

Senate Finance Committee
Hearing on
An Examination of U.S. Tax Policy
And its
Effect on the Domestic and International Competitiveness
Of U.S.-Based Operations

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Mr. Chairman, Senator Baucus, and Members of the Committee, I thank you for the opportunity to testify here today on this important set of issues. I am Bill Barrett, vice president of tax and trade for Applied Materials.

Description of Applied Materials

Applied Materials, Inc., was organized in 1967 to supply the then-newly emerging semiconductor industry. In the 35 years since then, Applied Materials has become the global leader in the worldwide semiconductor equipment industry. We compete in nearly every segment of the industry, including atomic layer deposition, chemical vapor deposition, physical vapor deposition, electroplating, etch, ion implant, rapid thermal processing, chemical mechanical polishing and others. In short, Applied Materials makes the systems that produce virtually every new microchip in the world. Applied Materials competes both with other U.S.-based companies and foreign companies in Europe and Japan – many of which benefit from far more favorable tax regimes than we do in the United States.

The semiconductor equipment industry develops, manufactures, markets, and services semiconductor wafer fabrication equipment and related spare parts. Our customers include both companies that manufacture semiconductor devices for use in their own products and companies that manufacture semiconductor devices for sale to others. More than 70 percent of our sales are outside the United States, with major markets in Taiwan, Japan, Europe, Korea and, increasingly, China. Our FY2002 sales were \$5.06 billion, and we spent more than \$1 billion on research and development – nearly 21 percent of our net sales. Headquartered in Santa Clara, California, Applied Materials currently employs 13,000 people with research and manufacturing located primarily in California and Texas.

The semiconductor equipment industry is integrated with numerous companies occupying critical niches and supply chains. At each component stage, companies must keep pace with rapid technological change and product cycles to survive. As these cycles repeat and new products and markets are created, residual markets from prior product cycles remain and as a result, over time the absolute market size and opportunity increases. At present, however, the semiconductor equipment sector is experiencing its worst downturn in history. Industry sales today are less than half of what they were at their peak three years ago.

Capital Investment Decision Making

Successful multinational companies expand offshore to increase global sales revenue and market share. To be successful outside the United States, a multinational must work closely with customers and adapt its corporate structure to accommodate customers located in foreign markets. Historically, the U.S. semiconductor equipment industry has serviced global markets with U.S.-based manufacturing and U.S.-based research.

A successful company is in the business of selling product and increasing financial return to its investors, and when tax rates reduce potential return, they play an increased role in the decision-making process. A company that makes sensible investment decisions based on after-tax returns – decisions that improve the ability to competitively price products – stands a good chance to improve its global market share.

U.S. multinational capital investment decision-making is influenced by both tax and non-tax factors. U.S. tax laws that increase the after-tax cost of doing business may impact the geographic location of investment. In turn, the location of capital investment has a direct impact on exports and export-related jobs for exporters. This is also true for U.S. supplier companies that support U.S. manufacturing and research activities. The various sectors within the semiconductor equipment industry tend to be closely linked and interdependent so that investment decisions by one sector will have a multiplier effect on where future geographic income will be earned.

When product lines mature, or components of a product can be produced more efficiently offshore, specific segments of manufacturing may migrate offshore. U.S. companies move to offshore production after consideration of not only labor costs, but also other costs of manufacturing in a foreign location.¹ The total costs of manufacturing in any location must be analyzed, and taxes are certainly one of those costs.

Competing Views On International Tax Reform

Two competing – but not necessarily incompatible – views of U.S. international tax reform have emerged. These views generally track with the location of a U.S. multinational's manufacturing, research and development locations. Companies with

¹ Labor, logistics, capital costs, regulatory, intellectual property protection, political stability, currency stability, are all examples of costs that must be considered when analyzing alternate site locations. See Haroldene Wunder, *The Effect of International Tax Policy on Business Location Decisions*, Tax Notes International, December 24, 2001. In 1993, Applied Materials moved its volume manufacturing to Texas from California to reduce its cost of manufacturing. California versus Texas tax costs factored into that decision.

established offshore profit-making operations generally support the approach embodied in last year's House bill H.R. 5095 and in this year's H.R. 285.

H.R. 285's simplification provisions address important areas such as: repeal of the subpart F trading provisions; allocation of interest expense on a worldwide basis; reduction of foreign tax credit baskets; extension of the foreign tax credit carryforward period; and repeal of the alternative minimum tax foreign tax credit limitation. These provisions would lower the current U.S. tax on offshore profits that are properly earned pursuant to bilateral transfer-pricing principles.²

Also included in last year's H.R. 5095 was a repeal of the exclusion for extraterritorial income (ETI), which would increase the U.S. corporate tax rate for U.S. manufacturers. Taxpayers that benefit from the ETI exclusion are companies that manufacture or develop products in the United States and export their products overseas. For many U.S. manufacturers, the geographic location of research and development also corresponds with the location of manufacturing. An increased tax rate for U.S. manufacturers reduces their competitiveness, and could cause multinationals that currently manufacture in the United States to migrate activities to offshore locations. Although ETI is no longer sustainable following the WTO decisions, the underlying purpose of ETI remains – the maintenance of at least some level of U.S. competitive balance of tax policy relative to our foreign competitors.

In contrast to the approach in H.R. 5095, the Jobs Protection Act of 2003 (H.R. 1769) provides a partial replacement to the eventual repeal of ETI. H.R. 1769 would reduce the effective U.S. corporate tax rate on U.S. production profits. It is important to note that this legislation, while mitigating the impact of ETI repeal to U.S. exporters, still represents a significant tax increase on many of America's most competitive manufacturers. H.R. 1769 also includes important transition provisions that would ease the pain from ETI repeal. In overturning three decades of established U.S. tax policy, appropriate transition mechanisms are in order.³

The importance of a healthy domestic manufacturing base to overall U.S. economic vitality is hard to overstate. Accordingly, it is imperative that any repeal of ETI provides a "soft landing" to this change in U.S. tax policy. Raising taxes on American manufacturers is rarely a *good* idea. To impose an additional \$5 billion annual burden, at a time when domestic manufacturers have lost an average of 100,000 jobs per month for the past two and one-half years and when the United States faces yawning and growing merchandise trade deficits, is a *spectacularly bad* idea.

² Importantly, it is because bilateral transfer pricing enforcement is so much better than it was in the 1960s that many of the reform proposals are possible.

³ The EU recognizes the principle of transition in phasing out tax programs either because they are to be repealed as a matter of policy or because they are unlawful. For example, in January 2003, the European Commission ruled that certain Member State tax programs are inconsistent with the EU's state aid rules, which are the rules against unfair, market-distorting subsidies. The decision gives the offending Member States (Belgium, Luxembourg, Netherlands, Ireland, and Portugal) almost eight years of transition. Similarly, the U.S. Congress in the past has provided significant tax reform transition relief (*e.g.*, see 5 year IRC §936 transition provisions).

In addition to some type of ETI replacement, improvements to the U.S. R&D tax credit are under serious consideration by the House and Senate (H.R. 463 and S. 664). Reducing the tax rate on U.S. manufacturing profits (patterned after H.R. 1769) in combination with improvements to the R&D credit (patterned after H.R. 463 and S. 664) represents a partial offset to the increased tax burden (approximately \$5 billion per year) on U.S. manufacturing profits that will result following a repeal of ETI.

Applied Materials believes international tax reform goals can be reconciled with other tax policy viewpoints. Reconciliation within Congress, and the U.S. high-tech multinational community, is possible if international tax reform is founded on the following:

1. Reduced rate of tax on U.S. manufacturing profits patterned H.R. 1769.
2. R&D credit enhancements patterned after H.R. 463 and S. 664.
3. Subpart F repeal for trading income and foreign tax credit simplification measures patterned H.R. 285; and
4. Enactment of the “homeland investment” provisions to encourage investment of foreign earnings in the United States.

Fundamental Tax Reform Should Remain the Long-Term Goal

In theory – and in practice – lower corporate tax rates attract investment. The emergence of Ireland as a high-tech growth area in the EU is a good example. Closer to home, we see businesses moving operations from high-tax states to lower-tax states. The trade multiplier effect resulting from significant tax reform is very important as well. The larger economic benefit gained from reduced tax rates is not necessarily reduced tax costs, but rather increased trade and the leveling of cross border balance of payments.

Understanding these basic macro economic principles provides focus for the direction of tax reform. Tax reform should hold to the principles of simplification, increasing fiscal transparency, and trade promotion. Simplifying the corporate tax system benefits corporations and the economy, simplifies Internal Revenue Service audits, unburdens the courts, and simplifies the tax legislative process. Fiscal transparency improves both federal and local governments ability to predict tax revenue.

Alternative Corporate Tax (ACT)

A dramatic and comprehensive solution to the international tax reform is the Alternative Corporate Tax (ACT).⁴ The fundamental elements of ACT are: (1) the gross margin on exports is not taxed; (2) imported inventory is deductible, except for purchases from related foreign entities; (3) no deduction for salaries and wages; (4) accelerated write-off for capital assets; (5) passive income is not taxed; (6) income earned offshore is not taxed;⁵ (7) a credit for OASDHI paid by a corporation against tax liability; and (8) a significantly reduced corporate tax rate.

⁴ ACT was developed by Ernie Christian, Gary Hufbauer, and other members of the Center For Strategic Tax Reform/Cost Recovery Action Group. ACT is a variation of subtraction method VAT.

⁵ Post-ACT election, income earned offshore would not be subject to U.S. taxation and therefore, foreign earnings could be repatriated without U.S. tax and reinvested in the U.S. economy. This aspect of ACT is similar to the Homeland Investment Act (H.R. 767 and S. 596) and carries with it economic stimulus cited

ACT has several advantages over the current income tax system. ACT is much simpler to compute because: foreign earned income is not taxed, which also eliminates complicated foreign tax credit calculations; other credits, such as R&D, would be eliminated; and alternative minimum tax would be eliminated.⁶ In addition, because both profits on exports and offshore profit earned by related foreign entities are not taxed under ACT, U.S. transfer pricing and offshore intangible transfer issues would be minimized.⁷

Conclusion

Applied Materials appreciates the opportunity to participate in these important Senate hearings on U.S. international tax reform. The state of the economy, World Trade Organization rulings with respect to FSC and ETI, and the willingness of Congress to simplify the taxation of foreign operations present a convergence of events that compels meaningful international tax reform. In an increasingly competitive global marketplace, enhancing the after-tax return to U.S. manufacturers is an important step forward in making the United States *the* preferred choice for locating investment, pursuing economic opportunity and creating jobs.

by various economists (e.g., James P. Lucier, *The Homeland Investment Act – Congress Cures Up A Second Blockbuster Tax Reform This Year*, Prudential Securities Equity Research, June 23, 2003).

⁶ Note also that “inversions” would no longer be relevant for companies that elect ACT. In addition, because the tax base is broadened (i.e., salaries and wages are not deducted), there should be less incentive to implement aggressive tax planning.

⁷ More or less profit on an export sale, and more or less offshore profit, matters less because export profits and offshore profits are not taxed under ACT.