Committee on Finance
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Hearing on the Extraterritorial Income Regime

Testimony of
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On behalf of
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My name is Dan Kostenbauder, General Tax Counsel at Hewlett-Packard Company in Palo Alto, California. HP was founded in 1939. With our recent merger with Compaq Computer Corporation, the new HP is a leading technology solutions provider for consumers and businesses with market leadership in fault-tolerant servers, UNIX® servers, Linux servers, Windows® servers, storage solutions, management software, imaging and printing and PCs. Furthermore, 65,000 professionals worldwide lead our IT services team. Our $4 billion annual R&D investment fuels the invention of products, solutions and new technologies, so that we can better serve customers and enter new markets. HP invents, engineers and delivers technology solutions that drive business value, create social value and improve the lives of our customers.

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

Summary of Testimony

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 If the ETI is repealed, then it should be replaced with tax legislation that clearly will comply with WTO rules.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

In particular, the AeA suggests that the following provisions should be among those that should be adopted upon repeal of the ETI:
1. Repeal the foreign base company sales income and the foreign base company services income rules under Subpart F,
2. Remove active rents and royalties from the passive income rules under Subpart F,
3. Increase the foreign tax credit carryforward period to 10 years, and
4. Repeal the limitation on use of foreign tax credits to offset the corporate alternative minimum tax.

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

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

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

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

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

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

In general, U.S. tax is imposed under Subpart F not only on a foreign subsidiary's passive income (interest, dividends, etc.), but also on income earned from certain active business transactions with related persons. For example, U.S. tax is imposed on the income of a foreign subsidiary from purchasing goods from legal entities within the multinational group and reselling them outside its country of incorporation.

By imposing U.S. tax on intercompany payments between foreign subsidiaries, Subpart F of the Internal Revenue Code puts U.S. multinationals at a competitive disadvantage in the global marketplace by imposing current U.S. tax on ordinary foreign business transactions that otherwise would not be subject to current U.S. taxation.

The Subpart F base company rules have been justified as measures that counteract efforts by U.S. multinationals to shift foreign profits to tax havens by making payments to related companies located in tax havens. The 1962 legislative history to Subpart F reveals that the related person provisions were targeted at transfer pricing abuses. Since 1962, however, the ability of the IRS and foreign tax authorities to combat transfer-pricing abuses has improved dramatically. The IRS has issued increasingly detailed transfer pricing regulations to provide guidance, and Congress has enacted stern penalties

for non-compliance. As a result, the profits of the various members of a U.S.-based multinational group are much more likely today to be properly allocated based on real economic factors (such as the functions performed, investments made, and risks borne).

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

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

The Subpart F base company rules do not automatically generate revenue for the U.S. Treasury. In cases where Subpart F income is generated due to activities in high tax countries, foreign tax credits can eliminate any residual U.S. tax liability.

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

An interesting proposal that was considered, but rejected, in 1962 when Subpart F was enacted would have treated the European Economic Community (now the European Union) as a single country for purposes of the Subpart F related persons provisions. According to the legislative history, the basis for this decision was the fact that, although the European countries had formed a common market, they did not yet have a unified tax system. Recent proposals introduced to simplify Subpart F include provisions relating to the treatment of the EU as one country. For example, in H.R. 2018 (106th Congress), the Secretary of the Treasury would have been tasked with analyzing the impact of treating the EU as one country for purposes of applying the same country exceptions under Subpart F.

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

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

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

Exclude Active Software Royalties from Passive Income

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

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

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

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

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

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

Increase Foreign Tax Credit Carryforward period from 5 years to 10 years

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

U.S. taxpayers may claim FTC's against U.S. tax in order to avoid double taxation of income. The amount of FTC's that may be claimed in a year is subject to a limitation, so that the credit is allowed only to offset U.S. tax on foreign source income. To the extent the amount of creditable taxes of a given taxable year exceeds the limitation, the excess may be carried back two years and forward five years.

Problems of double taxation often arise because the foreign tax treatment of items of income and expense may differ from the U.S. tax treatment. For example, the same income may arise in different taxable years for foreign and U.S. tax purposes. As a

result, the foreign taxes may be imposed in a year during which little or no foreign income may arise under U.S. tax principles. The rules for FTC carryovers seek to address this problem by allowing the FTC's to be carried over from years in which foreign taxes are imposed to years in which the foreign source income arises under U.S. tax principles.

Extending the period of the FTC carryforwards would allow companies to offset their U.S. tax liabilities in later years when they are profitable without facing the pressure of expiring FTC carryovers. This modification would allow U.S. taxpayers that had accrued or paid foreign taxes additional time to utilize their FTC carryovers.

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

Remove 90% Limitation on Claiming Foreign Tax Credits from Alternative Minimum Tax

The regular corporate income tax allows companies a credit of 100 percent of the foreign taxes on income earned abroad subject to various limitations and restrictions. Only 90 percent of the alternative minimum tax ("AMT") may be offset by FTC's that would otherwise be available. This rule causes double taxation of foreign income and thwarts a fundamental and long-standing principle of U.S. tax policy.

The Joint Committee on Taxation April 2001 Study (JCX-27-01, 4/25/01) recommended that the corporate AMT be eliminated. The report concluded, "The original purpose of the corporate AMT is no longer served in any meaningful way." Furthermore, it has been estimated that the cost of tax compliance alone for the complexities costs companies many times the amount of AMT collected. Repeal of the entire AMT is an issue for another day. In terms of overall international competitiveness, however, eliminating the double taxation of international income clearly is appropriate.

The AMT has a perverse effect of penalizing U.S. global companies for distributing overseas earnings to U.S. parent companies to support domestic operations. Because of the AMT's limit on FTC's, earnings distributed from abroad are effectively taxed at a higher rate than domestic earnings, and certainly at a higher rate than the earnings of non-U.S. competitors operating in those same foreign markets. This puts U.S. companies in this position at a competitive disadvantage vis-à-vis their foreign competitors in overseas markets.