h)(3)(B).

[26] Section 954(d).

[27] *See* Rev. Rul. 97–43, 1997–2 C.B. 59; Rev. Rul. 75–7, 1975–1 C.B. 244.

[28] Section 103 of the Tax Increase Prevention and Reconciliation Act of 2005 amended section 954 of the Code to provide that for a three year period dividends, interest, rents, and royalties received from a related CFC will not be treated as subpart F income to the extent attributable to income of the related CFC that is not itself subpart F income. Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109–222, § 103, 120 Stat. 345 (2006). This provision represents the logical extension of the application of the check-the-box rules.

The implication of the principle articulated in the NFTC report that our CFC rules should be in line with those in major foreign countries is that we need not have our CFC rules be more lenient than the comparable rules found in these major foreign countries.

In my experience at least, the kinds of earnings stripping transactions that check-the-box planning and the newly enacted related party look-through rules permit are substantially more difficult to accomplish, and are thus less frequently undertaken, by French, German, Japanese and U.K. multinationals because the CFC rules in those countries tax such transactions in most cases. (Canada has a look-through rule for related party interest payments under its FAPI regime, and so is an exception).

Moreover, if similar look-through exclusions to their CFC rules were adopted by major foreign countries, the long-run result would arguably be unfortunate from a global tax policy perspective; the only limitation on earnings stripping transactions would be imposed by the country of source. Yet countries have great difficulties in limiting earnings stripping transactions solely on a source basis. Many countries in Europe, for example, have recently reexamined their thin capitalization rules, but substantial taxpayer flexibility remains.

The United States last attempted to further limit earnings stripping on a source basis in 2003, when the Treasury Department proposed to tighten section 163(j) by, among other things, abandoning the existing uniform 1.5 to 1 debt-to-equity ratio safe harbor approach in favor of an approach that would divide the assets owned by a taxpayer into identified classes and allow a safe harbor based on the degree of leverage typically associated with such types of assets.[29] A worldwide leverage test would also have been added that could apply in addition to the adjusted taxable income test to disqualify interest deductions for interest in excess of safe harbor amounts.[30] The foreign investment community and others complained that neither the asset categories nor the worldwide leverage test would be sufficiently reflective of commercial realities for any specific multinational, while also raising a host of technical issues with the proposal.[31] While some of the criticisms of the Treasury proposal may have been exaggerated, they did highlight the difficulties with designing tailored earnings stripping rules to be administered by source countries.

These source country limitations leave the U.S. and other jurisdictions with two alternatives in dealing with earnings stripping transactions: they can permit the transactions and thereby implicitly accept as a fact that cross-border investments are generally taxed at a lower global tax rate than are purely domestic investments; or they can attempt to minimize the rate reductions on cross border investments in large part through CFC rules that tax earnings stripping transactions.

In other areas of international tax policy, the U.S. has been a leader in encouraging foreign countries to adopt reasonably consistent regimes. For example, the United States was largely responsible for the adoption of the arm's length standard for evaluating transfer pricing arrangements. Maintaining CFC rules that reasonably align with those of other major countries at least with respect to earnings stripping transactions, and avoiding any "race to the bottom" competition, does require a longer run perspective. Nevertheless, such consistency would seem to be potentially achievable U.S. policy. Thus, in the related party passive income area of subpart F, it may be appropriate for Congress to reconsider whether the balance between maintaining competitiveness and minimizing tax incentives for foreign investment has been struck appropriately.

In doing so, Congress should recognize that it would also be possible to adjust the check-the-box regime (with all of its attendant simplification benefits) to avoid the self-help repeal of the earnings stripping provisions of subpart F. For example, a regime that respected transparent entities with one member as a separate partnership-type flow-through entity could be adopted for purposes of subpart F. It is the check-the-box regulation's treatment of single member entities as disregarded, leading to the disregarding of actual transactions, that effectively repealed the earnings stripping provisions of subpart F.

### III. *The Connection Between Related Party Passive Income Rules and a Territorial Tax System*

Since check-the-box became effective in 1998, U.S. multinationals have understandably migrated to check-the-box tax planning structures that incorporate the

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[29] Office of Mgmt. & Budget, Exec. Office of the President, Analytical Perspectives: Budget of the United States Government, Fiscal Year 2004 (2003).

[30] *Id.*

[31] *See, e.g.,* Andrew Berg, *NYSBA Comments on Proposals to Modify Earnings Stripping Rules,* Tax Notes Today, Sept. 12, 2003.

types of earnings stripping transactions subpart F was originally intended to prevent. Over that time the amount of income deferred by U.S. taxpayers has grown substantially. In 2003, for example, U.S. corporations retained $169 billion dollars of foreign earnings abroad, representing 67% of total foreign profits.[32] That is a 122 percent increase over the $76 billion of retained foreign earnings in 1997 (which represented 48% of foreign profits). A selective survey showed that among 38 of the largest U.S.-based multinationals the amount of annual foreign earnings retained abroad grew from $9 billion in 1997 to $46.3 billion in 2003.[33]

Clearly, not all of this increase can be attributed to check-the-box planning for earnings stripping transactions. Over this same period section 936 of the Code was capped, leading many section 936 companies to convert to foreign companies and take advantage of deferral on their manufacturing income in Puerto Rico. Moreover, during this period many companies' foreign affiliates adopted cost sharing of R&D. Nonetheless, the impact of check-the-box planning should not be underestimated. One recent estimate suggests that check-the-box planning saved the U.S. $7 billion in local country tax in 2002.[34]

In large part in response to the build-up of earnings resulting from check-the-box and other deferral planning, over the past couple of years increased interest has been given to proposals to move to a territorial system. By permitting tax-free repatriation of earnings that benefit from deferral today, a territorial system would eliminate the distortions that result from the requirement under deferral that offshore earnings remain offshore, and invested in foreign assets, in order to avoid U.S. tax. The deferral system together with provisions in subpart F that attempt to deem repatriation when profits are no longer needed in a foreign business lead not to increased repatriation but to increased distortion in the productive use of the funds in order to avoid repatriation. Thus, if properly structured, a territorial system can lead to a more efficient use of funds earned abroad without materially encouraging investment abroad.

Drafted properly, a territorial system would also allow for some significant simplification, including the repeal of section 956 and section 367(b), the elimination of dividends as a category of subpart F income (whether or not subpart F were to continue to permit other check-the-box planning) and a much more limited application of complex foreign currency translation rules. If the concept of territoriality were also applied to exempt gain on the sale of foreign affiliate stock, which would be consistent with most foreign country systems, U.S. multinationals could restructure their foreign operations (as is often required for business reasons) without worrying about whether each transaction meets the requirements of the Internal Revenue Code reorganization provisions. The simplification benefits from this change would in practice be very substantial.

Further, territoriality seems preferable to a periodic enactment of a Homeland Investment Act as a response to the continual build-up of foreign earnings. As a practical matter, the U.S. simply will not—and should not—repeal deferral on active business income generally any time soon for competitiveness reasons (unless perhaps our corporate tax rates were reduced below the 20 to 25 percent range). Thus, under deferral it is almost inevitable that over time foreign earnings will build to the point that another HIA will be necessary. Finally, even if one takes the view that our tax rules often do affect where "greenfield" foreign investment in plants, property, and equipment takes place, incentives to undertake foreign investment do not significantly increase if deferral is replaced with territoriality.

But in considering a territorial system, Congress will need to confront several important issues. First, the export source rule, embedded in IRS regulations under Code sections 861 and 863, currently treats all of the income from the export of products purchased by U.S. persons and essentially one-half of the income from the export of products manufactured by U.S. persons as foreign source income in the general limitation basket.[35] Moving to a territorial system would eliminate the excess foreign tax credits that can shelter that foreign source income from exports from U.S. tax. Congress retained the export source rule in the 1986 Act (even when a U.S. exporter had no taxable presence abroad) because it believed that the rule

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[32] Martin A. Sullivan, Presentation at the Tax Council Policy Institute 2005 Symposium (Feb. 10–11, 2005) (materials available from The Tax Council Policy Institute).

[33] John Almond & Martin Sullivan, *While Congress Dawdles, Trapped Foreign Profits Surge,* Tax Notes Today, June 28, 2004 at 1586.

[34] Rosanne Altshuler & Harry Grubert, *Special Reports: Governments and Multinational Corporations in the Race to the Bottom,* Tax Notes Int'l, at 459 (February 6, 2006).

[35] *See generally* Treas. Reg. §§ 1.861–7, 1.863–3.

helped encourage exports and therefore was sound economic policy; the impact of fully taxing exports should therefore be carefully examined.

Second, excess foreign tax credits also are used today to shelter royalty income from U.S. tax. These royalty payments are deductible in the foreign subsidiaries' country of residence. However, because the foreign tax credit look-through rules for categorizing income apply to royalty payments by foreign subsidiaries and the subpart F income that reflects such payments, excess foreign tax credits can reduce U.S. tax on these royalty payments. The impact on the conduct of intangible development activities in the U.S. of fully taxing royalty payments arising out of such development activities must be carefully examined, and alternative proposals for mitigating that impact should be considered.

Ironically, particularly if earnings stripping transactions remain eligible for deferral, the export and royalty issues are likely to be less important to many U.S. multinationals today than they were in the late-1980's and 1990's. Foreign tax rates have continued to come down in many high tax rate countries since that time. Moreover, in many instances U.S. multinationals have given up their excess credit shelter by initiating deferral strategies through check-the-box planning to push local tax rates significantly below the U.S. 35 percent rate. The look-through rules for foreign personal holding company purposes will further encourage such planning, especially if Congress chooses to make those rules permanent. Nonetheless, the impact of territoriality on U.S. exports and U.S. intangible development activities must be carefully reviewed.

Another important issue involves the disallowance of expenses. The territoriality proposal suggested by the President's Advisory Panel sensibly avoids any disallowance of R&D expense and appropriately limits interest expense disallowance to interest apportioned under a scheme like the worldwide interest allocation provision enacted as part of the 2004 Act.[36] But that proposal leaves open the question of disallowing general and administrative ("G&A") expenses.[37] That is troublesome. The principle underlying a territorial system of taxation is that all income should be taxable in one and only one jurisdiction. In a parallel manner, all expenses should be deductible in one jurisdiction either directly or indirectly through charge out payments. It is no doubt true that some G&A (including stewardship) factually relates to exempt foreign affiliate income and that in many cases that G&A expense cannot be charged out under Section 482 (in which case it should be fully deductible). Yet disallowing a deduction for G&A expenses that cannot be charged out means that such expenses are not deductible anywhere in the world even where all income is taxable somewhere in the world. The relevant G&A expenses moreover are typically for management services that reflect jobs the Congress should not want to discourage locating in the United States. Thus, a strong argument exists for permitting a full deduction of G&A expenses or at least for expanding cost-sharing to apply to G&A expenses.[38]

**IV. Conclusion**

So where does this leave us? In the end I think there are three key lessons. First, Congress should act to eliminate those parts of subpart F that lead to the current taxation of active foreign business income. Second, Congress should examine further whether exempting earnings stripping transactions from subpart F is necessary in the context of maintaining a subpart F regime that balances competitiveness concerns with minimizing tax incentives to invest abroad and that is reasonably consistent with those of other major countries. Finally, assuming substantial deferral planning is continued to be permitted, Congress should seriously consider moving to a territorial system to avoid substantial imbalances of funds abroad but should fully consider its impact on U.S. R&D activities, on U.S. exports, and on the tax treatment of G&A-type expenses in the United States. Because adopting such a territorial system would raise significant revenues, the costs of liberalizing subpart F as it applies to active businesses should be manageable and should leave additional revenues to consider other matters, including increased incentives for U.S. R&D. Properly done, the overall package could eliminate the distortions of the current deferral system and establish a system that from the perspective of the competitive-

[36] President's Advisory Panel on Fed. Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System 239–242 (2005).

[37] The Advisory Panel proposal would disallow that portion of G&A expenses that are not charged out to foreign subsidiaries allocable to exempt foreign affiliate income using an allocation scheme generally analogous to the worldwide interest allocation provision enacted as part of the 2004 Act. *Id.* at 241.

[38] Today our section 482 cost-sharing regulations only apply to intangible development costs. *See* Treas. Reg. § 1.482–7. Expanding it to include G&A expenses more generally would make sense, but only if other major foreign jurisdictions also accepted cost-sharing of these costs.

ness of U.S. multinationals would not be more burdensome than the systems of most major foreign countries.

Thank you for your attention and I look forward to taking any questions you may have.

Chairman CAMP. Thank you very much. Professor Graetz.

**STATEMENT OF MICHAEL J. GRAETZ, JUSTUS S. HOTCHKISS PROFESSOR OF LAW, YALE LAW SCHOOL, NEW HAVEN, CONNECTICUT**

Mr. GRAETZ. Thank you very much. I want to begin where the last panel left off, which is with the notion that it is no longer possible given the integration of the world economy to think about domestic tax reform and international tax reform as if they are two different subjects. Corporate income tax in the United States affects not only the competitiveness of U.S. companies abroad but also the attractiveness of the United States as a place for investment of both domestic and foreign capital.

When John Castellani, the president of the Business Roundtable, testified before this Subcommittee a month ago, he made the point that the U.S. corporate tax rate was the most important issue facing American companies, and I agree with him.

In my view, the most important corporate change that the Congress could make both to stimulate our own domestic economy and to increase the competitiveness of U.S. companies throughout the world would be to lower our corporate tax rate substantially. A 25-percent rate would put us in line where the OECD countries are now, but I think our goals should be lower than that. We should try to get the corporate rate down to 15 percent, the rate that is now applicable to capital gains and dividends. It would be good for the U.S. economy. It would diminish the payoff from corporate tax shelters and intercompany transfer pricing, and it would be good for America.

The $64 question I think is the one that Congressman Doggett put earlier, which is, given the financial shape of the U.S. Treasury, how do we replace the revenues that would cost? Given the fact that corporate tax receipts were about $300 billion last year, cutting the rate would be expensive. My answer to that is that we really ought to take seriously enacting a value-added tax or a similar tax on goods and services.

If we enacted such a tax, for example, at a 14—10 to 14 percent rate, that would allow us to pay for the corporate rate reduction. It would allow us to eliminate 150 million Americans from paying income taxes. It would allow us to get our individual tax rate down in the neighborhood of 20 and 25 percent, and it would keep the distribution of the tax burden about where it is today.

Compared to other OECD Nations, the United States is a low-tax country. However it is not a low-income tax country, so when people like the earlier panel talk about Singapore and Ireland, they talk about the low income tax rates, but all of those countries make up the revenue by a consumption tax, typically in the form of value-added tax. So, that kind of value-added tax reform would en-

hance our economic growth, basically simplify our tax system and maintain the same distribution of burdens that we now have.

The second point I want to make is that any domestic tax reform that we are going to undertake must fit well with international tax practices. While I found much to admire in the report of the President's panel on tax reform, their alternative to the income tax—what they call a growth and investment tax—is completely out of sync with international practices and, as they recognize, would require complete renegotiation of all of our income tax treaties and the General Agreement on Tariffs and Trade (GATT).

The idea that we are going to get a tax reform not only through this Congress and signed by the President but also through the World Trade Organization (WTO) seems to me hopelessly optimistic.

I don't mean to suggest that we can't make incremental improvements of the sort we have been talking about earlier to our international tax system without fundamental tax reform. My point is that the benefits to the U.S. economy will be quite small compared to the benefits of a fundamental restructuring of the U.S. tax system.

The third point I want to make, and this one seems obvious, but apparently, it is not. In evaluating either domestic U.S. tax or international tax reforms, the goal ought to be what is in the best interests, the well-being—the long term well-being—of the American people. That is the goal that we apply everywhere else in domestic and international policy, and we ought to apply it to international tax reform as well.

The Joint Committee pamphlet today describes that as a minority view. So, I think it is worth reconsidering.

On the question of territoriality in the few seconds remaining to me, let me say one thing. I believe the reason to go to territoriality instead of what we now have, which can be done on a revenue-neutral basis as has just been suggested, is that it eliminates the barrier to repatriation of earnings to the United States; and the current system now makes that expensive or—requires huge amounts of tax planning in order to make that possible.

As we have seen with the Homeland Investment Act (HIA) and the temporary exclusion of dividends, there is a major amount of earnings of U.S. companies that get trapped abroad that might repatriate to the United States if we did not have a residual tax on repatriations, and I think that is the reason to do it; that it would lower the cost of capital to U.S. businesses and improve our situation.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Graetz follows:]

**Statement of Michael J. Graetz, Justus S. Hotchkiss Professor of Law, Yale Law School, New Haven, Connecticut**

Mr. Chairman and Members of the Committee——

Thank you for inviting me to testify today on the subject of international tax reform. I want to begin my testimony with three basic observations.

First, it is no longer possible—given the integration of the world economy—to regard domestic tax reform and international tax reform as if they are two different subjects. When Congress last enacted fundamental tax reform—in 1986—the stock of cross boarder investment was less than 10% of the world's output. Today it equals

about one quarter of the world's output. The U.S. corporate tax affects U.S. companies doing business domestically, U.S.-headquartered firms doing business abroad and foreign-headquartered firms doing business here. It, therefore, affects the competitiveness of U.S. companies and the attractiveness of the United States as a place for investment of domestic and foreign capital.

When John Castellani, President of the Business Roundtable, testified here last month on the topic of tax reform generally, he said that the priority for U.S. corporations is to lower significantly the U.S. corporate tax rate. I agree that the U.S. corporate rate is a crucial issue for our nation's economy. After the 1986 tax reform, our corporate tax rate was one of the lowest in the world; today it is one of the highest. [See Figures 1 and 2.[1] In my view, the most important corporate tax change Congress could enact—both to stimulate our domestic economy and to increase the competitiveness of U.S. companies throughout the world—would be to lower our corporate tax rate substantially. Although a 25% rate would put us in line with most OECD nations, it is worth trying to get that rate down to 15%—the rate now applicable to dividends and capital gains—or to no more than 20%. Such a rate reduction would be very good for the U.S. economy. It also would allow much simplification of our rules for taxing international business income; for example, a 15% rate would greatly diminish the payoff from both corporate tax shelters—which frequently have international aspects—and intercompany transfer pricing that shifts U.S. income abroad while consuming great resources of the IRS and taxpayers alike.

But given the current financial condition of the federal government—with deficits as far as the eye can see—and the inevitable future demands for spending on retirement income, health care, and long-term care for an aging population, it is not possible to achieve this kind of corporate rate reduction without a major restructuring of our domestic tax system. Corporate tax receipts were $279 billion in FY2005, $303 billion in FY 2006, about 2.3% of our GDP. While some corporate base broadening is surely feasible, base broadening alone will not produce enough revenue to pay for the kind of rate reduction I am urging here. My first point, therefore, is simple but challenging: Lowering the corporate tax rate significantly—the priority for international competitiveness of the U.S. economy and for international tax reform—cannot happen without domestic tax reform.

In my view, the goal of such a tax reform should be to reduce our nation's reliance on the income tax and increase our reliance on consumption taxation. I have detailed elsewhere how enacting a value added tax (or a similar tax on goods and services) at a 10–14% rate would allow us to eliminate 150 million Americans from the income tax altogether by enacting an exemption of $100,000 (for married couples) and to lower the income tax rate for income above that level to 20–25%.[2] It would also permit the kind of corporate rate reduction, I am advocating here.

Compared to other OECD countries, the United States is a low tax country. As a percentage of GDP, our taxes are as low as Japan's and much lower than most European nations. [See Figure 3] But we are not a low *income* tax country. Our income taxes as a share of GDP are not lower than the average elsewhere. [See Figure 4.] The critical difference is that we rely much less than other OECD nations on consumption taxes. [See Figure 5.] The tax reform proposal I am advocating would shift that balance dramatically, making our consumption taxes comparable to those elsewhere and our income taxes much lower. [See Figures 5 and 6.] This would enhance our nation's economic growth and dramatically simplify our tax system while maintaining roughly the same distribution of tax burdens as current law.

Second, any major domestic tax reform must fit well with international tax practices. For example, while I found much to admire in the Report of the President's Panel on Tax Reform issued last November, a crucial weakness of its proposal for a consumption tax alternative to the income tax—its so-called "Growth and Investment Tax"—is that it does not mesh well with longstanding international practices. Indeed, adopting that proposal would require not only the votes of the Congress and the signature of the President, but also would require the U.S. to renegotiate all 86 of our bilateral Income Tax Treaties as well as the General Agreement on Trade and Tariffs (GATT). If the proposal had no other major shortcomings (which it does), it is so out of sync with our international tax and trade arrangements that it is unrealistic as a practical matter. The panel, in my view, also failed to take into ac-

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[1] Figure 2 illustrates only statutory corporate rates; other measures generally show similar patterns.

[2] See Michael J. Graetz, "100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System," Yale Law Journal, Vol. 112 pp. 261–310; Michael J. Graetz "A Fair and Balanced Tax Reform for the Twenty-first Century. *Toward Fundamental Tax Reform* (edited by Alan J. Auerbach and Kevin A. Hassett) (AEI Press, 2005). Low- and middle-income workers would be protected a tax increase by payroll tax offsets.

count the potential responses of other nations to the kind of major tax reform it was suggesting.

I do not mean to suggest that incremental improvements in our system for taxing international income cannot occur in the absence of fundamental tax reform. Some international tax reforms—such as moving to a territorial system—can be done independently of domestic tax reform on a revenue neutral basis. But in my view, the benefits for the American people of such changes will be quite small relative to the potential benefits achievable through a fundamental restructuring of our nation's domestic and international tax system.

Third, in evaluating either domestic or international tax reforms it is important to have the same goal in mind: improving the wellbeing of American citizens and residents. For too long, international tax reform has occurred in the context of a debate between two normative ideas—capital export neutrality and capital import neutrality—that both fail to ask the fundamental question: What will be the effects of the changes on the wellbeing of Americans?

Unfortunately and importantly, many policymakers longstanding understanding of the normative underpinnings of international tax policy is thoroughly unsatisfactory. I have made this point in detail elsewhere.[3] The essential problem is that at least since 1962, when Subpart F was enacted, the Treasury Department, the Joint Committee on Taxation, and most other policymakers have looked to capital export neutrality (CEN) and capital import neutrality (CIN or "competitiveness") as their guide to U.S. international tax policy. It is now well known that we cannot have both CEN and CIN simultaneously when there are differences in the tax base or tax rates between two countries. If our policy guideline is to compromise somewhere between CEN and CIN, that is no guideline at all. Such compromises make setting international tax policy free play; you can compromise anywhere. The fundamental questions we should be asking are "What policy is in the U.S.'s national interest?" What rules will best serve the long-term interests of the American people? These are the questions we normally ask about domestic tax policies and about other non-tax international policies, and these are the basic questions for international tax policy as well. There is no reason to depart here, as so many analysts do, by substituting worldwide economic efficiency norms.

The great difficulty, of course, is knowing what to do to improve the wellbeing of our citizens and residents. The essential problem is empirical uncertainty. As is so often the case with tax policies, it is very difficult to know with certainty the consequences of alternative policy decisions. Contested facts inevitably will play an important role. For example, does foreign expansion by U.S. multinationals reduce or expand American jobs? Although there is much concern about outsourcing U.S. jobs, the best evidence at the moment seems to be that foreign expansion by U.S. multinationals usually increases U.S. jobs. Nor do we know with certainty the extent to which capital used abroad replaces capital that would otherwise be deployed in the U.S. or, instead, is complementary to capital used in the U.S. Again, the best evidence seems to be that foreign investment is most often complementary to domestic investment. Nevertheless, we need to seek better information about these kinds of questions in order to make firm judgments about the effects of alternative policies on the welfare of the American people.

I should emphasize that seeking to advance the wellbeing of the American people does not, mean abandoning this nation's leading role in multinational organizations such as the OECD and WTO. Nor does it mean that we should always adopt policies advancing the competitiveness of U.S. multinationals. Advancing the competitive position of U.S. multinationals may or may not be the best course depending on the particular issue and circumstances.

In sum, my three basic points are these: (1) International tax reform and domestic tax reform are now inextricably linked, and the best way to improve the international competiveness of the U.S. economy is through a fundamental restructuring of our nation's tax system. (2) It would be a serious mistake to undertake a domestic tax reform that ignores international tax and trade arrangements. (3) The test for both domestic and international tax reforms should be whether they will improve the wellbeing of the American people. Let me know turn to discuss a few specific issues relating to the international taxation of business income.

*Taxing International Business Income*

Currently, the big debate in international tax policy is whether we should substitute for our foreign tax credit system—often referred to as a worldwide system—a system that exempts active business income earned abroad. More than half of

[3] Michael J. Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policy," Tax Law Review, Vol. 54, pp. 261–336 (2001).

OECD countries now exempt dividends paid from foreign subsidiaries. The origins of U.S. international tax policy demonstrate that our foreign tax credit was not put into the tax code to promote capital export neutrality. It was enacted in 1918 for mercantilist reasons. The policy of the U.S. then was to encourage U.S. companies to go abroad and trade. The limitation on the foreign tax credit, which was put into the law a few years later in 1921, was intended to protect U.S. taxation of U.S. source income.[4] An unlimited foreign tax credit would allow taxpayers to escape U.S. tax on U.S source income.

The key difficulty in international tax policy is that we have two national governments with legitimate claims to tax the same income: The country where the capital originates (the residence country) and the country where the income is earned (the source country). They must decide how to split the tax dollars between the two nations. The goal of multinational corporations, of course, is to pay taxes to neither.

It has long been the tax policy of the U.S. and of other industrialized nations to treat the prime claim between the two nations as the claim of the country where the income is earned—the source country—when the taxation of active business income is at issue. The primacy of source-based claims to income taxes on active business income has been a feature not only of the U.S. system, but of all OECD tax systems since the 1920's. The fundamental goal has been to avoid double taxation. If the source country taxes the business income, the residence country should not tax it again.

It is more difficult, however, to know how much to worry about low or even zero taxation by the source country. Should the United States, for example, be concerned if U.S. multinationals are avoiding taxes by stripping income out of source countries in Europe and elsewhere? This, of course, is the basic goal of much recent international tax planning involving the use of hybrid entities and the so-called check-the-box rules and the foreseeable effect of the new CFC look-through rules. Analysts who are predominately concerned with the potential for tax-induced capital flight abroad—those who urge policy based on capital export neutrality—will argue that the U.S. should act unilaterally to shore up the ability of foreign governments to prevent such tax reductions, for example, by tightening our Subpart F rules or even by eliminating the ability of U.S. multinationals to defer foreign-source income reinvested abroad.

My approach to this issue would take a different tack. My concern is that if U.S. policy encourages or readily facilitates the ability of U.S. companies to strip earnings without paying taxes to the country where the income is earned, foreign countries will respond by enacting rules that will allow their companies to strip earnings from the U.S. without paying tax. Our own experience with transfer pricing and our recent experience with efforts to restrict such earnings strippings demonstrates the difficulty of effective unilateral action by the source country. European nations will have even greater difficulties in protecting their corporate tax bases due to limitations imposed by the European treaties as interpreted by the European Court of Justice. The potential for an ongoing "race to the bottom" as each nation assesses the international "competitiveness" of its own multinationals and aids their avoidance of taxes abroad suggests great caution in enacting rules that facilitate tax avoidance abroad by U.S. multinationals.

However, given our system for taxing active business income, which concedes the primacy of source-based taxation, an exemption system and our foreign tax credit system with deferral generally available for active business income, are not terribly far apart. The two methods are very close, although they differ in certain important respects.[5] In my view, the major difference is that with an exemption system there would be little or no cost to U.S. multinationals in bringing earnings back to the United States. Under our foreign tax credit system, much tax planning occurs to avoid incremental U.S. income tax when money is brought back into the United States.

Thus, the crucial advantage of an exemption system is to eliminate the burden on the repatriation of foreign earnings to the United States and remove the tax barrier to investing here. As experience with the Homeland Investment Act has well demonstrated, there are substantial earnings of U.S. companies that have been trapped abroad which will return to the United States for either a small U.S. income tax or none at all. The key reason to move to an exemption system is to remove the tax barrier to repatriation, not simplification or international competitiveness. Removing this tax barrier would lower the cost of capital for U.S. companies

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[4] See Michael J. Graetz and Michal O'Hear, "The 'Original Intent' of U.S. International Income Taxation," Duke Law Journal, Vol. 46, pp 1022–1109, (1997).

[5] See Michael J. Graetz & Paul W. Oosterhuis, "Structuring an Exemption System for Foreign Income of U.S. Corporations," National Tax Journal, Vol. 44, pp 771–786 (2001).

and could do so without any substantial revenue loss. In my view, this would be a worthwhile improvement in U.S. tax policy, although, I have said, the key issue for the competitiveness of the U.S. economy both domestically and for U.S. multinationals operating throughout the world is a significantly lower corporate tax rate.

There are a number of important questions, however, that must be answered before moving to an exemption system. As is typically the case in tax policy, the devil is in the details. For example, there is the question to what extent expenses should be allocated between taxable U.S. income and non-taxable foreign income. A worldwide allocation of interest as under the 2004 legislation seems appropriate as the President's Panel suggested. The Joint Committee on Taxation has suggested that research and development expenses should also be allocated between domestic and foreign income. The President's Panel disagreed. I would support the President's Panel in this regard. Royalties will be taxed when paid to a U.S. parent under a dividend exemption system, and this should make the allocation of R & D to foreign income unnecessary. The Joint Committee on Taxation and the President's Panel also diverged on the treatment of general and administrative expenses. Again, I am inclined to think that the President's Panel came closer to the best answer. One option used abroad, which should be considered here, is not to allocate such expenses but to allow an exemption of only 90 or 95 percent of dividends.

There is also a question about how to treat exports. Should the current sales source rules for domestically manufactured products be retained? In my view, shifting from our current system to an exemption system does not itself demand revision of this rule, although such a shift would provide a good occasion to reassess its effectiveness.

Third, it is important to note that interest, rents, royalties, and other payments deductible abroad are not usually excluded in an exemption system. Exempting them from taxation here would mean that such payments are subject to tax nowhere, which clearly seems the wrong answer. On the other hand, under current law, foreign tax credit planning most often makes royalty income from abroad nontaxable. Many multinationals will no doubt push for continued exemption of royalty income. If we were to take that path, it would re-open the question whether to allocate research and development expenses. With both of these issues in play, assessing the impact of alternative rules on the level and types of research and development activities in the United States seems essential before reaching a final conclusion.

Fourth, with exemption, we would clearly have to maintain an equivalent to our current Subpart F for passive income. This means that there will be at least two categories of income: exempt income and income currently taxable subject to foreign tax credits. Congress should resist creating a third category of income that can be deferred and allowed foreign tax credits. With income either exempt or taxed currently subject to foreign tax credits, the question will inevitably occur regarding the proper scope of Subpart F, particularly with respect to "base company" income and other types of active business income, such as the income of financial services businesses.

Thus, moving to an exemption system for active business income does not allow the complete elimination of foreign tax credits. We will, for example, still have to maintain a foreign tax credit for taxes withheld abroad on payments of royalties and other income. An exemption system, however, should allow a single foreign tax credit limitation.

Finally, the question will arise whether dividend exemption should apply to pre-effective date income. Since the main reason for adopting an exemption system is to permit repatriations of income without imposing a U.S. tax burden, I am inclined to believe that the best answer to this question is yes, the exemption should apply to income earned before the date when the law changes. If Congress concludes otherwise, however, it would be much simpler to limit the exclusion to a specified percentage of dividends rather than attempt to determine whether dividends were from pre- or post-enactment earnings.

Before I conclude, I would like to illustrate once again the linkage between the level of corporate tax rates and fundamental issues of international taxation. In a recent paper, Harry Grubert of the Treasury Department and Rosanne Altshuler, who served as the staff economist for the President's Tax Reform Panel, have estimated that repealing deferral of all CFC business income would allow the corporate tax rate to be reduced to 28% on a revenue neutral basis. Personally, I do not think—given the rates of corporate tax around the world—that a 28% rate is low enough to permit the repeal of deferral without harming both the competitiveness of U.S. companies and the U.S. economy. But, if the corporate tax rate were lowered to 15%, as I have suggested should be our goal, repealing deferral would look very different. Current U.S. taxation of all foreign source business income at a 15% rate,

offset by appropriately limited credits for foreign taxes, would become a reasonable alternative worthy of careful consideration. And, as the Grubert-Altshuler paper suggests, repealing deferral might be one element to help finance the rate reduction. Current taxation of all income earned abroad, with a foreign tax credit up to the new U.S. 15% rate, would allow great simplification of our international income tax system in a context providing the economic advantages from restructuring our domestic tax system that I described earlier.

As I indicated at the beginning of this testimony, I do not believe that such a substantial rate reduction can be accomplished in the absence of a major restructuring of the U.S. tax system. Therefore, this option will no doubt have to wait until the Congress undertakes the broader task. Given the ongoing expansion of the individual AMT and the coming expiration in 2010 of the tax reductions enacted in the past several years, however, serious Congressional consideration of a major restructuring of our nation's tax system in the years ahead does not seem unrealistic.

Thank you for allowing me to make these observations here today. I will be happy to answer any questions.

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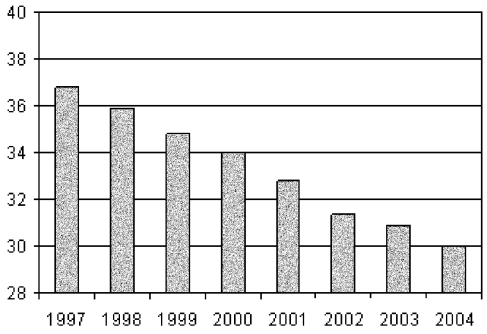
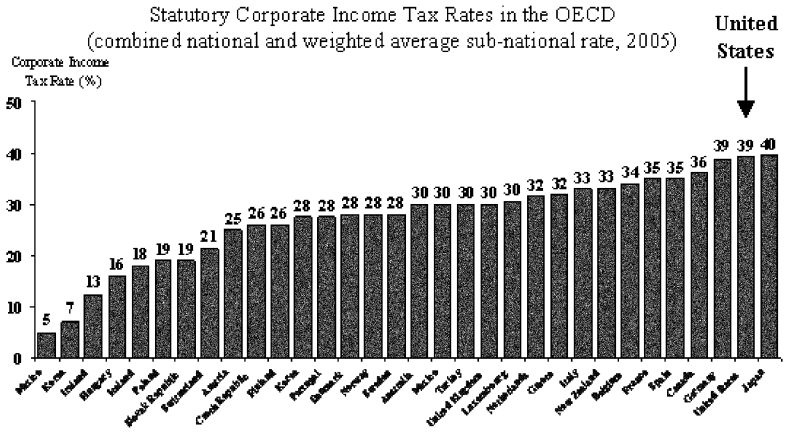
Figure 1
Corporate Tax Rates in the OECD Have Come Down



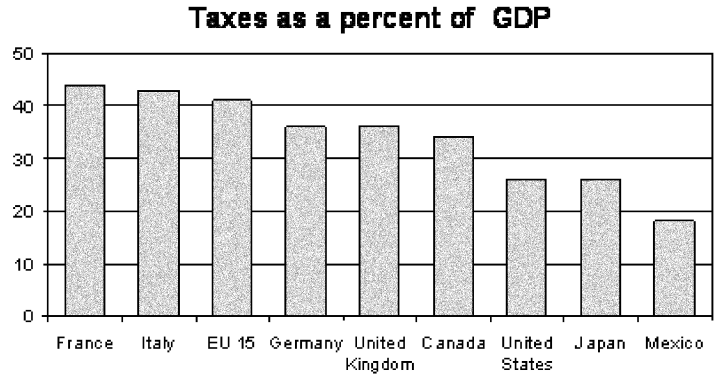

Source: Chris Edwards presentation before the President's Advisory Panel on Federal Tax Reform. Based on KPMG data.

Figure 2
But We Have One of the Highest Corporate Rates in the OECD




Source: OECD Data (2005).

Figure 3
We are a Low-tax Country




Source: OECD Revenue Statistics 18. Includes state and local taxes.

Figure 4
But Not a Low Income Tax Country

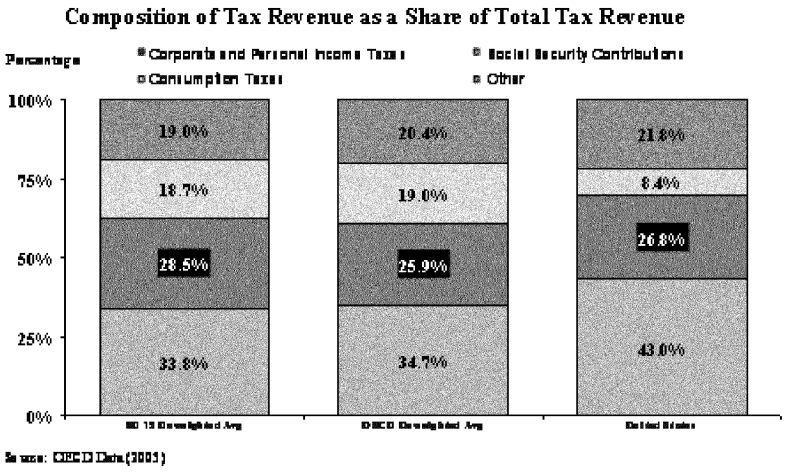
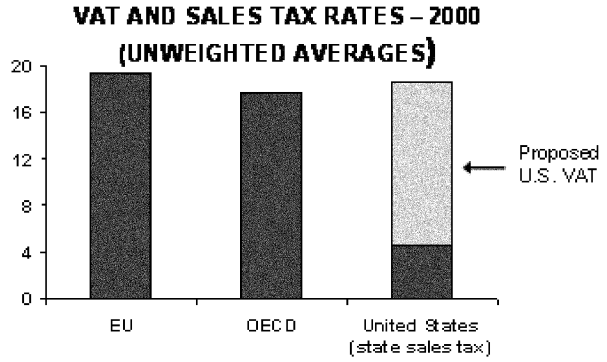
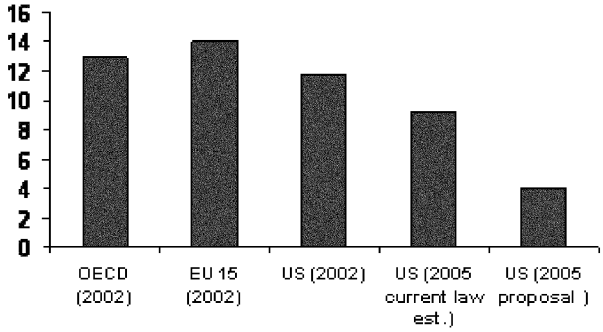



Figure 5
Consumption Taxes Around The World




Source: Consumption Tax Trends 2001 (OECD) Table 3.5; U.S. computations based on data from http://salestaxinstitute.com (visited 1/10/2002).

Figure 6
Income Tax Revenue As A Percent Of GDP




Source: OECD Revenue Statistics (2004, release 1); U.S. figures for 2005 are author's estimates.
Note: OECD reports U.S. revenue for 2003 as 10.9% of GDP.

Chairman CAMP. Thank you. Mr. Shay.

**STATEMENT OF STEPHEN E. SHAY, PARTNER, ROPES & GRAY, LLP, BOSTON, MASSACHUSETTS**

Mr. SHAY. Thank you, Mr. Chairman.

Our international tax rules are only one element of our overall system for taxing business income. As has been said by others on this panel, broader tax system design issues are more significant than the choice of whether you tax foreign income at a full rate or with exemption.

I agree that the primary focus of U.S. income tax policy should be how to raise revenue in a manner that improves the lives and living standards of our citizens and residents.

The manner in which we apply our rules should be guided by our traditional tax policy criteria of fairness, efficiency and administrability. There is a lack of consensus among the economists regarding what promotes efficiency in the home and global economy. I would take a commonsense practical approach which is to reduce the incentives to shift economic activity in response to differences in effective tax rates that exist under our current international tax rules.

Foreign income generally is treated more favorably than domestic income. Income earned through a foreign corporation may be deferred from U.S. tax without regard to whether it is subject to a foreign tax. Taxpayers that operate in high-tax jurisdictions can use foreign tax credits against other foreign income, which provides an incentive to earn low foreign taxed income.

Income from export sales is treated as foreign source income for our tax credit limitation purposes, though almost no country in the world will tax that income at source. Yet U.S. tax on this export income is being allowed to be offset by excess foreign tax credits. Cross-crediting effectively allows the burdens of other foreign countries high foreign taxes to be offset against U.S. tax. The 2004 Act, referred to as a reform act, expanded the scope for cross-crediting.

Our current international tax rules distort economic decisions, create incentives to structure business activity in a manner that takes advantage of lower foreign effective tax rates, and, the most disturbing in my view, is to undermine the confidence of U.S. citizens and residents that the American tax system is fair.

I did say at the outset that I am an international tax practitioner, and I have been doing it for 25 years.

The President's Advisory Panel on Tax Reform has suggested possible reforms. We have been speaking about exemption. The President's Advisory Panel on Tax Reform's Simplified Income Tax Proposal would exempt foreign business income as part of its reform plan. The proposal would not require any minimum level of foreign tax or even a subject-to-tax requirement, which is commonly found in other territorial systems as a condition for the exemption. I would contrast this with the proposal made in 1993 of the outgoing Department of the Treasury by the first Bush Administration.

Under the President's Advisory Panel's exemption proposal, any kind of non-Subpart F income that can be earned outside the United States at a lower rate would benefit from exemption, and the amounts could be repatriated. That would expand the scope of people who would be interested in creating a foreign operation. In my experience today, if a client comes in asking if they can set up in a foreign operation, I say, if you can't reinvest your money usefully outside the United States, deferral is not for you. Exemption would expand the scope for deferral of U.S. tax.

I am going to skip over some other technical problems with the Advisory Pale exemption proposal, but expense allocation is by far the most important. The rules in there have defects that need to be addressed.

Based on the foregoing, I do not believe that the benefits from an exemption system, even if redesigned, are likely to be superior to a reform that is based on full taxation of foreign income with an appropriately limited tax credit.

One approach would be to tax United States shareholders and U.S.-controlled foreign corporations currently on their share of the income. There would be a number of technical changes that would be necessary to make this workable, but these rules have a history of use since 1962 and could be implemented without substantial redesign. The current foreign tax credit mechanism should be improved by repeal of the sales-source rule and other rationalizations of source rules that today permit foreign taxes to offset U.S. tax and U.S. economic activity.

Full taxation of foreign income would eliminate the lock-in-effect of a separate tax on repatriation as would exemption. They are the same in that regard. In addition, full taxation would reduce the scope of effective tax rate differentials.

Finally, full current taxation of a foreign income is a fairer system. United States persons would be taxed on their income more equally and the advantages would not fall to those who operate principally outside the United States.

I respectfully encourage the Subcommittee to consider international reform proposals that would take in this broader perspective. This perspective has been characterized today as a minority view of fairness and a superficial view on full taxation, but I beg to differ with Dr. Hubbard on these points. Thank you.

[The prepared statement of Mr. Shay follows:]

**Statement of Stephen E. Shay, Partner, Ropes & Gray LLP, Boston, Massachusetts**

Mr. Chairman and Members of the Committee:

My name is Stephen Shay. I am a partner in the law firm Ropes & Gray in Boston. I specialize in U.S. international income taxation and was formerly an International Tax Counsel for the Department of the Treasury.[1] With the Chairman's permission, I would like to submit my testimony for the record and summarize my principal observations in oral remarks.

The subject of today's hearing is the impact of international tax reform on U.S. competitiveness. I will direct my testimony and remarks at the U.S. tax rules relating to the taxation of foreign business income earned by U.S. persons.

**The Context of International Tax Reform**

I respectfully submit that the formulation of the topic for today's hearing may be too narrow. Indeed, it almost suggests that U.S. international tax rules, as opposed, for example, to overall governmental fiscal policies, are a major factor in U.S. competitiveness. While some tax practitioners and teachers may believe that differences in systems for taxing foreign business income have great economic significance, it is clear that the effect of these rules on economic growth is vastly less important than sound overall fiscal and monetary policies.[2]

Our international tax rules are only one element of our overall system for taxing business income. The international rules govern how the United States taxes income earned by a resident in one country from economic activity in another country. The principal design decisions made with respect to our overall tax rules affect the design of our international rules. Thus, decisions to tax income and to impose a separate tax on corporate income are key design elements of the tax base on which our international tax rules are constructed. These overall tax system design decisions are far more significant than the choice between full taxation of foreign business income and exemption of foreign business income.

In this testimony, I will limit my remarks to possible reforms of our current system for taxing foreign business income. I will assume for purposes of this discussion that the income tax will be retained as a material element of the U.S. tax system and that the United States will continue to impose tax on corporate income.[3]

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[1] I have attached a copy of my biography to this testimony. The views I am expressing are my personal views and do not represent the views of either my clients or my law firm.

[2] In recent years there generally has been a vast overstatement in public policy debates of the role of tax rule design in our economic affairs. Recent academic work has questioned whether ideally designed income and consumption tax bases are materially different in what they tax. *See* Reuven S. Avi-Yonah, *Risk, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT,* 105 Tax Notes (TA)1651 (Dec. 20, 2004). The revenue estimates for shifting to a dividend exemption system also suggest that the revenue gain or loss from such a switch would be modest.

[3] The President's Advisory Panel on Federal Tax Reform has proposed two tax reform plans; the "Simplified Income Tax Plan" and the "Growth and Investment Tax Plan." President's Advisory Panel on Federal Tax Reform, Simple, Fair & Pro-Growth: Proposals to Fix America's Tax System, Report of the President's Advisory Panel on Federal Tax Reform (Nov. 2005), *available at* http://www.taxreformpanel.gov/final-report/ [hereinafter the "President's Advisory Panel Report"]. The Growth and Investment Tax Plan would move the federal tax system much closer to a consumption tax system,. However, it retains some taxation of capital income. The plan would permit business to expense most new investments with the consequence that the tax on business income would be very limited. I will not discuss the Growth and Investment Tax Plan in my testimony.

Continued

The specialized nature of the international tax rules and the importance of these rules to a concentrated and important business constituency, our multinational business community, has resulted in an emphasis on our international tax rules that obscures the fact that foreign business income is as much a part of the U.S. tax base as domestic income. Taxing foreign business income differently from domestic income should be justified under the same criteria that we apply to justify more or less favorable taxation of income from any other activity.

**Objectives of International Tax Reform**

As observed above, international tax policy is but a subset of a country's overall tax policy. The objectives of U.S. international tax policies must be understood in the framework of overall U.S. tax policy objectives.

The principal function of the U.S. income tax system is to collect revenue.[4] The manner in which the system serves this role is guided by traditional policy criteria of fairness, efficiency and administrability.[5] In applying the criteria, we start with the understanding that the correct measure of U.S. welfare is the well being of individual U.S. citizens and residents. Accordingly, the primary focus of U.S. income tax policy should be how to raise revenue in a manner that improves the lives and living standards of those individuals.[6]

President's Advisory Panel Report, at xiii.

The policy criteria of fairness, efficiency, and administrability conflict to some degree. The fairness criterion is based on the accepted notion that a fair tax should take account of taxpayers ability to pay. There is no *a priori* reason for excluding foreign income from the analysis of a person's ability to pay, whether the income is earned directly by individuals or indirectly through foreign activities of U.S. or foreign corporations. If U.S. taxation of foreign business income is lower than on domestic business income, U.S. persons who do not earn foreign business income will be subject to heavier taxation solely because of where their business is located. This would violate the ability-to-pay norm. To justify relief from U.S. tax on foreign business income, there should be an identifiable benefit to individual U.S. citizens and residents.

Allowing a credit for foreign income taxes, or exempting active foreign business income, is not fully consistent with the ability to pay criterion. Such relief from double taxation may be justified, however, by the expectation that the benefits of international trade will accrue to individual U.S. citizens and residents. This justification does not extend, however, to treating foreign income more favorably than necessary to eliminate double taxation.

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While there have been proposals to "scrap" the income tax and replace it with a consumption tax, these proposals are impractical. The problems of transition and the rates that would be required to achieve revenue neutrality, as well as other problems, are extremely daunting. *See* A.B.A. Tax Sec. Tax Systems Task Force, *A Comprehensive Analysis of Current Consumption Tax Proposals* (1997). The international implications of eliminating the income tax could be substantial. See Stephen E. Shay and Victoria Summers, *Selected International Aspects of Fundamental Tax Reform Proposals,* 51 University of Miami Law Review 1029 (1997).

Professor Michael Graetz has proposed enactinga broad federal consumption tax in addition to the existing income tax. *See* Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Income Tax System,* 112 Yale L.J. 261 (2002); *see* also Reuven S. Avi-Yonah, *Risk, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT,* 105 Tax Notes (TA)1651 (Dec. 20, 2004). While proposals to reduce the U.S. reliance on the income tax by adopting some form of value-added tax may have some merit, I do not comment on them in this testimony.

[4] A secondary role of the U.S. income tax system is to serve as a means for appropriating public funds. While I will not discuss the topic of "tax expenditures" as such, the deferral of income earned through controlled foreign corporations is the largest international item in the President's 2005 "normal tax method" tax expenditure budget.

[5] U.S. Treas. Dep't, Tax Reform for Fairness, Simplicity and Economic Growth 13–19 (1984).

[6] See Michael J. Graetz, *The David Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies,* 54 Tax Law Rev. 261, 284 (2001). The fact that a policy may advance global welfare on the one hand, or the interests of U.S. corporations or other U.S. business entities over foreign business entities on the other hand, should not be determinative unless there is a reasonable basis to conclude that individual U.S. citizens and residents will realize a benefit in relation to overall costs. The President's Advisory Panel on Federal Tax Reform articulated a standard for evaluating proposals that favor one activity over another that should be applied to evaluate proposals to tax foreign income more or less favorably than domestic income:

Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs, and can lead to an inefficient use of resources. A rational system would favor a broad tax base, providing special tax treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers.

Generally, the efficiency criterion supports rules that distort economic decisions as little as possible. There is a lack of consensus among economists regarding what tax rules are "efficient" in an open economy setting. A common sense approach is to seek to reduce the tax incentives to shift economic activity in response to differences in effective tax rates. In other words, from an overall U.S. perspective, the effective tax rate on an item of foreign income, taking into account foreign taxes, should not be materially lower than the effective rate on domestic income. Relief should not be given to higher foreign effective tax rates.

There is a general consensus that while taxpayers with international income are generally sophisticated and able to deal with complex provisions, a system whose complexity fosters wasteful tax planning and which is difficult to administer by tax authorities is undesirable.

Our current rules fail these criteria of fairness, efficiency and administrability.

**Current U.S. International Tax Rules**

The current U.S. tax rules allow the U.S. taxation of active foreign business income earned through a foreign corporation to be deferred until repatriated as a dividend. While arguably a measure to mitigate double taxation, the deferral privilege is allowed without regard to whether a foreign tax is imposed on the income. Accordingly, if low-taxed foreign income may be earned in a foreign corporation and reinvested in foreign businesses, U.S. tax may be postponed and a taxpayer may achieve low overall effective rates of taxation. The 2002 effective tax rate on net income of U.S. companies' foreign manufacturing subsidiaries was approximately 16%.

Taxpayers that earn high-tax foreign income can use excess foreign tax credits against other low-taxed foreign income. The effect of this cross-crediting is to provide an incentive to a taxpayer with excess foreign tax credits to earn low-taxed foreign income and to credit the foreign tax against U.S. tax on this income. This effectively shifts the burden of a foreign country's high taxes to the United States. Excess foreign tax credits even can be used to offset U.S. tax on income from export sales that is treated as foreign-source income for U.S. tax purposes (though in most countries income from such sales would be considered domestic income).

With proper planning, U.S. income tax rules may be applied to achieve, with respect to low-taxed foreign income, effective tax rates comparable to those possible under a territorial tax system that exempts foreign income. However, high foreign income taxes also may be cross-credited against U.S. tax on other "foreign" income in the same foreign tax credit limitation category. The latter benefit may be contrasted with an exemption system that generally does not allow a benefit for high foreign taxes. The current U.S. rules, while complex, represent the best of all worlds for U.S. multinational taxpayers. It is difficult to conclude that the U.S. rules for taxing international business income unfairly disadvantage U.S. multinational taxpayers.

The current U.S. tax rules encourage the following tax planning:

- Reducing foreign taxes below the U.S. effective rate,
- Using transfer pricing to shift additional income to foreign corporations subject to low effective foreign tax rates,
- Deferring U.S. tax on foreign income subject to a low effective foreign income tax rate,
- Accelerating repatriation of foreign taxes to cross-credit excess foreign taxes against U.S. tax on low-taxed foreign income in the same foreign tax credit limitation category, and
- Repatriating low-taxed income when excess foreign taxes are available to offset U.S. tax (or when homeland dividend effective tax rates of 5.25% are available).

In practice, the current U.S. system of worldwide taxation with deferral of U.S. tax on foreign corporate business income, while complex, can be managed to achieve low effective rates of tax on foreign income. If U.S. multinationals earn income through active business operations carried on by foreign corporations through low-effective-tax rate structures, the U.S. multinationals generally pay no residual U.S. tax until they either receive dividends or sell their shares. When this effective tax reduction is combined with other features of the U.S. international tax regime (i.e., the ability to cross-credit excess foreign taxes against royalty income and export sales income), the overall effect can be more generous than an exemption system.

To summarize, our current international tax rules (i) are complex, (ii) do not raise revenue (indeed, they permit erosion of the U.S. tax base), and (iii) provide incentives to locate business activity outside the United States. They offer substantially unfettered planning opportunities to aggressively reduce foreign taxes and to shift

income to entities with low-effective tax rates. This is a "paradox of defects."[7] The immediate effect is to distort economic decisions and create incentives to structure business activity in a manner that takes advantage of low or reduced effective tax rates. The more disturbing longer term effect is to undermine confidence of U.S. citizens and residents that the American tax system is fair.

There are two major reform alternatives for taxing foreign income: some form of exemption of foreign income and an expansion of current taxation of foreign income. While in theory it is possible to design an exemption system that would be an improvement over the current U.S. system, exemption is a second best alternative to full current taxation.

**The President's Advisory Panel's Proposed Exemption of Foreign Business Income**

The major approaches by which the tax system of a country (the "residence country") taxes income earned by its residents in a foreign country ("foreign-source income") are a worldwide system and an exemption, or territorial, system. The President's Advisory Panel on Federal Tax Reform's Simplified Income Tax Proposal would exempt foreign business income as part of its reform plan.

The President's Advisory Panel's exemption proposal would exempt a domestic corporation from tax on dividends from a foreign corporation attributable to certain active business income.[8] The proposal also would exempt gains on the sale of stock of a foreign subsidiary.[9] The proposal would not require any minimum level of foreign tax (or even a subject-to-tax requirement), as a condition for exemption. In other words, the proposal would extend exemption to foreign earnings of a controlled foreign corporation so long as they are not subject to current taxation under the anti-deferral rules of Subpart F of the Code, even if the foreign earnings were subject to no foreign tax on the income.

The President's Advisory Panel exemption proposal would tax foreign royalties (and interest), would tax export income and would retain current taxation and allowance of a foreign tax credit for Subpart F income. Significantly, the proposal would exempt pre-effective date earnings.

The principal attraction of a foreign exemption proposal is that it eliminates the tax on repatriation of earnings under a deferral regime. It nevertheless leaves other problems of current law unsolved. Significantly, the incentive for shifting activity to low-tax locations would increase.

One consequence of not having any subject to tax requirement would be that income earned in low-effective tax entities would be eligible for exemption without being includible in U.S. income under Subpart F.[10] While it also is possible today to defer U.S. tax on such income, the benefit of deferral is limited if the U.S. parent corporation needs to use the CFC's earnings in the United States because the earnings will be taxed upon repatriation as a dividend. Consequently, deferral is of the most benefit to U.S. multinational corporations that have other non-U.S. businesses in which to invest the deferred earnings. Under the President's Advisory Panel's exemption proposal, however, any kind of non-Subpart F income that can be earned at a lower tax rate outside the United States could benefit from exemption *and* repatriation.[11] An exemption regime like that in the President's Advisory Panel proposal would materially expand the U.S. businesses that could realize tax benefits from earning low-taxed foreign business income.[12]

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[7] Staff of Joint Comm. On Tax'n, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS–02–05, 189 (Jan. 27, 2005).

[8] President's Advisory Panel Report at 124–25.

[9] Id. at 240.

[10] Under Subpart F, income from manufacturing products, income from performing services in the CFC's country of incorporation, active financing and active insurance income are not included in Subpart F income without regard to the level of foreign tax. In addition, there are a variety of techniques that may be used under current law to avoid the reach of the Subpart F rules.

[11] For example, a U.S. manufacturer only sells products to U.S. customers could benefit from manufacturing the product abroad in a foreign low-effective tax rate structure, selling the product to unrelated customers in the United States and repatriating the exempt profits to the U.S. parent as exempt earnings. This would not trigger Subpart F and would qualify for exemption under the proposal.

[12] The 1993 Treasury Department Interim Report on International Tax Reform proposed a modified exemption system that either would apply an effective rate test, so that only foreign income that bears a certain level of foreign tax would be exempt, or alternatively, and arguably more simply, only would exempt income from certain designated countries. U.S. Treas. Dep't,International Tax Reform: An Interim Report, 1993 Tax Notes Today 15–30 (Jan. 22, 1993).

Under an exemption system without a subject to tax test, expenses must be allocated between exempt income and income not eligible for exemption. The stakes of such allocation for taxpayers and the Government would be higher than under present law and the likelihood of controversies in this difficult area would materially increase. Under the present system of deferral, the allocation of deductions to foreign income adversely affects a taxpayer only if the expenses allocated to foreign income reduce the taxpayer's foreign tax credit limitation to the point that foreign taxes are not allowed as a credit. In other words, the issue has practical significance for taxpayers with excess foreign tax credits. In contrast, under an exemption system, every dollar of expense allocated to exempt earnings is a lost deduction. Thus, the issue will affect *every* taxpayer with exempt foreign income. It may be predicted that there will be increased controversies between taxpayers and the Service over the allocation of expenses.

If, however, expense allocation rules are adopted that do not properly allocate expense to foreign income, there is substantial potential for revenue loss. Thus, for example, the President's Advisory Panel's proposal would allocate R&D expense entirely to taxable income. This apparently is based on the theory that all returns to intangibles are in the form of royalties, which would be fully taxed under the President's Advisory Panel's proposal. The premise, however, may not be correct. If a U.S. company holding a valuable intangible sets up a sales branch in a low-effective rate location and the sale is made through the branch, under U.S. principles, no royalty is charged back to the United States. The income embedded in the sales price that is attributable to the intangible developed in the United States would be exempted without the loss of any associated expense deductions.

The Joint Committee on Taxation's exemption proposal is more detailed than the President's proposal and anticipates this issue by requiring that the full range of rules dealing with inter-company transactions be applied to transactions between a foreign branch and the domestic corporation of which it is a part.[13]] While not specified in the proposal, this implies that an intra-company royalty would be charged to the branch by the domestic corporation's home office. This would achieve the correct result. A second best alternative to the Joint Committee Proposal would be to allocate the R&D expense to the foreign income. These approaches would involve transfer pricing or expense allocation determinations and illustrate the difficult issues involved in designing an exemption system that does not expose the United States to a loss of its domestic tax base. The dollars in the R&D allocation issue alone are very substantial and will be (indeed, I suspect have been) the subject of intense behind the scenes lobbying.

The potential for U.S. tax base erosion is materially reduced if the exemption is restricted to foreign business income that is subject to an effective rate of foreign tax that is at or reasonably close to the U.S. tax rate. Of course, if this approach were adopted, one should ask why a more effective reform proposal could not be adopted, namely current taxation of foreign business income.

Although an exemption system provides no direct benefit for foreign operations in countries with effective tax rates equal to or higher than the U.S. rate, absent a "subject to tax" condition, it offers greater opportunities for reducing high foreign taxes through tax planning techniques that shift income from a high tax to a lower-tax foreign country. If there is lower taxation of foreign income, taxpayers with foreign operations have an incentive to shift higher taxed U.S. (and foreign) income to lower taxed foreign operations.[14] While one of the advantages of an exemption system is that it permits repatriation of future exempted foreign business earnings without further U.S. tax, thereby avoiding the inefficiencies of the "lock-in" affect of a deferral regime, exemption also places pressure on transfer pricing rules that they are not designed to sustain.[15] The only way to limit tax avoidance through transfer pricing is to minimize effective tax rate differentials.[16]

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[13] Staff of Joint Comm. On Tax'n, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS–02–05, 191 (Jan. 27, 2005).

[14] The principal objection to a territorial system is that it creates a bias in favor of investment in foreign operations. In the worst case, this bias causes a foreign investment to be preferred even though the U.S. investment has a higher before-tax rate of return and is, therefore, economically superior.

[15] None of the current international proposals (including Chairman Thomas's) would provide for tax-free repatriation of future earnings eligible for deferral. The Homeland Reinvestment Act would allow a reduced tax on currently deferred income—much in the nature of a tax amnesty.

[16] It may be anticipated that the proponents will argue that benefits for operations in lower tax foreign countries will generate greater purchases of U.S. goods because U.S. multinationals will buy from their U.S. affiliates and suppliers. Although this is a claim that deserves some scrutiny, at best this is an assertion that reduced taxation of the operations of U.S. multi-

Continued

An exemption proposal that does not have a material subject to tax condition requires continued application of the Subpart F rules as an anti-avoidance device. Moreover, as proposed, by the President's Advisory Panel, the foreign tax credit would continue to be allowed with respect to income currently taxed under Subpart F. The foreign tax credit would continue to be subject to a limitation. This structure in essence creates two taxing regimes for foreign income, one for Subpart F income and another for income eligible for exemption. These rules are complicated and this approach would substantially undermine any simplicity gains from the proposal.

Based on the foregoing analysis, I do not believe that the benefits from an exemption system, even if re-designed, are likely to be superior to a reform that is based on full taxation of foreign income with an appropriately limited foreign tax credit.

**Reform of the Current U.S. Tax System of Worldwide Taxation with Deferral**

There are two basic approaches to taxing the income of a controlled foreign corporation currently in the hands of a U.S. shareholder. One approach would be to adopt pass-through treatment for earnings.[17] This would have the benefit of maintaining the character and source of the income and subjecting the income to the applicable tax rate of the shareholder. It would permit current pass-through of losses. While conduit taxation may be optimal as a theoretical matter, it would constitute a dramatic and difficult change from current law.

Current taxation of U.S. shareholders under an expansion of Subpart F, while second best to a conduit approach, would be a substantial improvement over current law and probably would enjoy broader support. One approach would be to tax 10% or greater U.S. shareholders by vote in a controlled foreign corporation (more than 50% owned, by vote or value, directly or indirectly, under constructive ownership rules, by 10% U.S. shareholders by vote), to be currently taxed on their share of the controlled foreign corporation's income. There are a number of changes that should be considered to the specifics of these rules, but they have a history of use since 1962 and could be implemented without substantial re-design.

Less than 10% U.S. shareholders and 10% U.S. shareholders in foreign corporations that did not have a controlling U.S. shareholder group would be taxed under current law rules on distributions when received. The passive foreign investment company (PFIC) rules would continue to apply, however, the PFIC asset test should be eliminated and the passive income threshold should be reduced to 50% from 75%. The PFIC taxing rules, a deferred tax with an interest charge, qualified electing fund pass-through taxation, or mark-to-market taxation, would apply to a U.S. shareholder in a PFIC.

The current foreign tax credit mechanism should be improved by repeal of the sales source rule and other rationalization of source rules combined with improvements to the expense allocation rules. Changes to limit cross-crediting of foreign taxes also should be adopted.

In the context of other base broadening reforms, the changes just described would move toward equalizing the taxation of foreign and domestic income. This approach would assist U.S. businesses that export from the United States or compete against foreign imports as well as businesses that operate abroad.

Full taxation of foreign income would eliminate the lock-in effect of a separate tax on repatriation of earnings. In addition, it would reduce scope for transfer pricing income shifting induced by effective tax rate differentials. While expense allocations would be necessary for purposes of the foreign tax credit limitation, the stakes would depend on whether U.S. business tax rates are reduced below foreign tax rates—which today generally are in the range of 30% in major trading partner countries.

Finally, full current taxation is a fairer system. U.S. persons would be taxed on their income more equally and the advantage would not fall to those who operate outside the United States. I respectfully encourage the Subcommittee to consider international tax reform proposals that will improve the well-being of all U.S. citi-

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nationals in low-taxed foreign countries indirectly encourages U.S. exports and economic activity. It is unclear how much support there is for this claim, but no proposal to expand deferral would limit its scope to businesses with foreign operations that purchase goods from the United States.

[17] I and my co-authors, Professors Robert J. Peroni and J. Clifton Fleming, Jr., have outlined a proposal for a broad repeal of deferral. Essentially, our proposal would apply mandatory pass-through treatment to 10% or greater shareholders in foreign corporations. Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income,* 52 SMU L. Rev. 455 (1999); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Deferral: Consider Ending It Instead of Expanding It,* 86 Tax Notes 837 (2000).

zens and residents, including workers, farmers and small business men and women, and not just those who work or invest in the multinational sector.

I would be pleased to answer any questions the Committee might have.

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Mr. Shay is not appearing on behalf of any client or organization.

**Practice**

Stephen E. Shay is a tax partner with Ropes & Gray in Boston, Massachusetts. Stephen has extensive experience in the international tax area, advising clients that include large and medium-sized multinational companies, financial institutions, and global investors on issues such as foreign tax credits, deferral of U.S. taxation, foreign currency gains and losses, withholding taxes and financial product issues. Stephen regularly advises clients on transfer pricing issues and has successfully resolved numerous transfer pricing controversies with the IRS. Stephen also works with Ropes & Gray's Private Client Group advising high net worth clients on cross-border income tax planning. Before joining Ropes & Gray in 1987, Stephen was the International Tax Counsel for the United States Department of the Treasury.

**Honors and Awards**

- *Chambers Global: The World's Leading Lawyers*
- *Chambers USA,* Leading Individuals (Tax)
- *Best Lawyers in America*
- Euromoney Legal Media, Expert Guide to the *Best of the Best* 2004
- Euromoney's Guide to *The World's Leading Tax Advisers*

**Professional & Civic Activities**

Stephen is a Lecturer in Law at the Harvard Law School teaching a course on international aspects of U.S. income taxation. Stephen was the Jacquin D. Bierman Visiting Lecturer in Taxation at Yale Law School in 2004. Stephen has served as Associate Reporter for the American Law Institute's Federal Income Tax Project on Income Tax Treaties with Reporters David R. Tillinghast and Professor Hugh Ault. He also has served as Chairman of the Tax Section's Committee on Foreign Activities of U.S. Taxpayers of the American Bar Association.

Stephen authored Revisiting U.S. Anti-Deferral Rules, 74 Taxes 1042 (1996), and has co-authored Selected International Aspects of Fundamental Tax Reform Proposals, 51 University of Miami Law Review 1029 (1997) (with Victoria P. Summers), Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 SMU Law Review 455 (1999) (with Robert J. Peroni and J. Clifton Fleming, Jr.), Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income, 5 Florida Tax Review 299 (2001) (with J. Clifton Fleming, Jr. and Robert J. Peroni), and The David R. Tillinghast Lecture "What's Source Got to Do With It?" Source Rules and U.S. International Taxation, 56 Tax Law Review 81 (2003) (with Robert J. Peroni and J. Clifton Fleming, Jr.). Stephen also has testified before Congress on international tax policy issues.

Stephen is a member of the Board of Directors of Outdoor Explorations, a community-based not-for-profit organization that promotes inclusion for people with and without disabilities through shared outdoor adventure and service.

**Memberships**

- American Bar Association, Tax Section
- American Law Institute
- International Bar Association
- International Fiscal Association

**Bar Admissions**

- New York
- Massachusetts

**Education**

- 1976, J.D., Columbia Law School
- 1972, B.A., Wesleyan University

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Chairman CAMP. Thank you. I appreciate all of your testimony. Thank you for coming before the Subcommittee. I think the main thing that we are trying to get at is this dramatically changing

world that we are in, and the fact that other countries are changing their tax systems. I guess I would like to, if you could—each of you, summarize briefly what best could we do immediately to address our international competitiveness and our ability to continue to have U.S. companies compete abroad?

Mr. OOSTERHUIS. I would say, considering a territorial exemption system would be the best thing you could do. I do not think it would take that long to put together a package, but you do need to consider some of the things I talked about earlier in terms of its impact on technology companies and on exporters. Assuming you put together an appropriate package, you may well be able to be able to improve the competitiveness of U.S. companies.

I agree with Michael that our current system with deferral does not discourage people from investing abroad, in my experience. My experience may be a little different than Steve's in practice, but companies do invest abroad taking full advantage of the fact that we do not currently tax their earnings, even if they are not taxed abroad. So, moving to an exemption system with territoriality isn't, in my judgment, going to significantly increase the incentives to move investment from the United States to abroad.

Rather, what it is going to do is what Michael was saying, which is free up those moneys abroad to be invested efficiently rather than distort it.

There was a survey that Marty Sullivan did for Tax Notes, and it indicated the amount of deferred income by 38 major multinationals in 1997 was $9 billion. By 2003, it was $46 billion a year. I would imagine by now, it is substantially higher than that. That is a lot of distortion. That is the reason why HIA was an important priority of the 2004 Congress and it will come back again in a few years if you do not think about it.

Chairman CAMP. Professor Graetz.

Mr. GRAETZ. On a purely incremental basis, I want to agree with Paul. I think that one should take seriously the idea of eliminating the barrier to repatriations by going to some form of territorial system. However, as I said, I really think that to be serious about the competitiveness of our economy, what we really need to do is find a way to get our rates down and move to a consumption tax. That is not an incremental change, but it is, I think, where we need to go.

Chairman CAMP. Thank you.

Mr. Shay.

Mr. SHAY. Mr. Chairman, I was at the Treasury Department and was international tax counsel in 1986. My views haven't changed, and some people would say that is a problem, but I think we should broaden the base, lower rates and not treat income differently.

Chairman CAMP. Thank you. Mr. McNulty may inquire.

Mr. MCNULTY. Thank you, Mr. Chairman. Some of you may have heard the question I posed to the first panel, and I think Professor Graetz said it better than I could. That was that whatever we do with regard to tax policy ought to be based upon what is in the best interest of the American people. Certainly, hundreds of billions of dollars in deficits every year and exploding national debt that has exceeded $8.3 trillion is not in the best interest of the peo-

ple of the United States of America. So, my question would be, how would the proposals which you are making today make that situation better.

Mr. GRAETZ. Mr. McNulty, if I could start, I think that tax reform ought to be proceeding on at least a revenue neutral basis in a way that will increase economic growth, and therefore will, in fact, increase revenues. So, I think, to the extent that we can move away from relying on corporate taxes, relying as heavily as we do on income taxes, taking advantage of our status as a low-tax Nation and taxing more consumption and less income, but doing it in a way that is consistent with international practices that would help. Trying to invent some new tax, as the President's panel did, taking American exceptionalism as the norm, seems to me the wrong way to go.

So, I think what we ought to do is look at a tax system like Ireland's where they have substantial value-added taxes, which could help close the deficit and at the same time be used to reduce income taxes on companies and eliminate income taxes on most Americans—the vast majority of Americans.

I think in our current fiscal situation and looking as you and Dr. Hubbard did, forward to an aging society and the demands for retirement income, long term care and health insurance, we are going to have to think seriously about a restructuring of our tax system. I know that it is a difficult thing to do, but I really think that is where we have to go.

Mr. OOSTERHUIS. I could not agree more. Heavily relying on the income tax in a global economy is a very difficult thing to do. There are just too many ways that income and activity can be moved to maximize competitiveness and it is necessary that companies do that because their foreign competitors are doing that. So, the more weight you put solely on the income tax, the more pressure you put on trying to capture that revenue with proposals like Steve's, to tax our multinationals on their global income, even though our foreign competitors do not do that with their multinationals.

The way to take the pressure off that is to get rates down, and the way to get rates down is to move to some sort of consumption tax to make up the difference.

Mr. SHAY. It seems to be clear that there is an advantage to achieving lower income tax rates, but, the only way I can see to get there consistent with the direction of your question is to broaden the base. In the event that you do not find additional sources of revenue in the value-added tax, if you are going to put the kind of reliance we do on the income tax, there is going to be a greater, not lesser, premium on not having holes in the bathtub.

What I do for a living is plan to take advantage of effective tax rate differences. You can see the fruits of that in the financial footnotes of companies. Further, nonpublic companies also do that by organizing themselves to take advantage of tax rate differences. It just seems to me common sense that you want to move in a direction that is going to reduce those rate differentials. Full taxation of foreign income moves in that direction.

Now it is different from other countries, so if you are going to do that, I do think you need to try to broaden the base and lower

the tax rate. If you can keep rates within the range of other major countries, that is where we want to be; I think it is where we have to be.

Mr. MCNULTY. Thank you all. Thank you, Mr. Chairman.

Chairman CAMP. Thank you. Mr. Chocola, may inquire.

Mr. CHOCOLA. Thank you, Mr. Chairman. Thank you all for being here. There has been a lot of talk today about moving from a world wide to a territorial system. Mr. Linder is not here unfortunately, but as you know, he likes the fair tax, and I think it is great in theory but it seems to me a lot of transitional issues we would have to work through. What kind of transitional issues would there be from going from a worldwide to a territorial system that would be beneficial or non-beneficial?

Mr. GRAETZ. The key question is whether you would apply an exemption for dividends back to the United States with respect to earnings that have been accumulated under current law or whether you would limit the dividend exclusion to earnings after the date of enactment.

I would argue that one should apply it to all dividends, and if that creates too big a hole, then exempt only a percentage of the payments. Trying to trace whether dividends are out of post-enactment or preenactment earnings, is simply going to create opportunities for planning and complexities and undermine what I believe is the major goal of going to a territorial system, which is to allow the tax free movement of capital that is now trapped offshore back to the United States.

Mr. OOSTERHUIS. If I could add two other transitional issues; one is, there are companies that have excess foreign tax credits which would lose their value once you move to a territorial system, in all likelihood. I think you need to provide some transitional measure for them to obtain value from those foreign tax credits through during a transition period, or else you unfairly, in effect, tax companies who just happen to be in a circumstance where they have excess credits in the years leading up to the switch.

The other are companies that have had losses outside the United States and thus have what we call overall foreign losses, which normally would be recaptured out of exempt income in the future under territoriality. A lot of those losses were created by our overreaching interest allocation rules that you addressed prospectively starting in 2009, I believe, in the 2004 Act, but that still apply. So, requiring recapture in effect as a result of those overreaching rules is something I think ought to be addressed in the transition.

Mr. CHOCOLA. We haven't had a lot of discussion this morning about a value-added tax. Would you guys like to discuss how that would impact competitiveness of U.S. companies, especially a border adjustable value-added tax?

Mr. GRAETZ. I will begin. I have been advocating a value-added tax for a number of years now as a way to reduce income taxes in the United States. I know that my economist friends on the prior panel would tell you that border adjustability does not matter because currency rates will adjust—I think, instantaneously is their position, so that it does not matter whether you tax production here or consumption here.

I really disagree with that. Border adjustability is the rule throughout the world with one or two very small exceptions in some of the former Soviet states. I think, as I have said earlier, what we ought to be seeking to do is to get to a tax system that meshes well with other tax systems. If you have to distort either consumption or the place of production, which is the choice between having border adjustability or not, all of the evidence I have seen suggest that you are much safer in distorting consumption rather than distorting the location of production and keeping these questions of competitiveness coming.

So, in my view, I think we ought to move to a tax which is border adjustable. Just to complete the point, that means that under the current WTO, that a standard credit method value-added tax will work. Mr. Linder's national sales tax will work on that ground, whatever it's other problems might or might not be. So, I think border adjustability is the way to go. A tax that is sometimes known as the X tax, sometimes known as the flat tax, sometimes known in the President's panel as the growth and investment tax, which give a deduction for wages is not allowed to be border adjustable under our current trade agreements. So, I think those are not terribly practical ideas.

Mr. CHOCOLA. Would anybody else like to? Thank you, Mr. Chairman.

Chairman CAMP. Thank you. The gentleman from Texas, Mr. Doggett, may inquire.

Mr. DOGGETT. Professor, do you believe that it is possible or wise to eliminate all taxes, all U.S. taxes on corporate foreign source income without substantially reducing the corporate tax on domestic corporate income?

Mr. GRAETZ. Well, I think the way you put the question I do not think that would be wise. That is why I am arguing that what we ought to do is lower the corporate tax rate generally. I do want to come back to Paul's earlier point, which is that moving to an exemption system compared to our current system where we defer earning abroad and give tax credits is not a system that lowers the overall rate of tax. It can be done in a revenue neutral way, and would not lower the overall rate of tax on foreign earnings. It would keep the overall tax the same. It changes, to a large extent, some of the rules about how and who would pay those taxes. However, it would not lower those taxes.

By talking about an exemption system compared to the current system, we are not necessarily talking about a reduction of tax on foreign earnings abroad. We are talking about a different system that would raise roughly the same amount of revenue. At least that is what Paul and I have been talking about.

Mr. DOGGETT. To have revenue neutrality on the corporate tax changes you would make at home and abroad, you recommend a value-added tax.

Mr. GRAETZ. I do. I would like to say that I think that the value-added tax not only allows you to do tremendous good in terms of our international competitiveness, in terms of our domestic investment and investment abroad, but it also allows you to eliminate from the tax rolls 150 million people at a reasonable rate. I have a chart at the end of my paper that shows you that the rate

would be no higher than that around the rest of the world. It creates a huge amount of revenue to lower income tax on individuals as well as on corporations.

Mr. DOGGETT. Mr. Shay, lower rates was one of the three things that you talked about as objectives, but you also said that if rates were to be lowered, we need to broaden the base, and we need to not treat different kinds of income differently. What steps would you take to broaden the base and to ensure that different types of income are not treated differently?

Mr. SHAY. Well, the focus of this hearing has been on foreign income, and so the proposal I would make in that context is to include foreign income currently with a foreign tax credit. After foreign tax credit, taking into account what the effective rate would be, the objective is to keep effective rates the same to minimize tax motivated decisionmaking.

Mr. DOGGETT. You discussed cross crediting. Do you feel that way the laws on tax credits are currently written is too generous?

Mr. SHAY. I think the most problematic aspect of our current foreign tax credit rules are source rules that effectively treat as foreign income, income that is never going to be taxed by a foreign jurisdiction. Therefore, you are not really serving the purpose of the foreign tax credit, which is to avoid or relieve double taxation, but what you are doing, in essence, is allowing high foreign taxes to offset what should be viewed as a U.S. tax base, so yes, that would be a reform.

Mr. DOGGETT. Like me, you have heard five witnesses say that the only way we can be competitive is to eliminate taxes on foreign source income. I note that in passing that the Congressional Budget Office has found that our effective corporate tax rate is at about the median of the Group of seven (G–7) versus the statutory rate on something like equity financed investments in machinery. Do you believe, Mr. Shay, we can have taxation of foreign source income and still be competitive?

Mr. SHAY. Well, I think we are using a very fair narrow definition of competitive. That is, what is the tax on a multinational, or a taxpayer who has international income. I really think that earlier in this hearing, we have heard a more appropriate and broader view. What is going to make us competitive as a country, is not what the particular tax rate is. We are not Ireland. We have to educate our people. We have a retirement crisis. That retirement crisis, by the way, is shared in Europe. It troubles me a little bit to not look out ahead and see they have already maxed out on value-added tax. Where is their future revenue going to come from? It is going to come from the income tax or it is going to come from somewhere.

So, the notion that this is all static and we should not be building a system for the future that is stable, that can sustain, if necessary, higher rates, strikes me as risky.

Mr. DOGGETT. Thank you.

Chairman CAMP. Thank you. The gentleman from Florida, Mr. Foley, may inquire.

Mr. FOLEY. Thank you. I would like you to expound on that thought, because it seems like we frustrate both the American economy and the consumer with our tax policy. It is confusing,

complicated; we are getting ready to adjust rates on estates taxes, capital gains taxes, and incentives for various activities. When I look at what Mr. Linder is proposing which really becomes a consumption tax, it seems to me those who want to spend more pay more. There is an embedded cost, I would assume, in this Blackberry. When you purchase one, isn't there on the price tag the tax consequence?

So, given that fact a consumption tax, give me an idea what you think would be the most logical progression from the complication we have today to a tax that not only frees the economy but increases competitiveness.

Mr. SHAY. I think you broaden the base in as many ways as you can. It may be heresy, but it is not clear to me why we need to have a differential tax rate on capital gains. It is not clear to me why we need to have favorable taxation of foreign income. We have major tax expenditures that have been viewed as sacred cows. As long as they are there, we are going to have difficulty achieving the objectives we need.

To be competitive, we need to broaden the base, and lower rates. If we need to go to the value-added tax, the one thing the panel needs to recognize is that the value-added tax is a tax on consumers. While it is possible to make it progressive, there are not great models for doing that. So, we need to think about how we integrate it with the State retail sales taxes.

It is not clear to me that it is efficient to have a retail sales tax in the State and a Federal value-added tax. I think there would be pressure to try to integrate those and there should be if we go in that direction. The core decision that I think Mike was alluding to is we have to decide what is the balance. Europe has achieved a balance of a much higher value-added taxation in relation to income taxation. We have the other end of that balance. If we are going to shift, we need to understand that it reduces our ability to achieve progressive objectives. We need to incorporate that into our overall thinking.

As I say in my testimony, there is tension between fairness, which is what progressivity is aimed at, and efficiency, which would imply broadening and possibly increasing the ratio of consumption taxation to income taxation and get masterability. I think there is a way to meld all of those, but it involves difficult choices. I do not see the difficult choice being made with respect to foreign income. I do not think exemption is the best way to get there.

Mr. FOLEY. Your thoughts.

Mr. GRAETZ. I really am interested in Steve's comments, because he said he was there in 1986. I guess everybody is claiming their prior experience. I was at the Treasury in 1990 to 1992 and in 1969 to 1972, so I was there twice. However, the world has changed since 1986. In 1986, international transactions were less than 10 percent of the global economy. Today they are more than a quarter of the global economy. We really do have to change our thinking. I think we have to change it in fundamental ways, and I think that we should moving toward a sales tax, a tax on consumption, which is what a value-added tax is, all it is there a lot of misunderstanding about it. People think it is French. In fact, it was invented by Thomas Adams in 1929 in the United States in

New Haven, Connecticut, I might add; but it is a U.S. idea and all it is is a sales tax with withholding. Instead of relying on the retailer to pay the whole amount, we require the wholesaler to withhold some of that sales tax and the manufacturer to withhold some of it, but it is not a multiple tax on different levels. So, I think that is what we ought to be thinking about.

Mr. FOLEY. Well, it also seems like you capture more of the economy. Right now, the underground economy is never captured. If they do not pay income taxes or capital gains taxes, then they are not going to be paying any tax. Whereas consumption does, in fact, capture every level of the economy.

Mr. GRAETZ. I think there are many advantages to it. The advantage of compliance of relying on more than one tax, that is the ability to collect at low rates on multiple tax bases is a great advantage in terms of making sure that you collect the tax. The more eggs you put in one basket in this economy, the less you are going to collect.

Chairman CAMP. Thank you. The gentlewoman from Pennsylvania, Ms. Hart, may inquire.

Ms. HART. Thank you, Mr. Chairman. I want to follow up on some of Mr. Chocola's line of questioning. As he was asking his question, I was reading my notes from a meeting we had back home. I am from Pittsburgh, and I had the opportunity to meet with a number of the senior tax people in my larger manufacturing companies about this issue. They sent me out of the room with a whole lot of questions and some suggestions. One was that they all announced to me that they do prefer the territorial tax structure because they do want to be able to make their decisions about where they locate their manufacturing facilities based on what is better for their company and what is better for their customers. In some cases, they are going to want to locate the manufacturing facility in the Far East because that is where their customers are.

But in a significant number of the cases, they would prefer to locate their facilities here in the United States, but when they look at their balance sheet, it is not making a lot of sense to them.

What I would like you to do for me, and I am not sure if any of you are very heavily schooled in the difference as far as the tax decisions for a manufacturer. I expect that you are, I would guess, especially.

Mr. Oosterhuis, I want to start with you. Can you help me as far as the analysis of a territorial tax, if that is going to make a big difference as far as some of these decision these folks make, they tell me it will. What is your experience?

Mr. OOSTERHUIS. To be honest my, experience is that it will make a marginal difference, not a big difference, because today manufacturing income—if you have a plant, whether it is in Germany or Singapore or Ireland, the income from that is not subject to current U.S. tax. It is only subject to U.S. tax if you bring those earnings back to the United States in the form of a dividend.

Ms. HART. Before you go on, I am presuming that they are going to want to repatriate.

Mr. OOSTERHUIS. Right. Well, that is where the rub is because for years, the inability to bring money back was not a problem for most multi-nationals. The amount of income relative to the growth

outside of the United States was modest, and so the funds could be reinvested. What has happened over the past 10 years is the amount of earnings that people—that companies have from their facilities outside the United States, has grown very substantially. That puts a lot more pressure on the utilization of those funds and therefore, a lot more pressure on being able to put those funds back to use them efficiently in the United States.

So, I do think that is one of the main reasons why we should consider territorial. Not that it will necessarily lead people in the future to make decisions to invest abroad that they otherwise would not have made, but rather, that it will free them up with respect to their existing investment to utilize the funds most efficiently, which may actually discourage them from investing in the newest plant abroad and build it back in the United States, because they can get the money back here to build it.

Ms. HART. That is obviously what a lot of them expressed as far as a concern. Mr. Shay.

Mr. SHAY. Look, the companies are going to want the flexibility that territoriality offers. That just makes sense. Implicit in your question was what would increase the likelihood that they would invest in the United States. It presumably would be greater depreciation, exactly what Dr. Barrett was saying earlier, more benefits for investment in the United States.

Well, how do you fund those benefits, and do you fund them by exempting foreign income? There is a circle here that needs to be completed. Part of the premise that I have is, look, I think the companies are very important productive part of our economy. They are my clients. However, the perspective that you have to have to take is what is in the best interest of the United States and what is going to maximize economic activity here in relation to the world? That is the question. The question is does exemption get you there?

Ms. HART. Thank you. Did you have a comment?

Mr. GRAETZ. I would just like to comment on something that Mr. Shay said earlier that is related to these questions, and that is, the suggestion that we would somehow be better off by taxing all foreign income currently. If you go back, we have never taxed foreign active business income currently in the United States, nor has any other OECD country ever taxed all foreign income currently when it is active business income. The idea that if, in 1918, when the foreign tax credit came into the Code, we had taxed income currently, that looking backward we would be better off if we had not had all the U.S. investment abroad that we have had during the interval, just seems incorrect to me.

It seems to me that one has to be careful when one talks about base broadening, not to talk about base broadening in a way that will make things worse in terms of the economic benefits to the U.S. people.

Ms. HART. I see my time has expired. Thank you, Mr. Chairman.

Chairman CAMP. The gentleman from Illinois, Mr. Weller, may inquire.

Mr. WELLER. Thank you, Mr. Chairman. I commend you for conducting this hearing today. I am sorry I missed part of it. I

would like to ask our panelists here, the folks I represent back home, when they look at the Tax Code, they think it is complicated, they all hear the stories about jobs going offshore. They believe that the Tax Code has something to do with it. As many business decisionmakers have shared with me, the Tax Code does influence business decisionmaking, particularly in the area of investment. One of the areas they raise, of course, is how we depreciate assets, as we look at the capital purchases and how they impact investment in the United States.

Ninety-six percent of the globe's population is outside our borders, 4 percent is inside our borders. Obviously, we want to produce products over here in the United States and sell them outside our own territories and serve that market.

I was wondering, could each of you share your perspective on how our current corporate Tax Code as we treat capital assets from the standpoint of depreciation—how do you believe that affects business decisionmaking on investing particularly in production from manufacturing and other capabilities to serve the international market, producing the product here, how that behavior is influenced.

Mr. Oosterhuis, do you want to go first?

Mr. OOSTERHUIS. I will go first. It is very dependent on which kind of industry, which kind of company you are talking about. The semiconductor manufacturers that Dr. Barrett represents are very capital intensive and make investments in physical assets, tangible property assets, so for them depreciation is very important in their location decisions. I have no doubt about that. There are other industries, the software industry, for example, where there are a lot of high paying jobs, but where depreciation is not particularly relevant at all because other than the computers that their employees use, their tangible assets are not that substantial. Most of their investments are in intangible development costs, software development type activities.

So, I think you are absolutely right that focussing on our depreciation rules can be very important to selected sectors of the economy, but to industries like pharmaceuticals and software, it is not all that important.

Mr. WELLER. How about those who make cars and bulldozers?

Mr. OOSTERHUIS. Certainly for cars and bulldozers it would be, sure, absolutely.

Mr. GRAETZ. While I do not disagree with anything Paul has said, I just want to make an additional observation, and that is throughout the history of the United States, going back actually to the Depression, we have changed depreciation laws to stimulate investment and had investment tax credits to stimulate investment in 1954, 1962, 1971 and on and on.

We could go through a list. The best evidence that I have seen is that those changes have affected mostly the timing of investment rather than the overall level of investment. To my mind, there is a trade off. We saw it in the 1986 Act. We have seen it over a long period of time between whether you have low rates and relatively higher depreciation, or whether you have faster depreciation and higher tax rates. I think in the current economy, we really ought to focus on getting the rates down, and then the depreciation allow-

ances won't matter nearly so much as they do with high rates. Rather than singling out, as this earlier conversation suggests those capital intensive industries for a tax break, we should spread the tax break more evenly throughout the economy through low rates.

Mr. WELLER. Was part of the reason, though, if people move the timing of their purchase—if they fast forward it, is it because those, whether it was bonus depreciation that was in the Bush tax cut, or some of the various investment tax credits, was it because of the temporary nature of that. Had they been permanent provisions of the Tax Code would the behavior been different?

Mr. GRAETZ. Well, Mr. Weller, as you know well, the fat lady never sings in tax policy. I do not know what the meaning of "permanent" is in tax policy. We have tax legislation constantly. The investment tax credit is a great example. It was put in on a permanent basis, then it was repealed permanently, then it was put back in and then it was taken back off. So, I think that companies are well aware, especially in a climate like the current fiscal climate, where we really do have to believe that we are going to be looking for revenues ahead, that a depreciation break today may well be gone tomorrow even if it is labeled permanent.

Chairman CAMP. Mr. Shays, if you could answer briefly, because the time has expired.

Mr. SHAY. The whole thrust of the 1986 Act was to try and equalize the taxation of capital and non-capital intensive businesses by pushing rates down. That is the advantage. Depreciation always turns. That is why once it is gone, you are paying full tax on it. So, lower tax rates tends to be a better long-term answer.

Chairman CAMP. All right. Thank you. The gentlewoman from Ohio, Ms. Tubbs-Jones may inquire.

Ms. JONES. Thank you, Mr. Chairman. Gentlemen, good morning. I want to start with Mr. Shay. Mr. Shay, you were talking about the 1986 tax changes. If you had a looking glass looking forward, what would you have done differently, what would you have suggested that we would have done differently with regard to taxes?

Mr. SHAY. Preserve the base broadening better. It really has been largely eroded since then. Maybe this isn't fully responsive to your question, but I think every time——

Ms. JONES. My feelings will not be hurt. It happens.

Mr. SHAY. I think every time we have tried to put in benefits and preferences, whether it is capital gains preferences, whether it is accelerated depreciation, it is the government trying to guess right. I think the whole thrust of the approach I would propose is let's try and get as close to economic depreciation, as broad a base as we can, lower tax rates, and not have the government policy be the one that is dictating where the investment is made.

I beg to differ slightly with my colleague, Professor Graetz. The U.S. financial industry was subject to full current taxation from 1986 to 1997. They persuaded this Congress to change that with the advent of the active finance exception to Subpart F. I am not aware that there is really strong data that they became a second rate citizen during that period.

Ms. JONES. Okay. I am giving you time. What else would you suggest that we should be doing. It is still your time.

Mr. SHAY. Well, I think actually I would just stop there.

Ms. JONES. He is so stunned that I am giving him this much time. He is at a loss of words. I am kidding, Mr. Shay. Go ahead.

Mr. SHAY. No, really, that is the way I would respond.

Ms. JONES. In the State of Ohio since 2001, we have lost 186,000 jobs, in the city of Cleveland alone, we lost 60,000 jobs. I want to come off of you for a moment, Mr. Shay. Professor Graetz, what would you suggest we might do in terms of taxing authority to help return some of those jobs to the United States, because, of course, most of those went overseas somewhere for lower labor rates, and so forth, and so forth, et cetera.

Mr. GRAETZ. It is true that we do lose some jobs to overseas competition, especially where lower——

Ms. JONES. Some jobs, Professor Graetz, come on now.

Mr. GRAETZ. The best evidence about overseas investment that I have seen is that in the aggregate overseas investment increases U.S. jobs because it creates jobs at home in order to supply the growth abroad. I do however understand what you are saying about Ohio, and I think it is an important question and it is certainly true that this is very important for certain localities. I would say that I think the best thing we could do is to try and get the rates on investment in Ohio down. One way to do that is to lower our corporate tax rates and our tax rates on capital investments.

The difficulty—which is the difficulty we keep bumping back into, is that we are going to have to tax something else if we are not going to tax that kind of income, unless we believe that the economic growth will be enough to pay for it, which I am skeptical of.

So, I think that this relates to your earlier question to Mr. Shay, I think the big difference looking backward 20 years is that in 1986, we decided to continue the sole reliance of the United States Federal Government on income taxes rather than consumption taxes. We broadened the base and lowered the rates. What happened in the 20 years since is the rate has gone up and the base has gotten narrower, and that will happen again. I think we just have to spread out our way of raising taxes and include a consumption tax in the mix.

Ms. JONES. So, you will not accuse Democrats of raising taxes and doubling taxes in order to reach this outcome that you are proposing?

Mr. GRAETZ. I have to say I think there are occasions in which taxes have to be raised. I am not a person who has ever accused anybody of anything.

Ms. JONES. Say it again so my colleagues on the other side can hear.

Mr. GRAETZ. There are occasions when taxes need to go up. I am clear about that.

I think there are those occasions, but the question is in order to raise the revenue you need to finance the government, you are going to have—how can you do that in a way that is fair and most conducive to economic growth and less burdensome to U.S. citizens? There, I think, we are in the wrong place in relying as heav-

ily as we do on the income tax and on taxes on capital investments, both domestically and throughout the world.

Ms. JONES. Thank you, Mr. Chairman.

Chairman CAMP. Thank you. I want to thank this panel for your testimony, and I appreciate the Members for attending this hearing.

At this time the Select Revenue Measures Subcommittee is adjourned.

[Whereupon, at 1:39 p.m., the Subcommittee was adjourned.]

[Submissions for the record follow:]

**Statement of Alliance for Competitive Taxation**

**INTRODUCTION**

The Alliance for Competitive Taxation ("ACT") is a group of companies with diverse industry representation organized to promote independent academic research on the economic effects of U.S. corporate income taxation and to disseminate the findings to policymakers and the public. ACT member companies are listed at the end of this statement.

The Alliance's Research Director is Dr. Glenn Hubbard, Dean of Columbia Business School and former Chairman of the President's Council of Economic Advisers. Under Dr. Hubbard's direction, the Alliance has commissioned a program of research by highly respected economists. To date, ACT has sponsored five research papers on the following topics: [1]

- A history of corporate income taxation in European Union and G–7 countries over the last two decades and an analysis of the relationship between corporate tax rates and tax revenues, by **Michael Devereux** at the University of Warwick.
- A simulation of the economic effects of federal corporate income tax reform proposals using a dynamic, general equilibrium model of the U.S. economy, by **Dale Jorgenson** at Harvard University.
- The effect of corporate tax rates on wages across OECD countries, by **Kevin Hassett** and **Aparna Mathur** at the American Enterprise Institute.
- An assessment of the cost of complying with the U.S. corporate income tax and how tax reform may affect those costs, by **Joel Slemrod** of the University of Michigan.
- An examination of how corporate taxation affects investment, economic growth, risk-taking, and innovation, by **Kenneth Judd** at Stanford University.

The results of ACT's research program are summarized in the following section of this statement.

**SUMMARY OF RESEARCH**

**Corporate income is subject to double taxation.** Investments made by corporations are subject to tax at both the corporate and the individual shareholder level. By contrast, investments made through other forms of jointly-owned businesses—partnerships, limited liability companies, and small business "S" corporations—are taxed just once on the individual income tax returns of the owners on a flow-through basis. As a result, $100 of corporate income distributed to shareholders bears a maximum federal income tax of $44.75 while $100 of income earned by a partnership bears a maximum tax of $35.

**U.S. Taxation of Business income, 2006: Corporation versus Partnership**

[Corporation and business owner in top federal income tax brackets; 100% dividend payout]

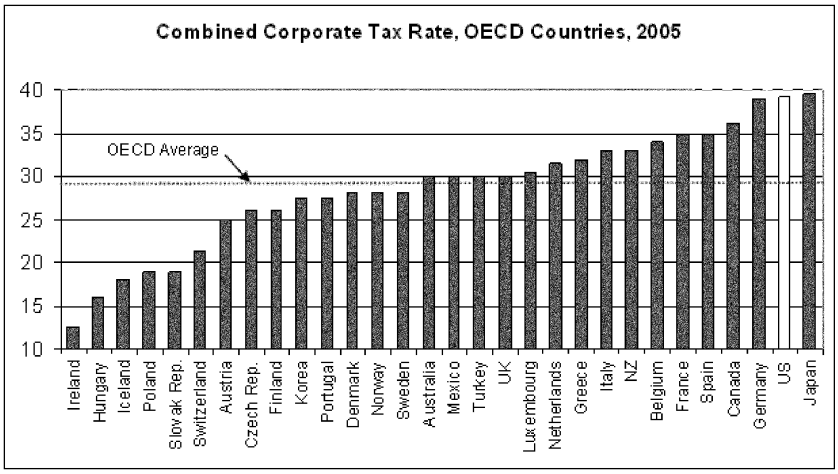
| Item | Corporation | Partnership |
|---|---|---|
| Business income | $100.00 | $100.00 |
| Corporate income tax at 35% (federal) | $35.00 | $0 |

[1] All ACT research papers are available at www.competitivetaxation.org.

| Item | Corporation | Partnership |
|---|---|---|
| Net business income | $65.00 | $100.00 |
| Owner's income tax | | |
| Individual income tax on dividend at 15% | $9.75 | $0 |
| Individual tax on business income at 35% | $0 | $35.00 |
| Combined corporate and individual income tax rate | $44.75 | $35.00 |
| Net income after federal and individual income tax | $55.25 | $65.00 |

**Non-corporate business income has increased rapidly and has exceeded corporate income since 1998.** To avoid double taxation, many businesses that can operate without access to public capital markets organize as a legal entity taxed on a flow-through basis (e.g., a partnership or small business "S" corporation). According to the most recent available data, business income earned by flow-through entities has exceeded that earned by regular corporations since 1998. In 2002, the most recent year for which IRS data is available, regular corporations accounted for less than one-third of business income.

**Once competitive, today's combined corporate income tax rate in the United States is over 10 percentage points higher than the OECD average.** The combined top federal, state and local corporate tax rate (39.3%) is second highest (after Japan) among the 30 OECD countries, and 10.7 percentage points greater than the OECD average.[2] Even in the high social spending Scandinavian countries—Sweden, Denmark and Norway—the combined corporate income tax rate (28%) is more than 11 percentage points below the U.S. rate.




**The double taxation of corporations hinders capital formation and economic efficiency.** The corporate tax discourages investment in the corporate sector and distorts financial decisions—favoring high debt levels and low dividends. The economic drag of the corporate income tax is quite high relative to revenues raised. Harvard professor Martin Feldstein observes that "the differential taxation of profits in the corporate sector—drives capital out of the corporate sector and into other activities, particularly into foreign investment and real estate (both owner-occupied and rental property)."[3] A recent study by the Joint Committee on Taxation found a cut in the corporate income tax rate would increase long-term economic growth by more than other equal revenue tax cut proposals examined (i.e., a cut in individual income tax rates and an increase in the personal exemption) due to increased

[2] Organization for Economic Cooperation and Development, http://www.oecd.org/dataoecd/26/56/33717459.xls (data accessed May 22, 2006).

[3] Martin A. Feldstein, "The Effect of Taxes on Efficiency and Growth," *Tax Notes* (May 8, 2006), p. 684.

capital formation at a lower corporate rate.[4] According to new research by Harvard Prof. Dale Jorgenson, relieving the double taxation of corporate income by taxing corporate assets like non-corporate assets would result in a welfare gain of $1.1 trillion.[5]

**The costs to the economy of the corporate income tax are higher than commonly recognized.** The economic efficiency costs of the corporate income tax are even larger than commonly recognized when the following three central features of the modern, technologically-advanced economy are taken into account: (1) the role of patents, know-how, and other sources of imperfect market competition; (2) risk; and (3) technological change. In a recent paper, Kenneth Judd at the Hoover Institution finds that, "The case for reducing, if not eliminating, the corporate income tax is already strong, and made stronger when we include those features which make our economy a modern and technologically advanced one."[6]

**International experience shows high corporate income tax rates do not translate into high corporate tax revenues.** Using tax information from 20 OECD countries over the last 40 years, the University of Warwick's Michael Devereux finds that while the average corporate tax rate has fallen, the level of corporation tax revenues has risen as a proportion of GDP.[7] Possible explanations are that high corporate tax rates make home country investment less attractive, push business formation into non-corporate legal entities (e.g., partnerships), and create an incentive for companies to report profits as earned abroad. The United States is a case in point—it has the second-highest combined (federal, state, and local) corporate tax rate among the 30 OECD member countries and the fourth-lowest corporate revenue yield as a percentage of GDP (based on 2003 data).

**In a global economy, the burden of the corporate income tax increasingly falls on workers.** In the 1960s, the burden of the corporate income tax was thought to lower the return on capital and thus primarily burden investors. However, with fewer impediments to cross-border investment, shareholders can seek higher returns abroad, leaving the corporate tax burden on less mobile factors, such as labor. In 2005, U.S. investors put three times as much money into international mutual funds as domestic funds.[8] Based on data for 70 countries over 22 years, Kevin Hassett and Aparna Mathur at the American Enterprise Institute find that higher corporate tax rates lead to lower wages, with a one percent increase in corporate tax rates associated with a 0.7 to 0.9 percent drop in wage rates. In general, countries with high corporate tax rates tend to have lower wage rates, a finding that is stronger for the OECD countries.[9]

**Over the last three decades, countries with higher corporate income tax rates have grown more slowly, other things equal.** Using cross-country data over the 1970–1997 period, Roger Gordon and Young Lee find that increases in corporate tax rates lead to lower future growth rates within countries (after controlling for various other determinants of economic growth). The coefficient estimates suggest that a cut in the corporate tax rate by ten percentage points raises the annual growth rate by one to two percentage points.[10]

**The complex corporate income tax imposes high compliance costs, diverting corporate resources from more productive activities.** While corporate income tax revenues accounted for 23 percent of all federal income tax revenues in fiscal 2005, the Tax Foundation estimates that corporations accounted for 36 percent of federal income tax compliance costs. For every $100 in corporate income tax payments, the Tax Foundation estimates that it cost corporations an additional $34 in recordkeeping, research, return preparation, and form submission costs to comply with the income tax.[11]

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[4] Joint Committee on Taxation, *Macroeconomic Analysis of Various Proposals to Provide $500 Billion in Tax Relief,* JCX–4–05, (March 1, 2005).

[5] Dale Jorgenson and Kun-Young Yun, "Corporate Income Taxation and U.S. Economic Growth," (April 21, 2006).

[6] Kenneth Judd, "Corporate Income Taxation in a Modern Economy," Hoover Institute, (May 10, 2006)

[7] Michael Devereux, "Developments in the Taxation of Corporate Profit in the OECD Since 1965: Rates, Bases and Revenues," (May 2006).

[8] Deborah Brewster, "U.S. investors flock towards foreign funds," *Financial Times,* (25 April 2006) p. 27.

[9] Kevin Hassett and Aparna Mathur, "Taxes and Wages," American Enterprise Institute, (March 6, 2006)

[10] Young Lee and Roger H. Gordon, "Tax Structure and Economic Growth," *Journal of Public Economics,* Volume 89, Issues 5–6, June 2005, Pages 1027–1043

[11] J. Scott Moody, Wendy P. Warcholik, and Scott A. Hodge, The Rising Cost of Complying with the Federal Income Tax, *Tax Foundation,* (December 2005).

**Internationally, support for corporate tax reductions abroad comes from across the political spectrum.** While support for corporate tax rate reduction often is associated with conservative politicians, there are a number of recent examples where left-of-center governments have reduced corporate income tax rates. The socialist government in Spain adopted a corporate tax rate reduction from 35 to 30 percent earlier this year. Britain's Labour Party cut the corporate tax rate to 30 percent in 1999, and Germany's Social Democrat-led government reduced the top federal corporate tax from 40 percent to 25 percent in 2000.[12]

**CONCLUSION**

In the technologically advanced and globally integrated economy in which companies now compete, the U.S. corporate income tax rate profoundly affect the competitiveness and performance of the U.S. economy. Traditional investment incentives, such as accelerated depreciation and investment tax credits, have diminished potency because the value of a company's intangible assets—such as patents, know-how, copyrights, and brands—frequently exceeds the value of its plant and equipment. Reductions in tariffs and transportation and communication costs, and market-oriented reforms in Central and Eastern Europe, China, and India, have removed many of the barriers that previously restrained cross-border investment. As a result, companies have far more flexibility in where to locate their value-generating activities, and corporate income tax rates can affect this decision at the margin. Moreover, U.S. companies must compete for capital globally, and high U.S. corporate income tax rates make this more difficult.

Reducing the U.S. corporate income tax rate would: make the United States a more attractive location for locating physical investment and high-value headquarters activities and would reduce distortions in the current tax system that harm revenues and economic efficiency, such as the incentive to finance with debt, operate through pass-through entities, shift income generating activities to lower-tax foreign jurisdictions, and engage in sophisticated tax planning to achieve globally competitive tax rates. Recent cross-country economic studies find that, other things being equal, nations with lower corporate income tax rates have over time achieved both higher real wage levels and economic growth rates.

**Alliance for Competitive Taxation**

**Member List**

1. Applied Materials, Inc.
2. Boeing Company
3. Caterpillar Inc.
4. Cisco Systems, Inc.
5. The Coca-Cola Company
6. Electronic Data Systems Corp.
7. Eli Lilly and Company
8. General Electric Co.
9. Intel Corporation
10. Johnson & Johnson
11. Lockheed Martin Corporation
12. Microsoft Corporation
13. Oracle Corporation
14. PepsiCo, Inc.
15. The Procter & Gamble Company
16. Wal-Mart Stores, Inc.

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**Statement of Citigroup, Inc., New York, New York**

Citigroup, Inc., is pleased to submit this testimony for the record to the House Ways and Means Subcommittee on Select Revenue Measures in regards to its June 22, 2006 hearing on the impact of international tax reform on U.S. competitiveness. In particular, Citigroup wishes to thank Subcommittee Chairman Dave Camp (R–MI), the ranking member, Rep. Mike McNulty (D–NY), and the other subcommittee members and staff for the opportunity to provide comments on proposals to move from the current worldwide system of taxing the foreign income of U.S.-based corporations to a territorial system.

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[12] Martin A. Sullivan, "A New Era in Corporate Taxation," *Tax Notes,* (January 30, 2006), pp. 440–442.

Citigroup is the world's largest financial institution. Citigroup's 300,000 employees provide financial products and services to millions of customers through subsidiaries and branches in more than 100 countries. Citigroup is truly a global company; nearly 50 percent of its earnings came from outside the United States in the first quarter of 2006. We expect that percentage will increase in the future as Citigroup views the marketplace for financial services outside the United States as a critical area of growth in the coming years. How our earnings are taxed by the United States and the other countries in which Citigroup does business is a critical ingredient in our ability to compete globally. Therefore, this hearing and the Subcommittee's work going forward in examining tax reform proposals and, specifically, proposals to transform the U.S. international tax regime address matters of significant concern to Citigroup.

Although Citigroup at this time is not taking a position as to any of the specific tax reform regimes that have been proposed, we hope that this submission will help the Subcommittee and staff better understand how some of the choices they face may impact the effectiveness of the U.S. financial services industry to compete globally. In January 2005, the staff of the Joint Committee on Taxation released JCS–2–05, entitled Options to Improve Tax Compliance and Reform Tax Expenditures. That report included a proposal for the United States to move to a territorial tax system in which the active earnings of foreign subsidiaries and branches of U.S. corporations generally would be exempt from U.S. tax. In November 2005, the President's Advisory Panel on Federal Tax Reform produced a similar recommendation.

Moving the U.S. tax system to a territorial regime could improve the competitiveness of U.S.-based financial services companies operating globally. However,adoption of a territorial tax system by the United States will only enhance the competitiveness of U.S. companies if it is constructed in a fair and effective manner. Further, concurrent with any adoption of a territorial system must be a reduction of the U.S. corporate rate. Without such a tax rate reduction, many of the benefits of a territorial system will not be realized.

For the most part, our competitors are foreign-based companies resident in territorial-based taxing jurisdictions that price their products and services and analyze potential acquisitions based on the tax rate in the countries in which they are doing business, rather than in the countries in which they are headquartered. Often times, this divergent and usually more beneficial tax treatment can place U.S.-based companies like Citigroup at a serous competitive disadvantage.

However, the United States faces important challenges as it contemplates modernizing the U.S. tax rules, as is clear from the two territorial tax proposals now on the table—the proposal by the President's Advisory Panel on Federal Tax Reform, and the proposal presented by the staff of the Joint Committee on Taxation. The goal of a territorial tax system should be to ensure that no dollar of net income is subject to tax more than once. Unfortunately, both proposals, based on the somewhat limited descriptions that have been provided, appear to fail to achieve this goal. If adopted as described by their authors, they potentially would represent a tax increase for many U.S.-based companies, and would place U.S. multinational companies in a worse off position competitively as compared to the current system.

**Treatment of Financial Income**

As an initial matter, any territorial system should recognize that interest and other income earned by a financial institution (such as a bank, securities firm, finance company, or other financial services business) is active trade or business income that should be treated as exempt income if earned by a foreign subsidiary or foreign branch of a U.S.-based financial institution. Thus, for a U.S. financial institution, "qualified banking and financing income" of a foreign branch or of a foreign subsidiary as described in the active financing rules of section 954(h) of the Internal Revenue Code should be considered "active income" under any territorial system adopted by the United States, and those rules should be permanent.

The President's Panel suggests the adoption of anti-abuse rules to ensure that passive income earned by financial institutions not be treated as exempt active business income. The existing rules under Section 954(h) include rigorous anti-abuse limitations that have been effective, and have been readopted on numerous occasions by Congress as it has extended the active financing provisions, most recently through 2008 as part of the Tax Increase Prevention and Reconciliation Act of 2006.

**Taxing Income Once**

A central theme of a territorial tax system should be to have net income subject to tax only once and in the jurisdiction in which such income arises. In other words, a company's worldwide tax base should not exceed its worldwide income. To achieve this goal, all income must be subject to taxation by only one jurisdiction somewhere

in the world. Under a territorial system, and unlike under the current U.S. system, if double taxation occurs, there would not be a foreign tax credit mechanism to offset the cost of double taxation.

In order to ensure that under a territorial system the correct amount of income is taxed in the U.S. and in foreign jurisdictions, all expenses must be properly allocated between jurisdictions that recognize their deductibility, usually through charge outs to specific businesses and jurisdictions. We believe stewardship expenses should be deductible in the United States. Any expense that is not permitted to be deducted in any jurisdiction will cause the worldwide tax base of a U.S.-based global company to be greater than its worldwide net income, resulting in excessive taxation and a burden on the company's ability to compete against its foreign-based counterparts.

Of particular concern are the rules for allocating worldwide interest expense. Financial institutions, such as Citigroup, borrow throughout the world and incur billions of dollars of interest expense annually. Both the JCT staff and Tax Reform panel proposals suggest that a U.S. territorial system should adopt the worldwide interest expense allocation rules that are currently in effect for computing net foreign source income for purposes of determining the foreign tax credit limitation. Specifically, the proposals provide that a taxpayer's worldwide interest expense is to be allocated fungibly to different jurisdictions based on the relative amount of assets located in those jurisdictions. This system may cause distortions because it ignores the differences in interest rates between the various currencies in which a taxpayer borrows. For example, interest expense incurred in the United States would, under the proposals, be disallowed as a deduction in the United States where interest rates outside of the United States are lower than those within the United States.

While the worldwide interest expense allocation concept may work for purposes of a foreign tax credit regime, the adoption of the worldwide interest allocation provisions would be inconsistent with a territorial system, particularly for large financial institutions for which interest is the primary expense. The application of the worldwide interest allocation rules could distort the true economic net income arising in the United States by disallowing interest expense arising in the United States (due to allocating such interest expense to a foreign jurisdiction). This might not be the case if interest rates were the same throughout the world; however, interest rates can differ dramatically from one jurisdiction to another. The example in the Appendix illustrates this problem.

We believe that a more reliable and realistic result would be produced with rules that determine the proper allocable U.S. interest expense based upon an attribution of capital to a branch or a subsidiary using a thin capitalization concept. In reviewing the territorial systems of several countries, we found that this approach, which was most recently adopted by Australia in 2003 as part of that country's conversion to a territorial system, provides a simple and fair method of allocating interest.

**Treatment of Branches**

Like many banks, Citigroup may operate its businesses in some countries through a branch. Under current U.S. law, (a) the income of a foreign branch is taxed currently by the United States as if the income were earned in the United States, and (b) transactions between U.S. and foreign branches of the same entity, including loans between branches, are generally not recognized for U.S. tax purposes.

Both the JCT staff and Tax Reform panel territorial proposals suggest that a U.S. territorial system should treat branches as if they are separate affiliates, so that their active income would be exempt from U.S. taxation. Unfortunately, both proposals provide no further details regarding the taxation of branches, allocation of expenses to branches, or the treatment of transactions between branches. Consistent with OECD principles, which generally recognize inter-branch transactions provided they satisfy arms-length principles, our recommendation is that a territorial system should recognize branch-to-branch transactions as the most appropriate and accurate method of allocating income and expense between branches. We also recommend that consideration should be given to looking to the local books of the foreign branch to determine the exempt "active" income and expense of the foreign branch business operation.

**Transfer Pricing and Tax Treaties**

The President's panel rightfully noted the critical role that transfer pricing enforcement will play if the United States adopts a territorial tax system. Under a territorial system, the U.S. tax authorities will need to combat efforts to artificially move U.S. taxable income to low tax jurisdictions.

What also seems fairly evident to us, however, is the fact that U.S. businesses with significant foreign operations will find it quite difficult to realize the goal of having their income taxed only once without robust transfer pricing rules and enforcement combined with an expanded network of U.S. bilateral income tax treaties. Today, U.S. companies face enormous challenges in ensuring that 100 percent of expenses that are properly charged out to foreign operations are accepted as deductions in some of the countries in which those operations are based. For companies with excess foreign tax credit limitation, such expenses that "fall through the cracks" can be problematic but not incurable. This would not be the case under a territorial system. In recent years, the U.S. policy towards expanding the U.S. tax treaty network, reducing or eliminating withholding taxes on cross-border interest and dividends, and beginning to adopt mandatory arbitration to resolve competent authority disputes has been impressive. However, this network will need to be expanded further, particularly into Latin America and parts of Asia, and competent authority dispute resolution efforts will have to be enhanced further if a U.S. territorial tax system is to be implemented effectively from the standpoint of both U.S. tax administration and the competitiveness of U.S-based companies.

**Conclusion**

Citigroup thanks the Subcommittee for the opportunity to provide its views on the topic of moving the United States to a territorial tax system, and looks forward to working with the Congress, the Treasury Department, and others as part of a thoughtful and productive debate over the future of U.S. international tax policy.

**APPENDIX**

***Worldwide Interest Allocation Example***

**Assumptions:**

- A business has its head office operations in New York, and branches in Tokyo and London. Each of the branches has the following assets (at the year-end U.S. dollar FX rates):

| ***New York*** | ***Tokyo*** | ***London*** |
|---|---|---|
| 12,000 | 500 | 500 |

- Each branch earns a 100 basis point spread on its assets with the following interest rates:

| | | **Interest** |
|---|---|---|
| ***Income*** | ***Expense*** | |
| New York | 6% | 5% |
| Tokyo | 1% | — |
| London | 3% | 2% |

**Calculations:**

| ***Local Books*** | ***New York*** | ***Tokyo*** | ***London*** | ***Totals*** |
|---|---|---|---|---|
| Gross Interest | 120 | 5 | 15 | 140 |
| **Interest Expense** | **<100>** | — | **<10>** | **110** |
| Net Interest Income | 20 | 5 | 5 | 30 |

Application of the worldwide interest allocation rules (interest expense allocated according to the relative assets of the branches and head office)

| | | | | |
|---|---|---|---|---|
| Gross Interest | 120 | 5 | 15 | 140 |
| **Interest Expense** | **<73>** | **<18.5>** | **<18.5>** | **<110>** |
| Net Interest Income | 47 | <13.5> | <3.5> | 30 |

**Conclusion:**

The use of the worldwide interest allocation formula distorts the true $20 economic net income of the U.S. head office. Instead, the U.S. head office would be subject to tax on $47 of net income.

**Statement of Dow Chemical Company, Midland, Michigan**

***Introduction***

I commend the Subcommittee on Select Revenue Measures for holding a hearing on the important subject of international tax reform and I am pleased to submit this statement for the record.

The Dow Chemical Company today is a truly global company. We have customers around the world, and many of our customers are themselves global companies. Our largest competitors, both for business in foreign markets and for business in the U.S. market, are global companies. Given this globalization of the economy, it is critically important that the U.S. international tax rules do not disadvantage U.S.-based companies competing in the global marketplace. The optimal U.S. international tax system would enhance the global competitiveness of U.S. companies and allow American businesses and the workers that they employ to make the most of the tremendous opportunities that are available as markets around the world become even more open.

***The Global Profile of The Dow Chemical Company***

*Dow Today*

Dow is a diversified, integrated science and technology company that develops and manufactures innovative chemicals, plastics, and agricultural products and services for industrial and consumer markets worldwide. Dow supplies more than 3,200 products, grouped within six operating segments: Basic Plastics, Performance Plastics, Performance Chemicals, Hydrocarbons and Energy, Basic Chemicals, and Agricultural Sciences. Dow serves customers in more than 175 countries in a wide range of markets, including food, transportation, health and medicine, personal and home care, and building and construction, among others.

Dow's annual sales are $46 billion; of total sales, 38% is in the United States and 62% is international, divided between Canada, Europe, Latin America, and Asia. Dow has total fixed assets of over $13 billion, with more than half located in the United States. Dow employs more than 42,000 people worldwide, including more than 21,000 employees in the United States.

*Evolution of Dow*

Dow began business in the United States in 1897. By the middle of the 20th century, Dow had to become a global company in order to remain competitive. Dow's first international expansion was into Canada in the 1940s. In the 1950s, with business growth after World War II, Dow began expanding into Europe and then Latin America. More recently, Dow's growth in the Middle East has been driven by high energy costs in the United States and the comparatively lower energy and feedstock costs in that region. Dow's expansion into China is driven by local market growth in that region. Dow now has 156 manufacturing sites in 37 countries.

The percentage of Dow's sales outside the United States has increased dramatically over the last fifty years. In 1955, Dow had $ 70 million in sales outside the United States, representing 12% of total sales. By 1980, Dow had $ 5.2 billion in sales outside the United States, representing 50% of total sales. Today, Dow's sales outside the United States exceed 60% of total sales.

The expansion of Dow's foreign operations has not only generated sales from those foreign operations but also has increased Dow's exports from the United States. Dow's foreign operations are significant customers for the output produced by Dow's facilities in the United States. Thus, foreign expansion creates expanded export markets for Dow's U.S. operations. The increase in Dow's total non-U.S. sales has been closely paralleled by an increase in Dow's U.S. exports, with exports from the United States consistently representing approximately 20% of Dow's total sales outside the United States and sales to foreign affiliates representing about 75% of Dow's total U.S. exports.

Even with the expansion of Dow's foreign operations, the percentage of capital spending in the United States continues to remain fairly constant, reflecting the company's historic base and headquarters in the United States. Approximately 60% of Dow's capital expenditures each year is devoted to plants in the United States. The predominance of U.S. capital spending matches the company's aggregate fixed asset base which also is located predominately in the United States.

***The Global Profile of Dow's Customers and Competitors***

Just as Dow has become increasingly globalized, so too have Dow's customers and Dow's competitors.

*Dow's Customers*

Dow's customer base is very diversified, both by industry and by geography. Dow's customers represent a broad range of industries, including food and food packaging, personal and household care, hydrocarbons and energy, building maintenance and construction, home care and improvement, automotive and transportation, and paper and publishing. As noted above, Dow's customers today are located in more than 175 countries around the world.

Increasingly, Dow's local customers are becoming global customers. They are themselves global businesses and they are looking for a global supplier. These customers want a supplier that can provide the same products at the same quality and the same price anywhere in the world. They are very well informed, are very sensitive to both price and quality, and are free to choose among multiple potential suppliers. In order to serve these customers, Dow must have production facilities in the many markets where the customers do business.

*Dow's Competitors*

Dow's competitors also are very geographically diversified and have highly-efficient cost structures and world-class competitive technologies. Dow is the largest chemical company in the United States. It is the second largest chemical company in the world based on sales. Its two closest competitors, ranked first and third in the world based on sales, are BASF and Bayer, both of which are German companies. Of the top ten chemical companies in the world, only three are U.S.-based companies. The other seven companies are based in Germany, France, the United Kingdom, the Netherlands, China, and Saudi Arabia. Some of these competitors face very little home country tax. Unlike Dow, even those competitors from countries with significant tax systems generally are not subject to home-country tax on their foreign earnings.

The competitive landscape is continuing to evolve. Focusing on the ethylene business for example, by 2010 four of the top ten global producers will be State-owned enterprises. These four government-operated businesses are located in China, Iran, and Saudi Arabia. Moreover, several other State-owned businesses are expanding very quickly, including Saudi Aramco, Qatar Petroleum, Oman Oil, and Petrochemical Industries of Kuwait. These competitors all face little or no home country tax. These enterprises are all of global scale, have competitive technology, and similar general and administrative cost structures. The principal differentiators between these enterprises and Dow and other companies are raw material supply and tax position.

Dow competes with these foreign companies not only in global markets but also in the United States. The U.S. market is open and accessible to foreign companies and its size and pricing makes it a very attractive market. Foreign production in the chemical industry is becoming increasingly competitive. Historically, the United States has been a consistent exporter of chemicals and related products. Now increasingly, these products are being imported into the United States by foreign companies.

***The United States Needs a Competitive International Tax System***

In order to succeed in today's global economy, U.S.-based companies must be able to compete with a wide range of foreign competitors. They must compete in markets around the world to serve foreign customers. They must be prepared to serve multiple markets in order to meet the needs of global customers. In addition, they must be able to compete against foreign companies in order to serve the U.S. market. The structure of the U.S. international tax rules has a significant impact on the ability of U.S.-based companies to compete and succeed both abroad and here at home.

*How U.S. and Foreign Taxes Affect Competition*

As the economy becomes increasingly globalized, customers are becoming increasingly sophisticated and are taking advantage of more freedom to choose the lowest cost, highest quality supplier. In the chemical industry in particular, there are many global suppliers, which heightens the competition in the industry. There are of course a whole range of factors that differentiate among suppliers and determine which company gets a customer's business. That said, the cost of taxes is one of the deciding factors in determining which company will build the next production facility and thus be in a position to supply the next customer.

In the chemical industry, the location of a new plant is determined primarily by non-tax factors such as the location of customers and feedstock and energy costs. Because of the robust competition in the industry, these factors tend to be the same for all competitors, particularly in the basic chemicals sector. What often differentiates among the competitors is the tax cost they face.

The cost of income taxes is an important factor in determining the rate of return on a project for a company. In the chemical industry's field of evenly-matched competitors, the tax burden does not often determine where a project will be built but rather determines which producer will build it. Dow measures the future tax costs associated with a project being contemplated by taking into account the expected tax on all cash flows from the project, including dividends, interest, royalties, and sales income. Where taxes reduce the rate of return on a project below an acceptable level, Dow will not undertake the project. One of Dow's foreign competitors, which operate in very different home country tax environments, may well undertake the project instead of Dow. Loss of business opportunities to foreign competitors affects not just foreign operations but also operations and jobs here at home.

It is very rare that the local tax burden alone would be so high that none of the global competitors in the industry will undertake a project the underlying economics of which otherwise make sense on a pre-tax basis. However, variations in the combined local and home country tax burden with respect to a project across the range of global competitors in the industry will determine which company undertakes the project. Although there are a few exceptions in the Middle East (where some countries subject foreign investors to more onerous taxation than is imposed on local investors), typically the local taxes on the project will be the same for all competitors. What varies substantially is the tax treatment of the project by each competitor's home country. Thus, the home country taxation of income from international business activities is the key tax factor in determining which competitor will undertake a particular project and build a new plant to serve customers in a particular market.

The current U.S. international tax rules, which impose current U.S. tax on many forms of foreign business income and subject repatriated foreign earnings to U.S. tax, can put U.S. companies at a significant competitive disadvantage. With the rise of State-affiliated enterprises as significant competitors for Dow, the sensitivity to home country taxes is becoming more pronounced because these competitors pay little or no home country tax. Even Dow's European competitors have a competitive advantage when it comes to taxes. Most of these companies are located in countries with territorial tax systems so that they are not subject to home country tax on their foreign earnings, even when they bring those earnings home.

*Burdens of the Current U.S. International Tax System*

The current U.S. international tax system, which subjects U.S. companies to U.S. tax on all their income wherever earned, operates to disadvantage U.S.-based multinational companies relative to the foreign competition in a variety of ways. For Dow, the most burdensome aspects of the U.S. international tax rules are the overly restrictive foreign tax credit rules and the overreaching subpart F rules which impose immediate U.S. tax on foreign earnings.

Under the U.S. worldwide tax system, foreign-source income of a U.S. company is subject to tax both in the country where it was earned and in the United States. In order to mitigate this double taxation, a foreign tax credit mechanism provides for foreign taxes to offset the U.S. taxes that would otherwise be imposed. The modifications made to the U.S. foreign tax credit rules in 2004 significantly improved this system, but the rules continue to include strict limitations that restrict the availability of credits for foreign taxes that have been paid. In this regard, complex expense allocation rules treat a portion of U.S.-incurred expenses as allocable to foreign-source income; this has the effect of reducing net foreign-source income and the allowable foreign tax credit, even though the allocation does not in any way reduce the company's foreign tax liability. The expense allocation approach in the current U.S. tax system is significantly more onerous than the approaches used by our trading partners. In addition, special rules regarding the treatment of losses further restrict a company's ability to use foreign tax credits. The economic effect of these restrictions is to cause U.S. companies to be subject to double taxation on income earned outside the United States. The 2004 changes extending the carryforward period and changing the domestic loss recapture rules help, but only to the extent that they help companies avoid losing use of their credits altogether. The strict limitations in current law continue to erode the value of the credits when their use is delayed for many years after the taxes were paid to the foreign country.

Under the current U.S. international tax rules, income earned abroad through foreign subsidiaries generally is not subject to U.S. tax until it is repatriated to the U.S. company through dividends. The subpart F rules which impose immediate U.S. tax on certain income of foreign subsidiaries are the exception to this general rule. The subpart F rules are intended to capture passive and other highly mobile income that is earned outside the United States. However, the subpart F rules operate to impose immediate U.S. tax on many forms of active business income earned abroad.

In particular, U.S. companies can be subjected to immediate U.S. tax on services income and sales income earned through active business operations in foreign markets. This immediate U.S. tax is a significant cost that is not borne by foreign competitors operating in those markets. These rules also encourage the use of complicated business structures and transactions, impede the efficiencies of U.S. companies, and distract management from focusing on business concerns, all of which represent additional costs for U.S.-based companies that are not borne by foreign competitors.

*A U.S. Territorial Tax System*

Many of the countries that are major U.S. trading partners and that are home to Dow's principal competitors have territorial tax systems under which active foreign business income of their companies is not subject to home country tax. A move away from the existing worldwide approach and toward a territorial approach could bring the U.S. tax system more in line with those of other developed countries in Europe and elsewhere. Such a move could eliminate some of the costs and disadvantages of the current U.S. tax system for U.S. companies that have operations outside the United States. However, the benefits of such a system depend entirely on the details of how the system is structured. Great care would need to be taken to ensure that a new U.S. international tax system does not create further disadvantages for U.S. companies competing in the global marketplace.

The Joint Committee on Taxation staff and the President's Advisory Panel on Federal Tax Reform have proposed possible territorial tax systems for the United States. Both of these proposals are largely conceptual, with many of the details unspecified. However, it is clear that a territorial system structured along the lines of these proposals would be very different than the territorial tax systems that exist today in Europe and elsewhere. These differences would make the proposed systems significantly more burdensome than the systems of our trading partners. These differences highlight some of the key features that must be carefully considered in designing a territorial tax system that would satisfy the objective of enhancing the competitiveness of U.S. businesses operating in the global marketplace.

***Treatment of foreign-source income:*** The territorial tax approaches that have been proposed would provide an exemption only for foreign-source dividends and would impose full U.S. tax on other forms of income earned abroad by a U.S. company. This taxable foreign-source income includes royalty income, services income, and income from export sales. These categories of income could be taxed more heavily under the territorial tax proposals than they are under the current U.S. tax system. Such a tax increase would be very detrimental to the competitiveness of U.S.-based companies and to the U.S. economy, including the loss of U.S. jobs associated with exports of goods manufactured in the United States.

Any increase in the U.S. tax on foreign-source royalty income would force U.S. companies to consider measures to reduce the royalties being paid back to the United States. This could be accomplished by shifting R&D activities outside the United States to foreign affiliates. Such a shift would mean that valuable new intangible property would be developed and owned outside the United States. Today, U.S. companies are net recipients of royalties paid by their foreign affiliates; if this sort of shift occurs, U.S. companies could become net payors of royalties to their foreign affiliates. The result would be a loss of high-paying U.S. R&D jobs, an erosion in the stock of valuable intangible property held in the United States, and a reduction in the U.S. tax base. This is a particularly inopportune time to drive companies to consider such a shift, as other countries (India and China, for example) are quickly increasing their talent pools to perform sophisticated R&D.

An increase in the U.S. tax on service fees received from outside the United States similarly could cause a relocation of service operations away from the United States. This would reduce U.S. employment in these high-technology sectors. In addition, an increase in the U.S. tax on income from exports would increase the cost of export activity. This would reduce the incentive to export and increase the incentive to source contracts and supply customers from outside the United States. This would adversely affect U.S. employment in the manufacturing sector.

In considering a territorial tax system for the United States, careful consideration must be given not just to the treatment of foreign-source dividend income but also to competitive treatment for other categories of foreign-source income. If a territorial system were designed in a manner that would lead to a tax increase on these important forms of foreign-source income, the adverse impact would harm the competitiveness of U.S. companies operating in the global marketplace and would create incentives to move activities outside the United States. Such results would be completely inconsistent with the reasons for considering adoption of a territorial tax system in the first place.

***Treatment of U.S. expenses:*** The territorial tax approaches that have been proposed by the JCT staff and the Tax Reform Panel include rules that would allocate a portion of U.S.-incurred expenses to income earned outside the United States. These proposals are out of line with the territorial systems of other countries. The proposed expense rules are based on the complex allocation rules currently used in the United States for purposes of the foreign tax credit limitation. However, the use of such allocations in a territorial tax system would have an even more dramatic effect by causing the denial of any deduction for expenses that are allocated to exempt foreign income.

As noted above, no other country has expense allocation rules that are as rigorous and burdensome as the U.S. expense allocation rules. The impact of these rules is even more detrimental in the context of a territorial tax approach. Expenses that are treated under U.S. tax rules as allocated to income earned outside the United States would not be recognized by the country where the income is earned. They would not be allowed as a deduction for purposes of calculating the tax liability in that country. Therefore, such expenses would not be deductible anywhere. That result would be contrary to the basic principle that taxpayers should be entitled to deduct all ordinary and necessary business expenses.

A denial of deductions for U.S.-incurred expenses also could trigger a behavioral response. If a portion of U.S.-incurred R&D expense were treated as non-deductible, the effect would be to increase the cost of conducting R&D in the United States. This would create a further incentive for U.S. companies to move their R&D operations outside the United States. Similarly, treating a portion of G&A costs incurred in the United States as non-deductible would create an incentive for companies to relocate these headquarters-type activities outside the United States. U.S. companies would be forced to consider these reductions in their U.S. activities and their U.S. employment simply in order to remain competitive.

In considering a U.S. territorial tax system, careful consideration must also be given to ensuring appropriate treatment of expenses. Simply incorporating the expense allocation rules of current law into a new territorial system is not the answer. Appropriate rules must be crafted that ensure that ordinary business expenses are deductible and that do not drive companies to eliminate U.S. activities and lessen their connections to the United States.

***Application of subpart F rules:*** As noted above, the subpart F rules of the current U.S. international tax system subject U.S. companies to immediate U.S. tax on certain income earned by their foreign subsidiaries. The territorial tax approaches that have been proposed by the JCT staff and the Tax Reform Panel would continue to apply these rules. This would be significantly more burdensome than the approaches used by our trading partners.

Many countries with territorial tax systems impose home-country tax on some income earned by foreign subsidiaries. However, the only foreign income that is covered by these rules is passive income. The U.S. subpart F rules are much broader than the passive income rules of other countries and impose immediate U.S. taxation on many forms of active business income earned by foreign subsidiaries of U.S. companies. For example, the U.S. rules impose immediate U.S. tax on income from the sales and services activities of foreign subsidiaries of U.S companies.

Incorporating these rules into a territorial tax approach would result in a system that continues to impose substantial U.S. tax on the income of U.S.-based businesses operating in foreign markets, income that is not subject to home country tax when earned by their foreign competitors. Such a system would continue to put U.S. companies at a significant competitive disadvantage relative to their foreign counterparts. As part of a territorial tax system, substantial modifications to the subpart F rules would be needed in order to focus these rules on passive income.

*Consideration of Other Countries' Territorial Tax Systems*

In considering the merits of a territorial tax system for the United States and the optimal design of such a system, it is useful to look to the international tax systems of our major trading partners. These are the tax systems faced by the global competitors of U.S.-based companies. It is the differences between these systems and the U.S. tax system that can determine whether a U.S. company or one of its foreign competitors wins the next project and builds the next plant to serve customers in markets around the world.

Dow's principal foreign competitors are headquartered in Germany, the Netherlands, and the United Kingdom. Germany and the Netherlands both have territorial tax systems. The United Kingdom is actively considering a possible future move to a territorial tax system. The Dutch and German international tax systems both are significantly more competitive than the current U.S. international tax rules. More-

over, both countries are currently considering changes that will further enhance the international competitiveness of their tax systems.

***The Dutch international tax system:*** In many respects, the Dutch tax system is a model system, particularly with respect to the treatment of international activity.

The Dutch tax system nominally subjects Dutch companies to tax on their worldwide income. However, virtually all income from foreign business operations is exempt from Dutch tax under one of two mechanisms. Under the participation exemption, dividends and capital gains from non-Dutch subsidiaries are exempt from Dutch tax. Under the double tax relief provisions of Dutch domestic law and tax treaties, income from foreign branch operations also is effectively exempt from Dutch tax.

Under current law, foreign-source interest and royalties received by a Dutch company are subject to full Dutch tax at a rate of 29.6%. A foreign tax credit applies with respect to foreign withholding taxes imposed on this income. However, substantial tax reforms proposed in the Netherlands in May 2006 would reduce the top corporate income tax rate to 25.5%. Moreover, the proposed reforms provide for a special tax rate of 10% for certain royalties and other income related to research and development and a special tax rate of 5% for net interest income received from affiliated companies.

Under the Dutch tax system, business expenses are fully deductible. The only limitations on expense deductions are relatively narrow. An anti-abuse rule applies to deny deductions for certain interest paid to related parties in situations involving excessive debt financing or thin capitalization. Interest paid to third parties is not affected by this rule. Expenses incurred to acquire a non-Dutch, non-EU company that is eligible for the participation exemption also can be non-deductible.

The Dutch tax system does not include any rules comparable to the U.S. subpart F rules. The system includes one limited rule related to passive income earned abroad. Income earned by a foreign passive group finance company in a low-tax jurisdiction is not eligible for the participation exemption. Thus, dividends from this type of company are subject to Dutch tax.

In sum, key features of the Dutch tax system serve to enhance the global competitiveness of Dutch companies: (1) Dutch companies operating in foreign markets are subject only to local tax and are not subject to Dutch tax on their foreign earnings; (2) expenses incurred by Dutch companies are not subject to any deduction disallowance, and (3) the Dutch rules for taxing foreign passive income are very narrowly targeted and do not capture active business income. In addition, proposed Dutch tax reforms would substantially reduce the tax imposed on foreign-source royalties and interest income of Dutch companies. Moreover, the Dutch tax system of advance rulings provides much-needed certainty regarding the tax treatment of international transactions.

***The German international tax system:*** Although Germany has traditionally been a relatively high tax country, recent reforms have made the German tax system more competitive and a substantial reduction in the corporate tax rate is currently being considered. Moreover, the German international tax rules are significantly more favorable to cross-border activity than the current U.S. international tax rules.

Germany also operates under a participation exemption system pursuant to its network of tax treaties. Accordingly, German companies generally are eligible for exemption from German tax on dividends and capital gains from their foreign subsidiaries and on income earned through foreign branches. German companies are subject to German tax on foreign-source royalties and interest, with a foreign tax credit. In this regard, as noted above, reductions in the German corporate tax rate are under consideration currently.

The German tax system does not include rules that require the allocation and deduction disallowance of expenses to exempt income. Instead, the participation exemption rules provide for a 95% exemption of foreign business income. This partial reduction in the exemption operates as a proxy for expense allocation rules.

Germany has rules that are similar to the U.S. subpart F rules, but the reach of those rules is significantly narrower. Under the German rules, the participation exemption is denied and immediate tax is imposed only on income of a foreign subsidiary that both is passive and is subject to a low rate of tax.

The territorial tax system in Germany provides a significant advantage to German companies operating internationally because their foreign operations effectively are subject only to local tax. German companies do not face the loss of deductions for business expenses or the risk of immediate tax on business income earned outside of Germany. The international competitiveness of the German system will be

further enhanced if the substantial corporate rate cuts now being contemplated are enacted.

***Conclusion***

Globalization means tremendous opportunities for U.S.-based businesses and American workers. It also means increasing competition from global businesses. The U.S. international tax rules subject U.S.-based companies to costs that are not borne by their foreign competitors. The need for a more competitive international tax system for the United States is made all the more acute with the rise of foreign business entities, including State-owned businesses, that are subject to little or no tax in their home countries. The time is ripe for international tax reform in the United States. It is prudent, however, to proceed cautiously and deliberately, in order to ensure that any changes that are made accomplish the objective of enhancing the ability of U.S.-based business to compete and thrive in the modern global economy.

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**Statement of Leo Linbeck, Jr., Americans For Fair Taxation, Houston, Texas**

**Mr. Chairman and Members of the Subcommittee on Select Revenue Measures:**

Witnesses before this Subcommittee today enumerate some key problems posed by our current system for America's international competitiveness. They criticize our corporate marginal tax rates as the highest in the developed world. They point out international reform must be integrated with comprehensive reform which does not punish savings and investment. They argue our extraterritorial tax system costs as much to comply with as it raises, even by the reckoning of the Joint Committee on Taxation staff.

However, none addresses the leading problem domestic producers face when competing against foreign producers: Our failure to adopt a border-adjusted destination-based consumption tax. We submit this testimony for two reasons: (1) to offer badly needed perspective on the importance of ensuring that reform adopts a border-adjusted tax system; and (2) to help untangle the underbrush of competing proposals to better explain what competitiveness should mean and how to achieve it.

Border-adjusted taxes are, quite simply, the most potent weapons foreign producers have against U.S. producers and workers. Border-adjusted taxes are consumption taxes removed on export by the producing nation and assessed upon imports as *ad valorem* taxes. At this point in time, 29 of 30 OECD countries enjoy border-adjusted tax regimes. Only one—the U.S.—refuses to adopt a border-adjusted tax system in order to continue to rely upon an origin principle, direct, world-wide income tax system that taxes returns to capital multiple times. We do so at our peril.

When two nations with border-adjusted tax regimes trade together, the effects negate themselves. Taxes one nation rebates on domestically produced exports are reimposed by the importing jurisdiction in what is effectively an economic wash. But the interaction of indirect border-adjustable systems with the U.S.'s tax system is devastating. Border-adjusted regimes effectively grant foreign producers an approximately 18-percent price advantage over U.S. produced goods, whether competing here or abroad. Our failure to respond to these incentives amounts to a self-imposed handicap which stimulates outsourcing, encourages plant relocations, lowers the wages of the American workers, harms U.S. small businesses and farmers, and decimates our production capabilities to such an extent it raises national security concerns. A recent MIT report states that the U.S. failure to recognize and confront this problem costs us more than $100 billion in exports annually. In our judgment, this is a conservative estimate.

Our unique failure to adopt a destination-based consumption tax combined with our uniquely high marginal corporate rates sends the wrong messages to American producers: "Move your plants and facilities overseas, hire foreign workers, and then market your products back to the American consumers whose tax system favors consumption over investment and savings." To retailers: "Stock foreign inventory." To consumers: "Buy foreign products." The problem is American industry and consumers are taking Congress's advice. Market forces do work. The burgeoning trade deficit, the loss of American jobs, and stagnating blue collar wages are consequences of failing to send the right message.

At a time when U.S. companies are struggling to compete against foreign manufacturers, at a time of record trade deficits and manufacturing job losses, at a time

when the tax-writing committees should finally realize that they cannot legally offer domestic producers export incentives like the Foreign Sales Corporation rules without violating WTO rules, the Congress is ignoring the root problem. And today, it is ignored again. If America wants to rebuild its manufacturing base and remain competitive, it must adopt a border-adjusted tax system. And the best way to accomplish that is by enacting the most border-adjusted tax system that could be devised—the FairTax (H.R. 25).

Second, we urge Members of this Subcommittee—before reaching for any particular solution to improve "competitiveness"—to take the opportunity to better define the contours of that fuzzy concept. The true test of international competitiveness is not whether a tax system benefits multinationals which by definition know neither national boundaries nor allegiances. Rather, the true test ought to be whether or not the tax regime achieves the objective of raising the standard of living for the American people. We believe the FairTax addresses more effectively the problems raised by the witnesses than the very plans they promote, and more importantly, it offers solutions to other issues that should be more fully explicated. When examining whether various tax plans help America become more competitive, ask these questions:

- *Do the plans create a better environment for domestic companies to produce in the U.S. and to hire American workers rather than to produce abroad and hire foreign workers?* Only under the FairTax would domestic corporations enjoy a zero rate of tax for producing in the U.S.
- *Do the plans make the U.S. a better environment from which to export?* Only under the FairTax would exports be fully exempted from taxation.
- *Do the plans tax foreign produced goods and U.S. produced goods alike in the U.S. market?* Only under the FairTax's inherently border-adjusted scheme would foreign goods be taxed exactly the same as domestically produced goods consumed in the U.S.
- *Do the plans encourage foreign establishment of plants and operations in the U.S. more than abroad?* Only under the FairTax would foreign business enjoy a zero U.S. tax on earnings. A territorial income tax system, in contrast, would probably drive job-generating plants and facilities overseas so that only the shell corporation remains headquartered here.
- *How well do the plans encourage tax competition (i.e., do they encourage global rates on savings and investment to fall or do they encourage a race to the top)?* Only under the FairTax would foreign nations have such a clear choice: Reduce your taxes or lose investment to America. This would have a pronounced positive impact on world economic growth.
- *How well do the plans reduce the costs of compliance with the international tax system?* Only the FairTax eliminates the complexity of the foreign tax credit scheme, the personal foreign holding company rules, intercompany transfer pricing rules, Subpart F, income sourcing and expense allocation rules, and a host of other complex international tax rules that create high compliance costs today. It does so by eliminating any business-to-business taxation and by taxing only consumption in the U.S.
- *Will the plans afford an easy transition from the current system to the alternative?* Moving to a territorial income tax will raise many transition issues, including how to treat pre-enactment dividends and how to treat excess foreign tax credits.
- *Will the plans allow businesses to make decisions entirely on economic grounds rather than for tax planning reasons?* Only the FairTax would completely remove taxes from decision making by being vertically and horizontally equitable.
- *Will the plan be sustainable or merely a temporary fix that will eventually devolve into the current morass?* The FairTax is the only plan that can be guaranteed not to devolve into the current morass by repeal of the 16th Amendment.
- *Will the interaction of the tax plan with foreign tax systems be favorable?* Only the FairTax eliminates fully the need to coordinate juridical taxation because source income is not taxed.

These questions properly frame the debate over whether or not a plan is good for America.

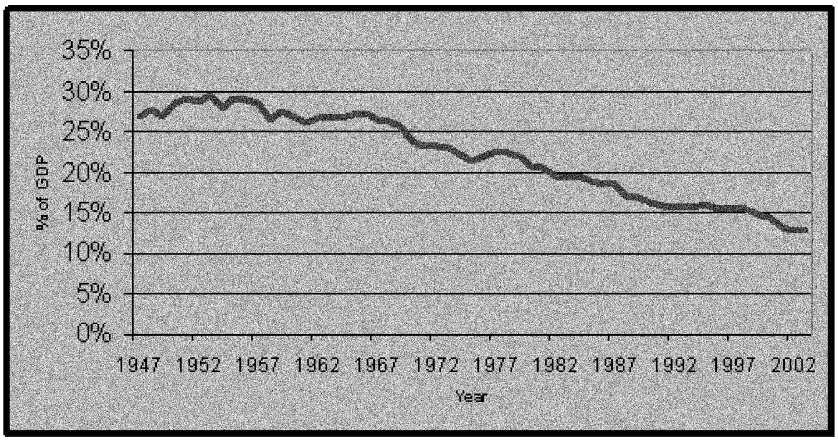
Mr. Chairman, as the nation's largest tax reform organization, we compliment this Subcommittee for focusing on the problem faced by U.S. producers. American producers struggle to compete in a global market where capital, technology, management, and increasingly labor are free to move to any venue offering the best opportunities for profit. However, American producers and the workers whose jobs depend on them are beyond mere rhetoric. They do not see increased outsourcing as a healthy correction in the economy, or a normal casualty of destructive capitalism

like the obsolescence of the buggy whip manufacturers caused by automakers. They do not see America's manufacturing decline as a statistical abstraction relevant only to those nostalgic about America's industrial past. They do not see our tax system as repairable. Rather, they see destruction of America's manufacturing base as a harbinger of hardship ahead for future generations of Americans. This Subcommittee has a duty to understand how the tax laws they helped construct contribute to this problem, and what can be done to fix it.

**I. America's Manufacturing Base is at Critically Low Mass**

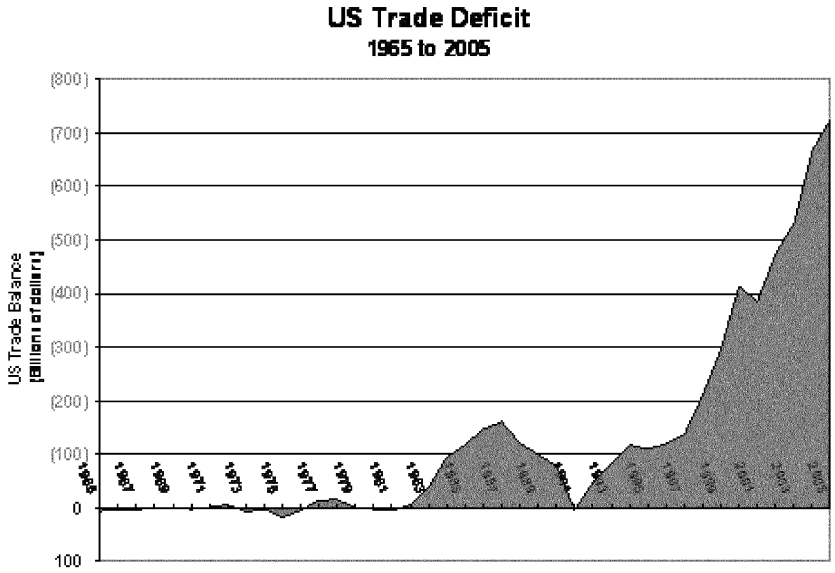
For many decades, American manufacturing has been the nutrient of national prosperity and security; raising the standard of living for working Americans, fulfilling dreams of immigrants, enabling sustainable national security, building communities, and launching America on the global stage as a world leader. American industry has long been distinguished for its productivity and sustained innovation. The health of the U.S., the well-being of its citizenry, and our very survival are undeniably and inextricably bound to the health, well-being, and survival of the American manufacturer. Without strong manufacturing, America's strength cannot endure.

***But U.S. manufacturing is rapidly eroding in the face of foreign competition.*** This erosion is visible in the dwindling contribution of manufacturing as a share of the U.S. economy.




Until recent years, U.S. companies employed Americans to produce most of the goods that Americans consumed, employment supported sales, and sales supported employment. Today, manufacturing represents half of what its share of Gross Domestic Product (GDP) was in the 1950s. With each passing year, manufacturing has become an ever-decreasing part of the overall economy. Consider that the value of all goods manufactured in the U.S. was roughly 30 percent of the value of all goods and services in the economy in 1953, 25 percent in 1970, 20 percent in 1982, and it fell below 15 percent in 2001. The share of the U.S. labor force working in the manufacturing sector fell over the same period from over 26 percent to about 10 percent.

When manufacturing moves overseas, it takes the practical engineering know-how with it. Manufacturing has declined so severely in many communities that basic industrial skills and the small business suppliers and support industries are disappearing. Even the industrial base necessary to maintain a technological edge in military hardware and the ability to ramp up in the case of war is starting to vanish. The National Association of Manufacturers has warned, "—the country may be dropping below critical mass in manufacturing."




The bad news does not stop there. The U.S. runs a sizable negative trade balance in goods with every principal nation and region in almost every category of goods; so large an imbalance that the U.S. trade deficit exceeded $700 billion in 2005, around 6 percent of GDP. Even the agricultural trade surplus is gone. In what is a demonstrably unsustainable pattern, we produce only two-thirds of the goods we consume.[1] And the relentless growth of the trade deficit has converted the U.S., once the world's largest creditor, into the world's largest debtor, enabling foreigners to own an estimated $3.7 trillion in U.S. assets (an amount on scale with the total privately owned portion of the U.S. federal debt).

***High paying jobs are being destroyed.*** The effect of this decline is not a numerical abstraction. It can be felt in the shrinking share of U.S. income earned by blue-collar workers. The decimation of our domestic producer base results in job losses for America's middle class, lost opportunities for the young, suffering for the poor, and a widening wealth gap. This decline corresponds with the outsourcing of jobs and production overseas, and an increase in the number of manufacturing start-ups basing their operations on foreign soil.

It means we must work harder for less. Indeed, the U.S., which led the world in adopting the 40-hour work week in the 20th century, enters the 21st century with a generally adopted 80-hour family work week simply to keep pace with costs. Today, it is becoming increasingly difficult for blue-collar families to achieve a middle-class standard of living.

## II. The Central Problem Ignored: Failure to Adopt a Border-Adjusted Tax System

The U.S. manufacturing decline and the ascendancy of foreign competition have been due in large part to the failure of the U.S. to adopt a border-adjusted tax base.

***We subsidize foreign producers and punish our exports.*** The U.S. should not target a particular trade deficit level, subsidize its exporters or impose tariffs on imports. By doing so, we would interfere with mutually beneficial transnational economic exchanges to the disadvantage of both countries' economies. That is the very purpose for seeking to achieve the objectives of capital export and import neutrality, which some witnesses believe are mutually unobtainable.[2] By the same token, how-

[1] This, of course, means that the U.S. is running a large capital surplus. But this capital is not being used to fund new investment. Business fixed investment is stable at 15 percent of GDP. Instead, the U.S. is selling its assets—and its economic future—to foreign investors to fund current consumption.

[2] Capital export neutrality is achieved when a taxpayer's choice to invest here or abroad is not effected by taxation. Capital important neutrality is achieved when all firms doing business

Continued

ever, the U.S. government should not accord a huge advantage to foreign companies competing in the U.S. market or impose a huge disadvantage on American producers and workers selling their goods and services in the U.S. and foreign markets—as we now do as a matter of policy.

***We harm the competitiveness of domestic producers and workers.*** The U.S. tax system imposes heavy income and payroll taxes on U.S. workers and domestic producers whether their products are sold here or abroad. As noted, U.S. corporate taxes are the highest in the industrialized world, with a top corporate rate about nine percentage points higher than the OECD average.[3] At the same time, the U.S. tax system imposes no corresponding tax burden on foreign goods sold in the U.S. market. Moreover, foreign VATs, which are a major component of the total revenue raised elsewhere, are rebated when foreign goods are exported to the U.S. market. This creates a large and artificial relative price advantage for foreign goods, in both the U.S. market and abroad.

**Advantage for Foreign Producers**

| Origin | Sold in U.S. market | Sold in foreign markets |
|---|---|---|
| U.S. production | Pays U.S. income and payroll taxes. | Pays U.S. income and payroll taxes and foreign VAT. |
| Foreign production | Pays no U.S. income or payroll tax and no foreign VAT. | Pays foreign VAT. |

As the table above illustrates, American producers pay two sets of taxes when selling into foreign markets. Conversely, in U.S. markets, foreign goods bear no U.S. tax and the foreign VAT is forgiven. Thus, among the most manifest unfairness in the U.S. tax system is that it places U.S. producers—including businesses and workers in manufacturing, agriculture, mining, and forestry—at a large competitive disadvantage relative to their foreign competitors both in U.S. markets and in foreign markets. Our failure to counteract these border-adjusted taxes explicitly encourages consumption of foreign, rather than American, goods. And it converts many of our nation's retailers into what are effectively tax-free trade zones for foreign produced goods.

***Birth of the anomaly.*** The U.S. has adopted this self-flagellating policy partly because of our laudable commitment to free enterprise and rejection of mercantilism and colonialism. At least since World War II, American business and political leaders have viewed free trade as the basis for international peace and prosperity. As the dominant economic and military power, the U.S. led the movement to dismantle trade barriers and supported international trade liberalization (GATT and WTO), economic cooperation (OECD), and customs unions (such as the European Union and NAFTA). According to the OECD, its members have reduced their average tariff rates from 40 percent at the end of World War II to 4 percent today. The U.S.'s average import duty on goods is currently 1.7 percent. As tariffs declined, however, a trend emerged in Europe toward border-adjusted taxation in the form of VATs. These taxes were levied principally on manufactured goods. The alleged purpose was to "level the playing field" by offsetting the expense of government welfare through taxation of spending on consumption.

***The scope of the problem.*** Today, the European Union has an average standard VAT of 19 percent, while the average OECD standard VAT is 17.7 percent. During the 1990s, Mexico and Canada increased composite rates to 15 percent from 10 percent and 7 percent, respectively. China adopted a 17-percent VAT in 1994. As foreign governments increased the VAT, they also reduced effective corporate income taxes. Meanwhile, high U.S. corporate tax rates today, coupled with U.S. taxation of the foreign income of corporations based in the U.S., caused the flight of corporations' headquarters to countries that exempt taxation of overseas income. In effect, the U.S. tax system is distorting the international marketplace and literally driving plants and good jobs out of this country at a devastating and unsustainable pace. There are, after all, only so many assets we can sell to foreigners before the entire financial system enters into a severe crisis.

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in a market are taxed at the same rate. While conventional wisdom is that all forms of neutrality cannot coexist, these mutual goals are obtainable with the FairTax.

[3] Edwards, Chris, "The U.S. Corporate Tax and the Global Economy," Cato Institute, September 2003.

***Counterarguments are usually self-serving.*** Some economists mistakenly argue that if America adopted a border-adjusted tax system, any relative price change would be eliminated by an offsetting appreciation in the dollar. This argument is normally advanced by supporters of tax plans that aren't or can't be made border adjustable. If the FairTax were implemented, for example, they hypothesize that the price change would be offset by a 23-percent immediate appreciation in the dollar. They contend such appreciation would be caused by a reduction in U.S. demand for foreign currency to acquire (the now more expensive) foreign goods and an increase in foreign demand for U.S. currency to acquire (the now less expensive) U.S. goods.

Their arguments are specious. The fallacy is that the demand for U.S. dollars is not limited to the traded-goods market. Nearly $90 trillion in U.S. assets owned by households and non-financial businesses are denominated in dollars. Financial institutions trade trillions of dollars in securities and currency each day based on expectations and guesses. Furthermore, the non-traded goods and services sector is much larger than the traded-goods sector and is also denominated in dollars.[4]

Prominent economists have recently begun to publicly disagree with their colleagues on the mitigating effects of exchange rates. A recent study by Professor Jim Hausman of M.I.T. found that:

- Existing disparities in treatment of corporate income taxes and VATs for purposes of border adjustment lead to extremely large economic distortions.
- U.S. exporters bear both domestic income taxes and foreign VATs when selling abroad.
- Foreign exporters in countries relying largely on VATs typically receive a full rebate of such taxes upon export to the U.S., and are not subject to U.S. corporate taxes.
- This situation creates a very significant tax and cost disadvantage for U.S. producers in international trade with significant impact on investment decisions—leading to the location of major manufacturing and other production facilities in countries that benefit from current rules on the border adjustment of taxes.
- The economic implications for the U.S. are very large.
- Elimination of the current disparity in WTO rules (by eliminating border adjustment for either direct or indirect taxes) would increase U.S. exports by 14 to 15 percent, or approximately $100 billion based upon 2004 import levels.
- Eliminating such economic distortions should be a high priority.

In sum, Professor Hausman agrees with FairTax.org that adjustments in exchange rates are not likely to counteract the relative price advantage of foreign produced goods.

**III. How to Confront Border-Adjustable Tax Regimes**

There are two ways tax writers could defend U.S. industry against global border-adjusted taxes: (1) encourage our trade representatives and trading partners to allow income taxes to be border adjusted, or (2) adopt a destination-based consumption tax. In order for our trading partners to allow border-adjusted *income* taxes (direct taxes), they would need to eliminate the admittedly artificial distinction between direct taxes (income taxes) and indirect taxes (consumption taxes) alluded to earlier. Because GATT/WTO rules treat border tax adjustment of "direct taxes" as a prohibited export subsidy, border-adjusted taxes are permissible only in the case of indirect taxing regimes and then only insofar as the amount remitted doesn't exceed the amount of indirect tax "levied in respect of the production." That rule was written so the U.S. income tax would not pass muster as a border-adjustable tax, and as a direct tax it does not. Professors Hall and Rabushka's flat tax proposal would also probably fail to satisfy that rule.

Were it politically expedient to eliminate the indirect/direct distinction in the Doha Round of WTO negotiations, such an action would warm the collective aortae of K Street lobbyists. They could immediately work to bring back FSCs, ETIs, DISCs, interest-charge DISCs, and other export subsidy vehicles which from time

[4] If these economists are right and there is no increase in the competitiveness of U.S. goods because of a 23-percent increase in the price of the dollar (more or less precisely) relative to foreign currency, then that means the FairTax will have succeeded in increasing the wealth of the American people by something on the order of $20 trillion (23 percent of $90 trillion) relative to the rest of the world, an instantaneous increase nearly equal to the value of all the goods and services produced in the U.S. over two years. Although that would be reason enough to enact the FairTax, it is impossible for the traded-goods sector to dominate the currency movements, since the dollar-asset markets are perhaps 100 times as large as the annual traded-goods market (net basis). See B. 100 and B. 102, Flow of Funds Accounts, U.S. of America, Fourth Quarter 2004, Federal Reserve System, for statistical information on asset markets.

to time have been lobbied, enacted, and then quickly found violative of the WTO (and before that GATT). But negotiating away the indirect/direct distinction is not a sensible long-term policy response because convincing the WTO's 139 Member countries to abandon the indirect/direct distinction—no matter how baseless that distinction—would take phenomenal diplomatic acumen. If we can't change our own system into one that stimulates economic growth, if this Subcommittee itself cannot appreciate the importance of granting foreign producers unchallenged subsidies to compete unfairly against domestic producers, if the Europeans were willing to sue for a relatively minor export incentive worth about $4 billion annually (the FSCs/ETIs), it may be naive to assume our negotiators could convince the Chinese, Japanese, Canadians, Mexicans, Koreans, Indians, and Europeans that they should abandon their unique bargaining leverage attributable to their border-adjusted taxes. After all, these nations adopted border-adjusted tax systems with the sole purpose of granting themselves a unilateral trade advantage *against the U.S.*

Assuming *arguendo* such diplomacy were miraculously successful, eliminating the indirect/direct distinction would solve only a fraction of the economic problem, and then only for exporters. If the indirect/direct distinction were fully eliminated, an export subsidy would only allow exporters to defer or exempt a portion of their *income tax,* even though payroll taxes constitute abut 36 percent of the gross collections by type of tax. And lest we forget about our record trade deficits, this does nothing to level the playing field on imports which continue to compete against domestic producers unfairly on our own soil.

Finally, such a victory would be but one step in a process. The Ways and Means Committee is unlikely to have the appetite to pay for another major FSC provision given the current level of deficit spending.

***The best alternative is to enact a destination-principle tax system (also known as a border-adjusted tax system).*** U.S. manufacturers can compete effectively as the most productive and innovative workers in the world, but the U.S. must first remove this large and unjustified inequity against U.S. domestic producers. The removal of this tax advantage is nothing more than the promotion of neutrality, not the enactment of a special advantage. Replacing current U.S. income taxation with comparable border-adjusted taxation would tax all goods consumed in the U.S. alike, whether the goods are produced in the U.S. or abroad. We need to eliminate those aspects of the U.S. tax system that artificially place U.S. production at a competitive disadvantage compared to foreign production.

***And the best border-adjusted plan is the FairTax.*** The November 2005 Report of the President's Advisory Panel on Federal Tax Reform recommends a border-adjusted tax system,[5] but fails to honestly conclude none of its proposals would pass muster under the WTO/GATT rules. In fact, of the five candidates for true tax reform, only three are or could be made border-adjustable. These are: The FairTax (the most comprehensive, single-stage consumption tax), a business transfer tax (BTT) or a credit-invoice method value-added tax (which is called a Goods and Services Tax in Canada and Australia). Each is a destination principle consumption tax.

Of these plans, only the FairTax is hard wired to make the entire system border adjusted. The FairTax would transform the entire U.S. tax system into a border-adjusted tax by:

- repealing *all* upstream federal taxes now embedded in the product price of U.S. goods and eliminating any business-to-business taxes, including payroll taxes,
- completely exempting exports from taxation, and
- imposing the FairTax on foreign goods entering our shores for final consumption.

Only the FairTax can claim that under its regime, foreign manufactured goods and U.S. manufactured goods would bear the same tax burden when the goods are sold at retail. Only the FairTax can make the claim that U.S. businesses selling goods or services in foreign markets are fully relieved of federal tax (including payroll taxes).[6] Only the FairTax addresses this preeminent issue ignored by the Subcommittee today.

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[5] See "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," Report of the President's Advisory Panel on Federal Tax Reform, November 2005, pp. 171–172 and 283.

[6] The problem with other consumption tax plans—apart from the fact that they can quickly develop into income taxes—is that they only make non-payroll taxes border adjustable. For example, the BTT, which allows for complete expensing of business inputs, could be made border adjustable by not allowing a deduction for foreign business inputs and exempting export sales. The Flat Tax is not border adjusted.

**IV. Other Criteria for Reform**

We can safely predict the issue of border adjustability will not be raised today because none of the plans the witnesses espouse can be made border adjusted. Instead, the witnesses are expected to support the combination of an origin-based territorial tax system and a reduction of marginal rates as the cornerstone of their competitiveness proposals. In touching upon the hundreds of pages of complexity that constitute our international tax system, from the income sourcing and expense allocation rules, to the foreign tax credit limitations, to CFCs, to Subpart F, to personal holding company rules, to the various "baskets" of income which have made tax lawyers basket cases, the witnesses recommend simplification.

If extraterritoriality, rates, and simplicity were the only factors the Subcommittee reviews to evaluate how various plans improve America's competitiveness, the FairTax would still be superior to every policy option presented.

Begin by reviewing the three principal objectives sought to be achieved by territoriality.[7] First, those that support territoriality argue that if an American company can enjoy low taxes and still be headquartered here, they are less likely to move their headquarters elsewhere. (Although they would certainly move their production.) Second, international tax laws are complex and often gamed, and companies spend billions complying with rules that yield little revenue. Third, by allowing U.S. production to move where the taxes are lowest we will force the U.S. to lower our own corporate tax rates. In other words, we will force the U.S. into tax competition. Advocates of a territorial taxing regime make some valid points. Add to the arguments the fact that the U.S. historically fell into an extraterritorial tax system, not by choice, but by default.

But before taking such a path, however, the Subcommittee should consider a past tax policy debate that offers valuable prologue on the merits of this course of action.

Forty and one-half decades ago, during President John F. Kennedy's campaign, the same question arose in an almost identical context: Should the U.S. tax the foreign earned profits of U.S. multinationals (should U.S. companies doing business overseas escape U.S. taxes)? Quite predictably, the debate pitted management (who liked to keep white-collar jobs here at a U.S. headquarters) against unions (who argued it would also be a good idea to keep U.S. blue-collar jobs in the U.S.). It pitted Democrats against Republicans. Economist against economist. And the unions argued, quite understandably, that if American companies are able to take advantage of tax sparing (as some witnesses doubtless praise) they will establish themselves overseas to the detriment of the U.S. workforce. So 45 years later what does this mean for the territoriality debate? It is really a debate over legitimizing corporate inversions in fact. Companies can remain in the U.S. in name only, but the jobs will flock to nations that dole out the tax holidays.

Tax writers may choose to stroll unwittingly into that political minefield, but history has shown that debate to be bloody and intractable. And more importantly, that course of action does not simplify the system. Determining whether or not activity takes place within or without the U.S., applying income sourcing and expense allocation rules, and figuring out how to treat older earnings that will be repatriated will equal or exceed the complexity posed by the arcane rules of current law because the stakes will not be merely deferral, but exoneration from tax. The witnesses no doubt will underestimate these effects or the necessary transition rules, but they are very, very significant because they retain almost all the cost drivers so despised by current law.

There is a better answer that accomplishes all these objectives—impose a zero rate of tax on productive activity with the FairTax. Only under the FairTax would the U.S. become the most attractive jurisdiction within which to invest. A zero rate of tax would give foreign jurisdictions two choices: Reduce their tax rate on savings and investment (which will stimulate global economic reform and growth) or lose investment to America. Companies now American in name only would repatriate investment and jobs back to our shores.

**Conclusion**

As this Subcommittee holds its hearings, it misses the chance to discuss the issue of border adjustability and the chance to better elucidate those factors that bear upon the concept of competitiveness. As U.S. negotiators work to level the playing field in the Doha round of trade talks in the coming months, we urge this Subcommittee to focus a second competitiveness hearing solely on the issue of border-

[7] Although today the U.S. taxes its citizens and residents on income no matter where is earned, under a territorial system the U.S. would exercise taxing jurisdiction only when income is earned in the U.S. Such a regime for example, would allow a U.S. multinational to escape U.S. corporate taxes on their foreign earnings.

tax adjustments. And it might wish to take a step back and ask itself to establish the criteria on which reform should be based.

Beyond any other plan, the FairTax solves the problem the Subcommittee ignored by converting the entire U.S. tax base into a border-adjusted system. Through WTO legal means, the FairTax exempts exports from taxation, while taxing imports the same as U.S. produced goods for the first time. And it solves the problems the Subcommittee should be considering. It is the simplest plan that could be devised, without the intercompany (and intracompany) transfer pricing problems present in an origin-principle income or consumption tax. It reduces U.S. corporate rates to zero, ensuring the U.S. is the most competitive environment in which to produce and from which to export. And it would stimulate economic growth by broadening the tax base and reducing marginal rates well beyond any other proposal and do so in a way that does not tax the poor, punish savings and investment or tax income more than once.

Mr. Chairman: None of that would please K Street, but it will please Main Street.

§ FairTax.org is the nation's largest nonpartisan, grassroots organization dedicated to replacing the current tax system. For more information visit the Web page: www.FairTax.org.

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Tuscaloosa, Alabama 35501
*April 26, 2006*

Committee on Ways and Means
House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Committee on Ways and Means,

The American people are ready for tax relief. Everywhere we go we are taxed from property, to income, to SSI and more. Corporations DO NOT pay taxes. We, the American people pay their taxes as they are in business to make a profit. Taxes are part of their cost of doing business. Eliminating the tax burden that corporations carry will make them more competitive internationally by lowering their overall cost of doing business and leveling the playing field.

The American people are now working through June to pay our taxes. It is truly overwhelming.

The FAIRTAX bill will not only provide tax relief for Americans, but generate additional revenue for our government. Through the collection of a national sales tax the average American can control some of the taxes he/she pays by making certain buying decisions. Those who pay no taxes, illegal aliens and drug dealers for example, will be paying into the system they benefit from.

Personally, I want to see the money I earn in my checking account, savings account, and investments and not being controlled by the federal government.

Please pass the FAIRTAX bill. America will prosper beyond our wildest imaginations.

Sincerely,

Perry Nye

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The Tax Council
*July 5, 2006*

The Honorable Dave Camp
Chairman, Subcommittee on Select Revenue Measures
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515

Dear Mr. Chairman:

The Tax Council is grateful for the opportunity to submit a statement on the principles of international tax reform for the record of your hearing on the Impact of International Tax Reform on U.S. Competitiveness which was held on June 22, 2006.

The Tax Council is an association of senior tax advisers representing over one hundred of the largest employers in the United States. The Tax Council's members

include senior tax officers of companies involved in manufacturing, mining, energy, transportation, consumer products and services, retailing, and financial services.

The Tax Council has adopted the enclosed principles on international tax reform and respectfully submits them to the Subcommittee. We urge that you consider these principles, as the subcommittee further examines the many complex and controversial aspects of international tax reform,

We would be pleased to respond to your questions or comments on these principles.

Sincerely,

Kenneth Petrini
*Chairman*

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**The Tax Council**

**Principles of International Tax Reform**

- A well-reasoned, pro-growth international tax policy will allow U.S. companies to remain strong at home while competing for and winning business globally.
  - While there currently is no universal agreement on the "best" way to reform international tax rules, "reform" should enable U.S. companies to compete and thrive globally.
  - U.S. international tax rules should focus on enabling companies to invest capital based on market forces.
  - U.S. multinationals must be able to compete for business in worldwide markets, including the U.S. domestic market, without an additional U.S. tax burden resulting from our international tax rules.
- Tax policy must reflect the reality of doing business in the 21st century.
  - It is critical that U.S. tax policy reflect the way business currently is done and that it accommodate the business models that are often required in a global economy. While many U.S. companies have multinational operations, the markets are often local; therefore business has to be located in these markets to serve local customers and consumers.
  - International tax policy cannot be based on misplaced concerns of those who believe that investment by U.S. firms in foreign locations substitutes for investment in the United States. The decision is not to "invest here or there." In today's global economy, it is increasingly a question whether U.S. companies will invest in growing markets around the world or cede that investment to foreign competition. The question is not investment in U.S. or foreign markets but rather investment and growth by U.S. or foreign companies. The U.S. economic health is not improved by foreign investment in foreign markets.
- Active businesses investing scarce capital in market-driven investments represent the real business model under which business operates. Taxes are a cost of capital and a key element in determining the ultimate return. On a close project, the difference between 35 percent and a 20 percent corporate tax rate can make or break the economic viability of a project and impact the identity of which investor develops the opportunity—the U.S. company or the tax-advantaged foreign competitor.
- Low corporate income tax rates do make a difference in competitiveness, as reflected in the downward trend in corporate tax rates outside of the United States.
- Income should be taxed once and only once.
  - Double taxation destroys the opportunity to compete.
  - Governments acting rationally impose income taxes that effectively tax or subject to tax income earned in each jurisdiction once and only once.
  - The "arm's-length" principle and the robust development of appropriate transfer pricing rules in the U.S. and most of our developed trading partners provide the best tools to ensure that income is appropriately sourced to each jurisdiction and subjected to the tax rules of those jurisdictions.
- A reformed tax system should be broad based and apply consistently across industry lines, so that no industry or group of taxpayers is favored or discriminated against.
- In order for U.S. companies to grow and thrive in the global marketplace, if the U.S. is to move to a territorial tax system, such a system must not be a tax increase disguised as reform.

- Misallocation of home country costs to foreign operations, excessive taxation of revenue from the deployment of intangibles in foreign markets, loss of cross crediting and the denial of deductions for certain costs impose a double tax on U.S. multinationals that distorts the economics of the market place.
- Reasonable transition rules must be adopted to protect those who have generated deferred tax assets under the existing international system.
- Other elements of broader tax reform and simplification must be analyzed and considered in the design of a territorial tax system, all for the purpose of fully realizing the practical advantages of territoriality as it functions in many of our trading partners.

- Active business income is active income, no matter how mobile.
  - All income from invested capital is, more or less, "mobile." The appropriate policy distinction is between active business income and passive income.
  - International tax rules should incorporate suitable and clear definitions of passive income that do not impinge on the active conduct of business activities. In addition, any new international tax rules should provide de minimis rules that reflect conditions in the market place allowing businesses to perform active economic and financial functions without the fear of an additional layer of tax.

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Americans For Fair Taxation
Houston, Texas 77227
*June 22, 2006*

Dear Sir,

At some point, we all have to admit that the current tax system is broken and beyond repair. Even the IRS doesn't understand the bulk of it. The staggering costs of compliance, the enormous burden placed squarely on the backs of the largest U.S. corporations, and the lack of incentive for small businesses and entrepreneurs have the cumulative effect of weakening the U.S. economy on the whole by increasing the trade deficit to horrifying levels.

Between labor outsourcing and a tax system that punishes corporations for being profitable and creating jobs, it is hard to believe that this is the same country that was founded on individuality, personal responsibility, and a drive to succeed and excel. For years I have been wondering what we could do to stem the tide that threatens to wash over us all and leave in its wake a service-driven economy. I heard about a plan called the "FairTax," introduced by a member of your subcommittee, John Linder, and was intrigued. I read the bill and the FairTax book, and was curious as to why this bill has not been passed through both houses and signed into law.

I realize that there are concerns about the minutia of the transition period for such a radical change, as I'm sure everyone must also realize that a switch to any of the proposed tax plans would involve such a transition period.

The most important question is this: which of the proposals would be most beneficial to the country as a whole, thus making the transition period more tolerable? The answer, after rational discussion and consideration, is the FairTax.

An informal study in 1996 concluded that out of the international corporations interviewed, 75% said their future plans would include building their next manufacturing facility in the U.S. if a proposal such as the FairTax were enacted. A full 20% of those corporations further suggested that their world headquarters would be moved to the U.S. as well.

Based on all the research I've encountered, the FairTax will create the largest corporate tax haven in history, right here in our country. This will create the "giant sucking sound" Ross Perot predicted would follow the passage of NAFTA. The difference is, this sucking sound will not be jobs leaving the country (which has happened) but corporations, jobs, disposable income, and hence, more tax revenue, coming back to the U.S. where they belong.

On behalf of millions of disgruntled American taxpayers, I would urge you, as the esteemed Chairman of the Subcommittee on Select Revenue Measures, to explore the FairTax plan with an open mind and intellectually honest discussion, I am sure that, given consideration, this committee will see, as so many Americans are begin-

ning to, that this is the "better way" we have all been looking and, dare I say, praying for. Thank you for your time and attention in this important matter.

Sincerely,

Bradley S. Rees
*Chief Correspondence Coordinator*

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**Statement of Martin B. Tittle, Law Office of Martin B. Tittle**

**Introduction**

Chairman Camp, Ranking Democratic Member McNulty, and other Distinguished Committee Members:

Thank you for the opportunity to share my views with you. My name is Martin B. Tittle. I am an attorney with a practice centered on international aspects of U.S. taxation. This statement is submitted on my own behalf and not on behalf of any government or private entity.

Several witnesses at the June 22 hearing suggested that it would be beneficial for the U.S. to consider exempting foreign-source income from U.S. income taxation. The mechanism suggested for such a change was a switch from the current worldwide system, which taxes U.S. residents on their worldwide incomes, to a territorial taxation system, which does not tax residents on most active foreign-source income.

One witness, Paul W. Oosterhuis, cautioned the committee about several drawbacks of such a switch, including the disallowance of currently deductible expenses that, in a territorial system, would be properly allocated to exempt, foreign-source income. Mr. Oosterhuis and another witness, Prof. Michael J. Graetz, discussed these and other conversion issues in detail in a paper published in 2001.[1]

**A Third Option: Extending Foreign Tax Credit to VATs**

The apparent "either-or," "worldwide-or-territorial" choice presented in the hearing should be broadened to include a third option. We could alter our worldwide system to achieve a territorial result—little or no taxation of offshore business income—without the upheaval and loss of current benefits involved in a change to territorialism.[2] One alteration that could help achieve this result is a capped foreign tax credit for value added taxes (VATs).

VATs are transaction taxes that businesses must pay on in-country sales. They differ from sales taxes in that they have an internal mechanism for giving businesses a credit for the VAT they pay on their purchases. VATs exist in more than 120 countries that cumulatively account for about 70% of the world's population.[3] Therefore, many if not most U.S. companies doing business overseas owe and pay VAT to one or more foreign governments.

Allowing credit for VATs would tend to eliminate U.S. taxation of foreign-source business income[4] because VAT is a tax on gross sales, while income tax is a tax on net income. For instance, sale of $100 worth of widgets on which the profit margin is 10% would yield a profit of $10 and an income tax of only $3.50, assuming a tax rate of 35%. That same sale, however, would yield $15 of VAT in Luxembourg, where the standard VAT rate is 15%, and $25 in Denmark or Sweden, where the rate is 25%.

Credit for VATs need not be an all-or-nothing proposition; it could, and should be phased in. One option, which I do not favor, would limit the credit to a percentage of each VAT dollar paid directly to a foreign government and allow that percentage to increase over time. The problem with that approach is that the cost of VAT cred-

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[1] *See* Michael J. Graetz and Paul W. Oosterhuis, "Structuring an Exemption System for Foreign Income of U.S. Corporations," 44 *Nat'l Tax J* 771 (2001).

[2] The various changes that the switch to territorialism might include are set forth in President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, Report of the President's Advisory Panel on Federal Tax Reform" 132–135, 239–244 (November 2005) and Joint Comm. on Tax'n, "Options to Improve Tax Compliance and Reform Tax Expenditures," JCS–2–05 186–197 (Jan. 27, 2005). Those proposed changes were recently analyzed and compared with the territorial systems of Canada, Germany, and the Netherlands in Peter Merrill *et al.,* "U.S. Territorial Tax Proposals and the International Experience," 42 *Tax Notes Int'l* 895 (June 5, 2006).

[3] Liam Ebrill *et al., The Modern VAT* xiv (2001).

[4] *See* Gary Clyde Hufbauer, Email to Martin B. Tittle (May 11, 2003) ("For the bulk of manufacturing and service establishments, my guess is that the bottom line of VAT creditability would be very similar to an exemption system, i.e., little or no U.S. tax collected on foreign business activity").

itability would be difficult to forecast, even with accurate data on the past VAT liabilities of potential claimants.

A better alternative would be to offer dollar-for-dollar credit with a fixed-dollar cap on the maximum reduction of any single year's tax bill, and then gradually raise the cap.[5] If this alternative had been enacted in 2001, when 5,748 corporations claimed foreign tax credit,[6] and if the cap had been set initially at $500, the lost-revenue cost in the first year of VAT credit would have only been around $2.87 million.

In addition to serving as a surrogate for territorial taxation, foreign tax credit for VATs would throw a monkey wrench into the international trade law gears that maintain the distinction between direct and indirect taxes. Under both the General Agreement on Tariffs and Trade and the WTO Agreement on Subsidies and Countervailing Measures, the rebate of indirect taxes like VATs on exports is not an export subsidy, but the rebate of direct taxes like the income tax is.[7] For years, U.S. politicians on both sides of the aisle as well as non-partisan commentators have argued that this distinction is outdated and should be discarded,[8] but those countries that benefit from continuation of the distinction have refused to accept any change. VAT credit would blur the line between direct and indirect taxes and therefore might be helpful in future trade negotiations.

Finally, VAT credit offers a distinct advantage over the two current proposals for territorialism[9] in that it does not necessarily require the repeal, revocation, or elimination of any of the benefits of the current U.S. tax system. For instance, if VAT credit were enacted, the current characterizations of different types of income could stay the same.[10] No deductible items would need to be disallowed because

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[5] The current limitation of all foreign tax credits to the U.S. tax due on the foreign income would, of course, remain in place. *See* Internal Revenue Code Sec. 904.

[6] *See* Scott Luttrell, "Corporate Foreign Tax Credit, 2001," *available at http://www.irs.gov/pub/irs-soi/01cftcar.pdf (visited June 9, 2006).*

[7] *See* General Agreement on Tariffs and Trade 1947, Art. VI(4) ("No product of the territory of any contracting party imported into the territory of any other contracting party shall be subject to anti-dumping or countervailing duty by reason of the exemption of such product from duties or taxes borne by the like product when destined for consumption in the country of origin or exportation, or by reason of the refund of such duties or taxes."), Annex *I,* Ad Art. XVI ("The exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy."); Agreement on Subsidies and Countervailing Measures (SCM), Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Uruguay Round of Multilateral Trade Negotiations[:] Legal Instruments Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations Done at Marrakesh on 15 April 1994, vol. 27 (1994) Annex I(e) and n.58, *available at http://www.wto.org/english/docs_e/legal_e/24-scm.doc* (visited June 10, 2006) (identifying the "full or partial exemption, remission, or deferral" of direct taxes as a prohibited export subsidy).

[8] *See, e.g.,* Chuck Gnaedinger and Natalia Radziejewska, "U.S. Lawmakers Still Divided Over FSC–ETI Remedy," 2003 *Worldwide Tax Daily (WTD)* 31–1 (Feb. 14, 2003) (quoting House Ways and Means Committee Chair William M. Thomas, R–California, as saying, "The difference between direct and indirect taxation . . . in today's world is a distinction without a difference." (ellipsis in original)); Chuck Gnaedinger and Natalia Radziejewska, "Baucus Deems WTO Dispute Settlement System 'Kangaroo Court' Against U.S.," 2002 *WTD* 188–1 (Sept. 27, 2002) (quoting Senator Max Baucus, D–Montana, as saying, "The [WTO] appellate body's FSC decisions make an unworkable distinction between countries that rely primarily on direct taxes . . . and countries that rely primarily on indirect taxes. . . . Although the appellate body acknowledged countries' sovereign right to set their own tax systems, they interpret WTO rules in a way that heavily favors one particular system."); Chuck Gnaedinger and Natalia Radziejewska, "White House Urges U.S. Senate Finance Committee To Repeal ETI Act," 2002 *WTD* 147–5 (July 31, 2002) (quoting Senator Charles E. Grassley, R–Iowa and Chair of the Senate Finance Committee, as saying, with respect to the distinction between direct and indirect taxes, "How can we justify allowing this distinction to continue?"). *See also infra* note 46.

[9] *See* Joint Comm. on Tax'n, *supra* note 2, at 186–197 and President's Advisory Panel, *supra* note 2, at 132–135, 239–244.

[10] *See* President's Advisory Panel, *supra* note 2, at 240 (under territorialism, royalties would be imputed to foreign branches, and "mobile income," taxed when earned, would include the Sec. 863(d)/954(f) ocean and space income that was just liberated from Subpart F by Sec. 415(a) of the American Jobs Creation Act of 2004, P.L. 108–357); Joint Comm. on Tax'n, *supra* note 2, at 191 ("Non-dividend payments from the CFC [and foreign branches; see note 12 *infra*] to the U.S. corporation (*e.g.,* interest, royalties, service fees, income from intercompany sales) would be fully subject to tax [under territorialism], and this tax generally would not be offset by cross-crediting as it often is under present law.").

they were allocated to exempt income.[11] No disregarded entities would need to become regarded.[12]

**Theoretical Basis for Extending Credit to VATs**

Historically, U.S. foreign tax credit has been limited to income-type taxes, but the reason for that limitation remains a mystery. No explanation was included in the 1918 act that introduced the credit,[13] and, surprisingly, none has been enunciated in subsequent legislation.[14]

In 1956, Professor Stanley Surrey speculated that the basis for the limitation might lie in the purported "nonshiftability" of income taxes.[15] "Shifting" taxes, he explained, were those whose economic incidence was generally assumed to be passed on from the statutory or nominal payor to someone else. Examples included sales, turnover, and excise taxes. Income taxes, on the other hand, were generally assumed to be "nonshiftable," and therefore actually borne, or suffered by the taxpayer.

Five years later, Elisabeth Owens came to same conclusion, saying "the chief determinative factor in deciding whether a tax qualifies for the credit should be whether or not the tax is shifted or passed on by the person paying the tax."[16] Joseph Isenbergh repeated that theory of creditability in 1984, calling it the "only plausible explanation that has ever appeared for limiting the foreign tax credit to income taxes."[17]

The issue of shiftability is not merely a technical one. As Judge Karen Nelson Moore has correctly noted, "the goal of achieving tax neutrality between foreign and domestic investment [sometimes called capital export neutrality, or CEN] is satisfied [only] if taxes do not alter the relative rates of return on investments; allowance of a tax credit limited to taxes that are not shifted to others is consistent with that goal, since taxes that can be shifted do not affect the taxpayer's rate of return."[18]

Shiftability and nonshiftability are understood today, not as separate states that are fixed characteristics of different taxes, but as the opposite ends of a continuum across which all taxes move in response to market circumstances. In 1989, Judge Moore reviewed over 40 sources before saying, "The tax policy maker must conclude that a conclusive answer is not available today to the question whether the corporate income tax is shifted or whether it is in fact borne by the corporation and its owners."[19] That question has not been resolved in the years between 1989 and the present.[20]

Similarly, Liam Ebrill and his co-authors freely admit in the International Monetary Fund's book *The Modern VAT* that "[t]he effective incidence of a VAT, like that of any other tax, is determined not by the formal nature of the tax but by market circumstances, including the elasticity of demand for consumption and the nature of competition between suppliers. . . . The real burden of the VAT tax may not fall

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[11] *See* President's Advisory Panel, *supra* note 2, at 134 ("Reasonable rules would be imposed to make sure that expenses incurred in the United States to generate exempt foreign income would not be deductible against taxable income in the United States."); Joint Comm. on Tax'n, *supra* note 2, at 190 ("[D]eductions for interest and certain other expenses [including R&D] incurred by the U.S. corporation would be disallowed to the extent allocable to exempt (non-subpart-F) CFC earnings.").

[12] *See* President's Advisory Panel, *supra* note 2, at 240 ("Income of foreign branches would be treated like income of foreign affiliates [CFCs] under rules that would treat foreign trades or businesses conducted directly by a U.S. corporation as foreign affiliates."); Joint Comm. on Tax'n, *supra* note 2, at 191 (foreign branches would be treated as CFCs "for all Federal tax purposes").

[13] *See* Revenue Act of 1918, ch. 18, section 222(a), 40 Stat. 1057.

[14] *See* Karen Nelson Moore, "The Foreign Tax Credit for Foreign Taxes Paid in Lieu of Income Taxes: An Evaluation of the Rationale and a Reform Proposal," 7 *Am. J. Tax Pol'y* 207, 213–215 (1988).

[15] *See* Stanley S. Surrey, "Current Issues in the Taxation of Corporate Foreign Investment," 56 *Colum. L. Rev.* 815, 820–821 (1956).

[16] Elisabeth Owens, *The Foreign Tax Credit* 83 (1961), *quoted in* Moore, *supra* note 14, at 217–218.

[17] Joseph Isenbergh, "The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes," 39 *Tax L. Rev.* 227, 288 (1984).

[18] Moore, *supra* note 14, at 217 (paraphrasing Owens, *supra* note 16, at 84).

[19] Moore, *supra* note 14, at 222. Despite this statement, Judge Moore continued, in the same sentence as that quoted, "however, it seems likely that a substantial part of the corporate income tax is indeed shifted."

[20] *See, e.g.,* Douglas A. Kahn and Jeffrey S. Lehman, *Corporate Income Taxation* 22–25 (5th ed. 2001) (noting "substantial uncertainty about the incidence of the corporate income tax"); Cheryl D. Block, *Corporate Taxation* 14 (1998) (noting that the extent and direction of corporate tax shifting "is the subject of much debate and the incidence question remains unresolved").

entirely on consumers but may in part be passed back to suppliers of factors through lower prices received by producers."[21]

The VAT that U.S.-based e-tailers are now required to pay under the EU's e-commerce VAT Directive[22] is likely nonshiftable either largely or completely because they face EU competition that can charge lower VAT and no VAT.[23] In 2005, the European Commission proposed a "leveling of the playing field" in which all e-sellers would calculate and pay applicable VAT on sales to individual consumers at the rate required by the buyer's place of residence.[24] (The current rule allows EU e-tailers to use the VAT rate that applies where they are established, but requires non-EU e-tailers to use the rate in effect for the buyer's place of residence.)[25] Unfortunately, the new proposal has still not been adopted as of the most recent, June 2006 session of the EU Council of Economic and Financial Affairs.[26]

Judge Moore's solution to the income tax's quasi-shiftable character was to suggest that the foreign tax credit be eliminated as a windfall, and that foreign income taxes be returned to their pre-1918, deductible-only status.[27] However, an equally rational solution would be to continue the credit for income taxes, so as not to disadvantage businesses when income taxes cannot be shifted, and, with appropriate limitations, to expand the credit to VATs and other taxes that, like income taxes, are sometimes nonshiftable.[28]

The fact that the shiftability of both income taxes and VATs varies dynamically in step with market forces is indicative of a broader similarity. Direct taxes like income tax and indirect taxes like VAT are not opposites, but rather are alternate methods for allocating the same tax burdens. For example, it is widely acknowledged that VATs are essentially equivalent to a combination of several direct taxes, including a direct tax on business profits and a direct tax on wages.[29]

On the other hand, taxes that, under WTO rules, must be classified as direct are sometimes so similar to VATs that the difference is not substantive. For instance, the flat tax proposed by Congressman Richard Armey and Senator Richard Shelby in 1995[30] was essentially a flat-rate subtraction VAT in which collection of the tax had been divided between business and individuals.[31] That division of collection was not considered significant by knowledgeable observers including University of California, Berkeley economics and law professor Alan J. Auerbach.[32] It was, however, enough to make the flat tax a direct, and not an indirect tax under existing WTO rules.[33] As such, it could not have been remitted on exports and applied to imports,

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[21] Ebrill et al., supra note 3, at 15, 76. See also Joint Comm. on Tax'n, "Factors Affecting the International Competitiveness of the United States," JCS–6–91 298 (1991) ("It is not at all certain, however, that the entire VAT is actually borne by consumers in the form of higher prices.").

[22] Council Directive 2002/38/EC of 7 May 2002, 2002 O.J. (L 128) 41 (hereinafter,"E–VAT Directive").

[23] *See* Martin B. Tittle, "U.S. Foreign Tax Creditability for VAT: Another Arrow in the ETI/E–VAT Quiver," 30 *Tax Notes Int'l* 809, 813–815 (May 26, 2003), 2003 *WTD* 101–16, *available at* http://www.martintittle.com/publications/FTC4VATs.pdf (visited July 3, 2006).

[24] See Amended Proposal for a Council Directive amending Directive 77/388/EEC as regards the place of supply of services, COM(2005) 334 final 12, 22 (July 20, 2005), available at http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/com/2005/com2005_0334en01.pdf (visited June 8, 2006).

[25] *See* E–VAT Directive, *supra* note 22, at art. 1(1)(b) (adding subsection (f) to Council Directive 77/388/EEC of 17 May 1977 on the Common System of Value Added Tax, 1977 O.J. (L 145) 1, art. 9(2)).

[26] *See* Chuck Gnaedinger, "ECOFIN Extends E–VAT Directive," 2006 *WTD* 110–1 (June 8, 2006).

[27] *See* Moore, *supra* note 14, at 226.

[28] *See* Isenbergh, *supra* note 17, at 294–295 (suggesting expansion of the foreign tax credit to include all foreign taxes and noting that, if the amount of the credit is capped, "the Treasury has little reason to care about [the foreign government's] precise methods [of taxing]").

[29] *See* Gary Clyde Hufbauer, "Institute for International Economics Policy Brief on Foreign Sales Corporations," 2002 *WTD* 230–18, para. 13 (Nov. 29, 2002); Ebrill *et al., supra* note 3, at 18–19, 198 (a VAT "levied at a uniform rate on all commodities" is equivalent to "a cash flow business tax and a tax on wage earnings"; if, in addition, "the VAT rate is constant over time," it is equivalent to "a tax on pure profits, a capital levy, and a tax on wage earnings"; if the VAT is applied to imports and remitted on exports, it is also a "uniform export subsidy/import tax").

[30] *See* Freedom and Fairness Restoration Act of 1995, H.R. 2060, 104th Cong. (1995); S. 1050, 104th Cong. (1995), *cited in* Stephen E. Shay and Victoria P. Summers, "Selected International Aspects of Fundamental Tax Reform Proposals," 51 *U. Miami L. Rev.* 1029, 1030 n.4 (1997).

[31] *See* Michael J. Graetz, "International Aspects of Fundamental Tax Restructuring: Practice Or Principle?," 51 *U. Miami L. Rev.* 1093, 1095 (1997).

[32] *Id.* (citing Professor Auerbach's Congressional testimony).

[33] *See* SCM, *supra* note 7, Annex I(e) and n.58. *See also* Shay and Summers, *supra* note 30, at 1054.

as VATs are, despite the fact that it was in essence a "broad-based flat rate consumption tax."[34]

In the face of this virtual equivalence, it is no wonder that House Ways and Means Committee Chair William M. Thomas, R–California, has said that the distinction between direct and indirect taxes is, "in today's world . . . a distinction without a difference."[35] Senators Max Baucus, D–Montana, and Charles E. Grassley, R–Iowa, have voiced similar sentiments.[36]

Recognition of both the economic parity between income taxes and VATs and their equivalence in meeting the foreign tax credit criterion of nonshiftability strongly suggests that both income taxes and VATs should be creditable. Alternate bases for extending credit to VATs could include the competitive needs of U.S. businesses,[37] or the fact that VAT is the "principal tax" of various foreign countries.[38] The nonshiftability criterion has the advantage of being a classic theory and thus does not require "breaking new ground" to validate VAT creditability.[39]

**Proposed Standards for VAT Creditability**

The standards for creditability of VATs may need to be slightly more stringent than the standards for income taxes. The three criteria for creditability of an income tax are: (1) the tax must be due from the taxpayer (the "technical taxpayer" rule), (2) there must be proof of payment, and (3) the tax must not have been refunded.[40]

The first and third of these should be applied to VATs without change. With respect to the second, however, the current rule allows credit for foreign taxes paid by others as long as the taxpayer claiming credit was liable for the tax.[41] If that rule were applied to VAT creditability, then in theory everyone with an invoice showing a charge for VAT might claim a tax credit. Allowing credits on this basis would undermine the rationale for extending credit in the first place—to prevent double taxation from discouraging business activity abroad—because people who make a single purchase abroad are not necessarily attempting to engage in business activity there, even if the purchase is for business purposes.

It would be possible to bar such claims on the ground that the taxpayer could not demonstrate that the tax shown on the invoice had actually been paid by the party issuing the invoice (that is, that it had not been partially or totally offset by deductions). Alternatively, it could be argued that the claimant was not the "technical taxpayer." That argument would be more tenuous because, according to the EU's Sixth Directive,[42] all taxable persons must pay VAT, and the term "taxable persons" includes everyone "who independently carries out in any place" any of the economic activities of "producers, traders, and persons supplying services." That category includes even those who, as members of special classes, are exempted from payment of VAT, and as a result, it might also include casual purchasers.

Therefore, unless there is a clear advantage in keeping the criteria for income tax and VAT creditability identical and addressing this issue in an exception, VAT creditability should require that the taxpayer demonstrate direct payment of VAT to the foreign government. That proof could be a VAT return and payment authorization, or, if no VAT return has been or will be filed, it could be the receipt issued to the taxpayer or its representative by customs when VAT was paid at the time of importation. Either way, those with no more than an invoice showing a charge for VAT should not be able to claim the credit.

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[34] Graetz, supra note 31, at 1097; see Reuven S. Avi-Yonah, "From Income to Consumption Tax: Some International Implications," 3 San Diego L. Rev. 1329, 1335 (1996).

[35] See Gnaedinger and Radziejewska, supra note 8.

[36] *Id.*

[37] *See* Glenn E. Coven, "International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes," 4 *Fla. Tax Rev.* 83, 86 (1999).

[38] *See* Surrey, *supra* note 15, at 820 (noting the need, in 1954, to exclude sales and turnover taxes from the "principal tax" proposal).

[39] *Cf.* Robert F. Peroni, J. Clifton Fleming, Jr., and Stephen E. Shay, "Reform and Simplification of the U.S. Foreign Tax Credit Rules," 31 *Tax Notes Int'l* 1177, 1204 (Sept. 29, 2003) (arguing for VAT credit but against any requirement of nonshiftability on the ground that "[f]oreign taxes on corporate income also are shifted to others [as VATs are often thought to be] (and not necessarily completely to the shareholder-owners of the corporation) but are treated as creditable for U.S. purposes. That is rightly so because even if shifted, they are part of the cost and pricing structures of the corporations that nominally bear them and thus affect decisions on whether to invest at home or abroad.").

[40] *See* Treas. Reg. Secs. 1.901–2(f) (the "technical taxpayer" rule); 1.905–2(a)(2) (taxpayer must present proof of payment); 1.905–3T(d)(3) (refund of a foreign tax constitutes a change in foreign tax liability).

[41] *See* Treas. Reg. Sec. 1.901–2(f)(1)-(2).

[42] Council Directive 77/388/EEC of 17 May 1977 on the Common System of Value Added Tax, 1977 O.J. (L 145) 1.

**Conclusion**

Are there other issues that would need to be addressed before VAT credit could be implemented? Of course. For instance, there is the potential problem of abuse of VAT credit, which I have addressed briefly in a recent Tax Notes International article.[43]

Should I address and try to resolve all implementation issues now? For two reasons, probably not. First, any person or group that decides to support VAT credit will likely want to put its own "stamp" on the idea, so it can receive appropriate credit when VAT credit is enacted. Leaving implementation issues unaddressed allows opportunity for this natural, political need to be met.

Second, VAT credit is interesting only if we want to preserve our current, worldwide tax system and avoid the wholesale change that a switch to territorialism would entail.[44] One counterargument to preservation is that a switch to territorialism is more dramatic, and success in achieving it might generate more political capital. Another counterargument is that switching to territorialism might come with a better "playbook," in the form of the laws that other countries have generated in implementing it.[45]

At the end of the day, VAT credit is just an option that has the potential to simulate territorialism while allowing the benefits of the current U.S. tax system to remain unchanged. Almost on a par with its territorial emulation, VAT credit also offers what I think is an enormous trade law "kicker." That kicker, as noted, is that it could begin the process of erasing the distinction between direct and indirect taxes, a distinction that has plagued the U.S. for decades.[46] Right now, the U.S. has only one trade law argument to use—"it's not fair anymore"—and that argument has been roundly ignored. Blending direct and indirect taxes by giving capped credit for the latter against the former would shake things up by putting a little of our money where our mouth is, and that could be just the edge our trade negotiators need the next time around.

**Statement of United States Council for International Business**

The United States Council for International Business (USCIB) is pleased to present its views to this Subcommittee on Select Revenue Measures (a Subcommittee of the Ways and Means Committee) with respect to this extremely important subject of the need to reform the international tax regime of the Internal Revenue Code (the Code) to enable U.S. multinational enterprises to enhance their international competitiveness vis-&-vis their foreign rivals. Although this hearing, and our statement, focus on the international aspects of the Code, many other, non-international provisions therein need re-examination and possible amendment, for the same reason.

The USCIB advances the global interests of U.S. business, both here and abroad, including, in many instances, the U.S. operations of non-U.S. enterprises. It is the U.S. affiliate of the International Chamber of Commerce (ICC), the Business and Industry Committee to the OECD (BIAC), and the International Organization of Employers (IOE). Thus, it clearly represents U.S. business in the preeminent intergovernmental bodies, where the many and complex issues that face the international business community are addressed, with the primary objective being to search for possible resolutions to these issues. The bottom line in all of this is to ensure the existence of an open and equitable system of world trade, finance and investment.

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[43] *See* Martin B. Tittle, "Achieving a Territorial Result Without Switching to a Territorial System," 43 *Tax Notes Int'l* 41, 46–47 (July 3, 2006), *available at* http://www.martintittle.com/publications/VAT_credit.pdf.

[44] *See supra* note 2.

[45] *See* Merrill *et al., supra* note 2 (summarizing the territorial rules of Canada, Germany, and the Netherlands, comparing them to the territorial proposals in President's Advisory Panel, *supra* note 2, and Joint Comm. on Tax'n, *supra* note 2, but emphasizing the negative aspects of a change to territorialism).

[46] *See, e.g., The WTO's Challenge to FSC/ETI Rules and the Effect on America's Small Business Owners: Hearing Before the House Comm. on Small Bus.,* 108th Cong., 1st Sess., 13 (2003) (testimony of Dr. Gary Clyde Hufbauer that "[t]his [FSC–ETI] dispute originates in the ancient, and I think unjustified distinction between a direct and indirect taxes [sic]").

**Introductory Background**

The U.S. income tax system was first enacted in 1913, following its authorization by a Constitutional amendment. The system evolved over the years, by way of annual income tax acts, three codifications culminating in the 1986 Code, which is the basis of the statute today (the earlier codifications occurred in 1939 and 1954). From the beginning, the Code subscribed to the so-called **Classical** system, applied on a **Global** basis (these terms and concepts will be described below). For many and varied reasons, the Code has become antiquated, reflecting an inability to deal effectively and efficiently with the modern day business models and practices. Therefore, most pundits in the area would agree that the Code is in dire need of a thorough overhaul at this time. In fact, this was corroborated by the Bush Administration, which gave a high priority to a fundamental tax reform project and appointed a blue ribbon panel (the Panel) to conduct such a study. (USCIB submitted a commentary to this Panel during its deliberations, which submission contained our thoughts and suggestions on this topic, many of which will be mentioned below.) Although this statement deals primarily with the international provisions of the Code, as mentioned above, the domestic provisions need a thorough, critical review as well.

**Conclusions**

Before commencing with a detailed discussion, it would be useful to outline briefly the relevant goals that USCIB would envisage be accomplished by a major reform of the Code's international tax regime. These are set forth below.

- A reformed tax system should aim to depart completely from the old Classical model, which doubly taxes corporate income, and, in its place, shift to an integrated system, which avoids multiple levels of income tax on the same income.
- A reformed international tax regime should **not** result in an increase in the tax burden of U.S. multinational enterprises. Thus, nominal tax rates should be reduced, not increased, and the situation where U.S. multinationals encounter residual U.S. tax on foreign source income after application of the foreign tax credit provisions should be the exception rather than the rule.
- A reformed tax system should be broad based, and it should, thus, apply consistently across industry lines. In other words, it should not discriminate against certain industries or specified groups of taxpayers. In addition, the revised regime must offer consistency in tax treatment to all forms of business organization availed of by multinational taxpayers to conduct business operations abroad, whether it be a controlled foreign corporation, a branch, a partnership, a joint venture (e.g., a 10/50 company), etc., so as not to unfairly penalize any taxpayer for selecting one form of business organization over another, presumably, for valid business reasons.
- A reformed international tax regime should ideally eliminate, but, at the very least, substantially cut back the reach of, the Code's Subpart F provisions, so as to restore the sanctity of the principle of deferral with regard to U.S. taxation of foreign income earned through associated overseas entities. In other words, the acceleration of taxation of overseas non-repatriated earnings, including the active income of a foreign subsidiary of a U.S. based financial services enterprise, puts U.S. multinationals in a competitively more disadvantageous position than non-U.S. multinationals. Also, in this vein, an appropriate definition of "passive" income should be carefully crafted so as not to subject to tax, in the guise of passive income, what is really active business income, prior to repatriation (e.g., royalties from intangibles and technology developed by a taxpayer for use in its trade or business).
- A reformed international tax regime should strive to minimize, if not totally eliminate, international double taxation by offering to U.S. multinational enterprises a **true** overall foreign tax credit limitation approach. In other words, the fracturing of the limitation into many different categories (baskets) defeats the goal of providing maximum relief from international double taxation, and adversely impacts the competitive position of U.S. enterprises. Moreover, for the same reason (i.e., competitiveness), the regime should simplify and ease the requirements and relevant rules in allocating and apportioning expenses to foreign source income. The alternative approach to providing double tax relief is the so-called territorial (i.e., exemption) approach, which is very popular among the European (and certain other) countries. The particular exemption system proposal currently under consideration in the USA is generally not favored by the USCIB membership; however, it is important to note that, if structured appropriately, territoriality could achieve the desired goals.
- A reformed international tax regime should fully support and encourage the enhancement of the U.S. tax treaty program, and strive to introduce into it inno-

vative concepts which will serve the interest of minimizing double taxation for all taxpayers, U.S. and foreign.
- A reformed international tax regime should retain the "place of incorporation" standard as the sole standard for determining corporate residency; a "place of management" test, as an alternative or replacement, is undesirable.

The discussion to follow will illuminate many of the above points.

**Classical Model and Double Taxation of Corporate Earnings**

The United States has followed the Classical system model since the inception of the U.S. tax law. Under such model, net corporate income after corporation income tax is again subjected to income tax in the hands of shareholders, with the exception of dividends eligible for the inter-corporate dividend exemption. The ultimate individual shareholders are subject to tax on corporate dividends, which are almost always paid out of income already taxed at the corporate level.

In contrast, many, if not most, of our trading partners, i.e., those nations in which the competitors of our U.S. multinational enterprises are domiciled, use some form of integrated tax system (there are several different methods of achieving an integrated system, but the imputation model has, over the years, been the most popular). Multinational enterprises which are resident in countries having integrated tax systems may well enjoy a competitive advantage over U.S. multinationals by reason of not being subject to the double taxation of corporate income as under the Classical model.

Over the years, legislative efforts have been made, from time to time, to reduce the incidence of double taxation of corporate profits, through a combination of dividend credits and exemptions, most of which were repealed because of revenue concerns. The latest move to redress this flaw in our system took place in the 2003 tax legislation, i.e., the Jobs and Growth Tax Relief Reconciliation Act, which imposed a tax of 15% on portfolio dividends in lieu of a resident taxpayer's invariably higher marginal rate. This is indeed a step in the right direction of achieving a fully integrated system; but full integration, comparable to that in many of our trading partners, is still the ultimate goal in this area. In our view, it would be a simple matter, at this point, of completing the job that the 2003 legislation started, and to provide, legislatively, for a zero rate on portfolio dividend income. End of story!

Although one might consider this issue more in the area of domestic tax policy, the elimination of the double tax on corporate income would make the Code more consistent with the approach of our trading partners and, thus, perhaps, tend to level the playing field for U.S. multinational enterprises.

**Overall Tax Burden Concerns**

In devising a rational and user-friendly international tax regime for U.S. multinationals, one that will enhance their competitive standing in the world, there are two major overall themes that should be considered as guiding principles behind any proposed detailed technical legislative amendments. First of all, whatever shape reform in the international tax regime might take, the drafters of the statutory language must be sure that the changes do not impose higher tax burdens on U.S. multinational enterprises than now exist. This may seem like a simplistic statement, and it may be; but, in a proposal for reform in the international area developed by the Joint Committee on Taxation in 2005, in which the JCT recommended replacing the current system with a territorial system for mitigating international double taxation, the scheme so presented resulted in a tax increase of over $50 billion on the population of U.S. domiciled multinationals. This has to be carefully avoided, or the cure will be worse than the disease.

Again, as a matter of domestic tax policy, if the rates of corporate tax must be tinkered with, they should not be raised so as to increase the tax burden. Ideally, they would be lowered, as the USA is today one of the higher tax countries in the world. (A tax decrease on multinational enterprises, in fact, could well have a salutary impact on the economic well being of the USA.) Moreover, we submit that U.S. multinationals should be in a position in which there is rarely any residual U.S. income tax on their foreign earnings. This can be achieved by way of a properly constructed foreign tax credit provision or a carefully tailored territorial system.

The second guiding principle is that of consistency of treatment across the board. The tax system, as well as the international tax regime therein, should be broad based, and, in accord therewith, have equal application across industry lines. In other words, the regime should not single out specific industries or groups of taxpayers for special, usually discriminatory, treatment. Consider the current foreign tax credit provisions, which contain (in Section 907) punitive rules with respect to the petroleum industry, treating that industry more harshly in terms of additional limitations on their foreign income taxes which are available for the foreign tax

credit. The standard of consistency also should apply to alternative forms of organization. Whatever form of organization a U.S. multinational enterprise elects for the conduct of its overseas business activities, be it a controlled subsidiary (a wholly-owned or majority-owned controlled foreign corporation), a branch, a partnership, or a joint venture (e.g., a minority-owned controlled foreign corporation or a non-controlled foreign corporation (a 10/50 company)), it should be subjected to similar tax treatment. The choice of form of organization is, in general, a business decision rather than a tax driven one.

**Deferral/Controlled Foreign Corporation Rules**

The principle of deferral has been an underlying tenet of the tax statute virtually since inception of income taxation in the USA. Deferral is nowhere defined in the statutory language, but it is implicit in the structure of the law. Essentially, it stands for the proposition that earnings amassed by the overseas affiliates of a U.S. taxpayer are not includible in the income of such taxpayer as earned, but only as actually paid out, or otherwise made available to, the U.S. taxpayer. In other words, the income as earned by a foreign affiliate is deferred from U.S. tax as long as it remains in foreign corporate solution.

In the United States, the principle of deferral was first violated by the introduction into the statute, under the 1939 Code (pre-1954), of the Foreign Personal Holding Company (FPHCo) provisions. This set of rules, together with its companion piece, the Personal Holding Company (PHC) provisions, targeted the incorporated pocketbooks of high net worth individuals who were attempting to reduce their personal tax burdens by shifting passive income-producing assets into corporate solution, either domestic (PHCo) or foreign (FPHCo). These provisions had no real effect upon publicly held U.S. multinational enterprises. It wasn't until 1963, courtesy of the Revenue Act of 1962, when the Controlled Foreign Corporation (CFC) provisions became effective that the large U.S. international corporations began to feel, to a degree, the impact from a partial ending of deferral. These CFC rules introduced into the Code a novel concept, that of taxing all U.S. taxpayers, including the large multinationals, on certain specified income earned by CFCs in which such shareholders held a greater than 10 % voting interest. These new provisions went beyond the PHCo/FPHCo attack on passive income held by a closely-held corporation (i.e., the so-called corporate "pocketbook"), although passive income was included as an item of income to be covered under the new regime.

The main thrust of the CFC rules, in brief, was to treat low-taxed income earned by CFCs as dividends to the U.S. shareholders. It was aimed at preventing U.S. multinational enterprises from enjoying the tax deferral benefits arising from the use of tax havens or special tax incentive provisions in non tax haven jurisdictions to conduct bona fide business activities (e.g., product sales, services, etc). It is quite easy to see just how these changes adversely affected the competitiveness of U.S. business abroad, even at a time when the USA still dominated the world economy. Unfortunately, in the years since the Revenue Act of 1962, Congress has enacted a plethora of ill conceived, onerous amendments to Subpart F, having little relationship to the original purpose of the provisions, resulting in a further erosion of the competitiveness of U.S. business abroad. Although many other capital exporting nations have since enacted their versions of the CFC concept, the U.S. version is, by far, the most burdensome to its multinational community.

The 2004 tax legislation did redress some of the issues and problem areas in the CFC rules. But what is really needed to shore up the competitive vigor of U.S. international enterprises is a complete repeal of the Subpart F provisions. The USCIB strongly supports this, which, in conjunction with the changes in the double taxation relief rules, to be discussed below, is just what the doctor ordered to cure the competitive ills of U.S. business abroad.

**International Double Taxation Relief**

***Credit Approach***

Doubtlessly, the most important set of provisions in the Code with regard to restoring and enhancing the competitiveness of the U.S. multinational community is the set of provisions aimed at granting such enterprises relief from the scourge of double taxation (by two or more jurisdictions) on the same income streams. The provisions so designed to carry out this mandate encompasses the actual foreign tax credit mechanism (Sections 901–907 and 960) and the related expense allocation and apportionment principles (regulations under Section 861 and 862). The existence of a flexible and efficient system for the elimination of international double taxation is, in essence, the cornerstone upon which is built a suitable international tax regime for U.S. multinational enterprises.

Initially, the foreign tax credit regime offered a country-by-country limitation (referred to in the Code as the per-country limitation), under which a taxpayer would be limited in the amount of foreign tax credit allowable each year to the aggregate of the amounts of U.S. tax attributable to the taxable income from each foreign country in which the taxpayer incurred foreign income taxation. In 1960, effective for calendar year 1961, the Congress enacted an overall limitation to replace, after a transitional period in which both limitations were in the law, the per-country limit. This mechanism, which allowed for the averaging of all foreign income taxes, irrespective of the source country or the nature of the activity giving rise to such income taxes, proved to be an a very effective shield for U.S. corporations against the burdens of double taxation, in terms of maximizing the foreign tax credit relief and, thereby, minimizing the tax burden (U.S. and foreign) on foreign source income. The ink was barely dry on the legislation enacting the overall approach when Congress took its first baby step toward diluting it by enacting a separate limitation on certain passive interest income. From then on, Congress kept chipping away at the effectiveness of the overall limit, culminating in the 1986 Code which established a series of separate limitations with the result that the overall limitation existed in name only, not in fact. Naturally, the competitive position of U.S. business was severely compromised by this development.

Like in the deferral area, the 2004 tax legislation provided some relief by reversing some of the mischief created to the overall limit in the previous Congresses. But more needs to be done to truly re-establish a level playing field for U.S. multinationals. This should be a two-pronged program. First, the overall limitation needs to be reborn in its original (1960) configuration, i.e., absolutely no separate limitations, not for passive income nor any type of operating income (e.g., oil and gas income covered now under Section 907). The second prong relates to expense allocation and apportionment which is discussed in the ensuing two paragraphs.

Having a reasonable set of expense allocation and apportionment rules, for foreign tax credit purposes, is as important to U.S. multinationals in ensuring competitiveness abroad as having a monolithic (non-fractured) overall foreign tax credit limitation. If anything can dilute the efficiency of the overall foreign tax credit relief, it would be an arbitrary and unreasonable set of rules for allocating and apportioning expenses against foreign source income to arrive at foreign source taxable income, the numerator of the foreign tax credit limitation fraction. We were pleased to see the amendments enacted in the 2004 tax act introduced very sensible rules in the allocation and apportionment of interest expenses, which previously had been tilted unfairly against maximizing allowable foreign tax credits, as well as in the allocation and apportionment of general and administrative expenses. Such sensible rules should be retained and a similar approach should be utilized with respect to all other expense categories that require allocation and apportionment against foreign source income.

***Exemption Approach***

An alternative to the credit approach is the exemption approach, often referred to as the territorial method. This method has been under intense scrutiny of late, having been the subject of a U.S. Treasury Department study as well as the recommended approach of the Presidential Advisory Panel on Tax Reform. In addition, a blueprint for such a system has evolved from a Joint Committee on Taxation (JCT) study thereof. In broad outline, the territorial system would operate to exempt U.S. enterprises from income tax on the business earnings of their overseas entities, including subsidiaries, branches, joint ventures, etc., while continuing to tax them on their so-called passive income where the foreign tax credit mechanism (probably on a per-item basis) would operate to eliminate the double tax on such income. The USCIB does not concur with a territorial system modeled along the lines of the JCT blueprint. If, however, a territorial system structured in the manner of those in use in certain of our trading partners (e.g., the Netherlands, France) were to be established, it could well achieve similar results, i.e., relieving double taxation as discussed in the immediately preceding section. Otherwise, retention of our present system will be more apt to enhance our nation's competitive position vis-&-vis these competitor nations.

It is important to note that the territorial system is only about mitigation of the potential international double taxation burden that arises from engaging in cross border trade and investment, nothing more. The question is: does this system more effectively provide for U.S. multinational enterprises the maximization of double tax relief, and, therefore, the minimization of global tax burdens? The answer to this question depends upon the structure of the particular territorial model selected. We believe, however, that a territorial system installed in the Code for the purpose of

raising additional tax revenue for the Government would be a very unfortunate development.

Should a territorial system be adopted, a number of industry specific issues will emerge. For example, for the financial services industry, the most important international issue is the allocation of interest. Careful attention must be paid to developing rules that do not result in the loss of interest deductions to members of the financial services community. In particular, the tax systems of our major trading partners and OECD countries must be analyzed to understand how they treat interest expense so our financial institutions are not put at a serious competitive disadvantage.

If one were to initially construct a tax system today, it would be a very close call as to whether to opt for a credit system or an exemption system. The answer would evolve about the design of the credit mechanism vs. the design of the territorial exemption and the comprehensiveness of the relief produced by each such approach. Although the territorial method would appear to enjoy the virtue of simplicity, this can be misleading. Simplicity may be desirable, but it is not the primary goal, which is the effectiveness of a system in minimizing the double taxation burden. It should be noted that the credit system, even if amended as we suggest above, is very familiar to the managements of U.S. multinationals, and, in particular, to the tax departments of these enterprises. Thus, taxpayers would be knowledgeable with all the nuances of the system and comfortable with its application. There would be no growing pains to suffer as there no doubt would be in implementing a whole new approach to double tax relief, which, although its proponents claim is simpler, does have its own complexities.

In addition, the transition from the present system to a territorial system, involving an exemption from tax for business income and a foreign tax credit for other income, would, we estimate, be initially burdensome on the tax department resources of the U.S. multinational community, both financial and human. Also, there may have to be some very complex transition rules with regard to the phase-out, over a relatively long period of years, of the existing foreign tax credit rules so as to permit taxpayers the opportunity to somehow utilize credits accumulated in years in which the old system was in force. As a corollary, this would probably necessitate a gradual phase-in of the new system. The change thus could be a long, drawn-out affair, replete with complications as the two systems operated in tandem. This factor alone, although not as significant as the comparative effectiveness of the two approaches, could be enough to substantially erode support for such a conversion at this time.

***Importance of Tax Treaties***

Tax treaties have been with us since the 1930's. The number thereof and their importance has increased tremendously over the years. The foreign tax credit (as well as territoriality) is a unilateral approach to the elimination of international double taxation, while treaties present a bilateral approach for, *inter alia,* accomplishing this goal. All interested parties, government, business, investors, etc., support a vigorous, proactive and innovative treaty policy. In the context of these hearings, it should be said that any legislation addressing the reform of our international tax regime should be carefully structured to ensure consistency with this goal of enhancing our international treaty program.

***Corporate Residence***

We noted that the Presidential Panel, in its report of November, 2005, made a recommendation to alter the long standing definition in the Code of corporate residence. We do not concur with the Panel on this matter, and we wish to express that concern here in the event that this Subcommittee (or its parent, the W&M Committee) might decide to consider and recommend the Panel's position on this issue.

Since inception of the U.S. income tax law, the test of corporate residence has been the place of incorporation. Accordingly, an entity organized under the laws of one of the fifty states of the USA (or under U.S. federal law) was a U.S. corporation, and, thus, resident, so to speak, in the USA. This is a straight-forward objective test, simple to apply. The Panel has recommended adding to the mix an additional, much more ambiguous, standard, i.e., the place at which the entity is managed and controlled. This so-called "mind-and-management" test is, admittedly, used in more countries than anything comparable to our standard, but that doesn't make it right. This mind-and-management standard was developed under the legal principles of the United Kingdom. Under it, one looks to various indicia in an effort to establish the place from which the entity is managed and controlled, and thus resident.

The Presidential Panel recommended that the management and control test be included in the Code, in addition to the place of incorporation test. In other words,

all U.S. incorporated entities would be U.S. residents by way of the long standing rule, while all non-U.S. incorporated enterprises would be tested under the new management and control standard, however that would be implemented, if enacted. Although it seems clear that the new standard would be aimed squarely at foreign controlled enterprises doing business in the USA, it could prove to be a pitfall for U.S. controlled enterprises as well, since it could easily be used by the IRS to assert a U.S. residence with respect to their CFCs. Accordingly, we see the potential for such a change in the corporate residence test to give rise to much controversy with the IRS, both with foreign controlled enterprises operating in the USA and U.S. controlled enterprises as to their CFCs. If this comes to pass, such additional controversy will no doubt lead to more, needless, costly (both to the IRS and taxpayers) litigation. The key consideration in this context is the possibility that a U.S. enterprise's CFCs could be treated as U.S. residents, for U.S. tax purposes, thus negating the benefit to U.S. competitiveness that will result if our recommendations on international tax reform discussed above with respect to deferral and controlled foreign corporations are taken seriously.

An interesting observation to be noted, in the context of this discussion, is the distinct possibility that an amendment to the corporate residence rule along these lines would probably discourage decision-making executives of foreign enterprises engaging in U.S. business activities from residing in the U.S. Although such an eventuality might not have an adverse impact on the competitiveness of U.S. business, it could certainly have an adverse effect on inbound foreign investment in the U.S., which is not necessarily a good thing for the U.S. economy.

***Conclusion—A Final Note***

In conclusion, we would urge the legislators to seriously consider the arguments and suggestions discussed above with respect to the Code's international tax regime in their effort to re-establish the strong competitive position internationally of the U.S. business community.

We would further suggest that, as part of this review, tax reform should also look at competitiveness of the U.S. economy. In other words, whatever reform legislation emerges from this current exercise, it should attempt to render, and retain, the U.S. economy as a user friendly jurisdiction in which to establish business operations. Over the years, our country has been a leader in attracting foreign investment. As the global economy, hopefully, continues to expand, we face increasing competition from other countries for this investment, which, of course, means that we should strive to eliminate tax policies and rules that discriminate against foreign investment. After all, foreign investment in the USA creates jobs for U.S. workers just as domestic investment does. It must also be said, in this vein, that tax legislation that discriminates against foreign investors tends to breed the enactment of similar measures by our trading partners which would act against the best interests of U.S. enterprises operating or investing internationally.

We thank the members of this Subcommittee for the opportunity to present our views on this subject of utmost importance to our membership, to the U.S. multinational community and to the well being of the U.S. economy, in general.

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Elmsford, New York 10523
*March 21, 2006*

An extremely important and delicate relationship exists between the citizens of this great country and its federal government. Putting it lightly, this relationship is very much aggravated by our current income tax system. Why must we have a tax system that causes so much friction? It need not be like this. As Mr. Goldberg so clearly stated, "What I find so discouraging is the gulf between what can be done and what's being done. It's not as though we are lacking for ways to simplify the system . . . there is no end to the good ideas; what's lacking is their enactment into law."[1]

We have created an environment that punishes hard work, savings, capital investment, and the entrepreneurial spirit. A tax system that has sliced and diced our country into a myriad of categories, groups, industries, races, classes, non-profit/profit, all clamoring and pleading with Washington for "breaks," causing the very foundation of America to twist and bend with those who best promote their cause. The end result causing friction, lack of confidence, confusion, frustration, anger, in a nutshell, class warfare between all Americans.

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[1] TAX CODE SIMPLIFICATION—FRED T. GOLDBERG, JR. 15 June 2004, Congressional Testimony by Federal Document (c) 2004 FDCH / eMedia, Inc. All Rights Reserved.

We spend over $200 billion dollars and 6 billion hours in complying with over 42,000 pages of code. At the end of it all it is estimated that some $300—$500 billion dollars escapes taxation and no tax preparer arrives at the same conclusion given a set of circumstances. Knowbody knows what the heck is going on!

The Whole System is Unfair because it doesn't treat everybody equally. It has strayed from what should be the original intent of any taxing system, the Collection of Taxes. It has been warped into a tool for social change, (this is like trying to clean a window with a bulldozer), causing the environment which I have described above.

The following must be recognized:

- The sole guiding principal is Collection with Simplicity and Fairness as the characteristics.
- Administered equally to all with one rate and with no exclusions. Note that I am a home owner and I donate to many causes.
- Any re-distribution of wealth should be in the form of specific targeted accountable programs. Of course we need to help those who are less fortunate, however, do not do it in the tax system.
- Only consumers pays taxes.
- Don't be too overly concerned with transitioning. Though we don't like having to do it, we have become quite resourceful and adept at doing it. How? With every modification that occurs with the current income tax code and there have been over 14,000 changes since 1986.

I am of the belief that we pull the income tax out by its roots so it will never grow back. *I implore you to support the FairTax, H.R. 25 & S.25.*

Realize, that we find ourselves in a wonderful moment in time where we have a leader in President Bush who recognizes that America has problems and is willing to confront those problems. I believe our income tax system is one of the largest and most pervasive problems that we face today and it isn't worthy of our United States of America.

Thank you.

Most Respectfully,

Adam S. Yomtov

PS. Pregnancy is complicated. Paying our Federal taxes need not be!

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Statement of The Honorable Fred T. Goldberg, Jr. Commissioner, Internal Revenue Service, 1989–1992.

Subcommittee on Oversight/Committee on House Ways and Means June 15, 2004

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