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FOREIGN TAX ISSUES

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

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FOREIGN TAX ISSUES

FRIDAY, JULY 21, 1995

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:30 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman of the committee) presiding.*

Also present: Senators Roth, Chafee, Grassley, Hatch, D'Amato, Moynihan, Baucus, Bradley, Rockefeller, Breaux, Conrad, Graham, and Moseley-Braun.

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order, please. This morning we are deviating slightly from our series of hearings on Medicare and Medicaid to go into the exciting topic of foreign taxation.

We have with us as our first witness Joseph Guttentag, the International Tax Counsel for the Department of Treasury. Mr. Secretary, we are glad to have you with us today.

STATEMENT OF JOSEPH H. GUTTENTAG, INTERNATIONAL TAX COUNSEL, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. GUTTENTAG. Thank you, Mr. Chairman.

I am pleased to be able to present the views of the Treasury Department with respect to the deferral of tax on foreign income of U.S. persons and the special tax regime accorded foreign sales corporations. I would like to submit my prepared statement for the record, and summarize it.

The CHAIRMAN. Without objection.

[The prepared statement of Mr. Guttentag appears in the appendix.]

Mr. GUTTENTAG. The Treasury is committed to the basic concept of deferring U.S. income tax on active business income of foreign corporations in which U.S. persons have an interest.

We are as strongly committed to eliminating such deferral and imposing tax as the income is earned—or equivalent taxation—with respect to U.S. interests in incorporated foreign pocketbooks

*The Joint Committee on Taxation prepared a document relating to this hearing entitled: *Description and Analysis of Present-Law Tax Rules Relating to Income Earned by U.S. Businesses From Foreign Operation* (JCS–20–95), July 20. 1995.

used to earn passive income as well as peripatetic activities whose locations are primarily tax-motivated.

Furthermore, we continue to support provisions which remove tax incentives for shifting passive assets overseas or allowing them to accumulate there, often in no- or low-tax countries.

But we do not draft these provisions in a vacuum. We are keenly aware of the competition which U.S. companies face overseas and are committed to ensuring that our tax laws do not create inappropriate barriers to the success of U.S.-based multinationals.

At the same time, we must ensure that our tax laws provide a level playing field for decision makers with respect to choosing a situs for expanded or new facilities.

We must consider the interrelated provisions of the Internal Revenue Code, as well as the constantly changing panoply of economic activities and structures and how they affect each other. Accordingly, it is wise when considering changes to these tax rules not to view them in isolation.

Section 956A of the Code, enacted in 1993, falls squarely within the parameters of the policies which I have enunciated in a greatly summarized and simplified fashion. Under pre-1993 law, U.S.-controlled foreign corporations were enabled to maintain huge hordes of passive assets overseas, bearing no reasonable economic relationship to the active businesses from which they flowed.

Section 956A requires U.S. companies to pay U.S. tax on current and accumulated earnings of controlled foreign corporations to the extent they hold these excess passive assets. The assets subject to this rule are the ones in excess of 25 percent of all assets.

Our research showed that the amount of passive assets of foreign companies located in countries subject to a normal tax regime averaged 7 percent of the total assets involved in the business, while passive assets were 30 percent for companies in no- or low-tax countries. That is where many of the companies most affected by 956A are located.

Our data clearly indicated that we were closing a loophole that you could drive a truck through. We continue to support Section 956A and would oppose any changes at this time.

Prior to adoption of the Passive Foreign Investment Company rules in 1986, U.S. persons had a substantial tax incentive to make passive investments through a foreign company, thereby avoiding the current tax on earnings. In some cases, the rules encouraged U.S. persons with savings to shift their savings overseas.

The PFIC rules subject any U.S. shareholder of a foreign corporation to the choice of current taxation of all earnings or deferred taxation but subject to an interest charge, incorporating the time value of money concept.

All of these provisions are complicated. Our economy is a complicated one. We have been working with taxpayers and the Congress toward simplifying and rationalizing the rules which govern taxation of foreign income, and specifically the PFIC rules. We remain committed to that project.

We are satisfied that current policy strikes an appropriate balance between deferral and current taxation and reflects the need to ensure the continued and effective competitiveness of American business. Many foreign competitors are subject to similar tax regimes, providing for deferral, granting foreign tax credits, and limiting deferral using methods similar to ours.

Finally, I turn to Foreign Sales Corporations, whose rules permit a reduction of approximately 5 percent in the generally applicable corporate tax rate. FSCs must be considered together with our source of income rules, which permit certain U.S. exporters to shelter export income from tax with excess foreign tax credits attributable to high-tax foreign operations.

Congress monitors the effectiveness of the FSC rules by requiring a quadrennial report from Treasury. The first such report reflected a relatively modest amount of incremental exports resulting from the use of FCSs, possibly for the reason I have described.

We do appreciate the opportunity to discuss these important issues with you. Our economy can be subject to swift, massive changes or, just as important, gradual ones. In either event, we must constantly monitor our tax rules, particularly in the international area, to be able to assure ourselves that we have done the best job possible in balancing the need for revenue, equity, and simplicity while ensuring the competitiveness of American industry.

Thank you. I will be glad to answer any questions.

The CHAIRMAN. Mr. Guttentag, thank you.

Do most foreign countries exempt from taxation foreign-source income?

Mr. GUTTENTAG. No. Most of the countries—and I think the ones I assume you are referring to would be the ones where our major trading partners are located, our competitors—use a system similar to ours.

The CHAIRMAN. So that when foreign-source income is brought home it is taxed.

Mr. GUTTENTAG. That is right. And many of them have rules similar to our subpart F rules, which do tax passive income and other similar types of income as we do, even if it remains overseas.

The CHAIRMAN. Just for the record, will you define passive assets and, therefore, I guess, active assets, if that is the contra, and passive and active income? I do not mean a legal definition, a lay definition.

Mr. GUTTENTAG. Alright. Looking at it from a balance-sheet perspective, active assets, I think, would include everything except the passive assets. We would include in the passive assets in a business the working capital, which could be cash, short-term investments, portfolios of securities, and so forth.

The CHAIRMAN. Now, portfolio security, you mean foreign securities owned by the company?

Mr. GUTTENTAG. No, they could be U.S. securities.

The CHAIRMAN. But you could that as active income, an active asset.

Mr. GUTTENTAG. Well, it would depend. This is a very difficult line to draw, Senator, between active and passive. We know that. Something that could be active for one taxpayer would be passive for another, and vice versa. For example, with respect to a bank, certain assets held by a bank would be active business assets, while if those same assets were held by another kind of operation, a mercantile company or a manufacturing company, they would be passive assets.

The CHAIRMAN. Likewise then for an insurance company that invests for long-term return on an actuarial basis, that for them would be an active investment, for a textile company it would be a passive investment?

Mr. GUTTENTAG. That is very possible. An asset may be passive in the hands of one taxpayer and active in the hands of another that is engaged in a different business. Generally, by "passive" assets, we mean passive in the sense that the owner of the assets is not directly involved in the management of those assets and the generation of the income. Even if an asset is clearly passive, it may be needed in the business. The section 956A and PFIC thresholds both take into account the needs of any business to hold a certain amount of assets classified as passive.

The CHAIRMAN. So the insurance company that buys 5-year German bonds and buys common stock in a French company and is basically averaging out their long-term investments but managing them, those would be active assets. They need them for their long-term actuarial soundness.

Mr. GUTTENTAG. An insurance company is in a very highly specialized industry that is subject, as you know, to special tax rules under the Code, both domestic and international. Whether a particular asset is active or passive would require a look at the whole balance sheet, at the entire operation.

In connection with insurance companies, for example, we often look at the regulatory rules which govern them and which may require that they have certain assets, and we pay a lot of attention to such regulatory rules.

The problem can arise in determining not the nature of the assets themselves, but exactly how much are needed. That is why I said, if local regulations, for example, require that they have a certain amount of assets, we might then look at assets in excess of that as being passive.

The CHAIRMAN. Does this become an incentive for American companies to invest overseas in an active investment in order to get their passive investments below the percent rule?

Mr. GUTTENTAG. This decision would be affected by Section 956A of the Code, which would apply for the purpose of determining whether a company had excess passive assets. The question then is, did the enactment of that provision, which distinguishes between active and passive, caused taxpayers overseas to switch to active assets to avoid the impact of Section 956A?

This is obviously an issue that Treasury looked at most carefully before proposing and supporting the provision. As I explained in my prepared statement, Section 956A clearly does limit any tax incentives to bring new capital overseas. Passive assets which are already overseas have been there without reinvestment in an active business. Generally, returns on passive assets are lower than returns on active managed assets. The companies have had the opportunity to invest them in active businesses and have chosen not to do so.

Accordingly, we do not believe that Section 956A creates an inappropriate incentive to convert passive to active assets. If they did convert them to active assets, that does not necessarily mean there would be new foreign businesses created. Companies could convert passive to active, for example, by acquiring a 25 percent interest or more in an existing business.

The CHAIRMAN. Senator Hatch.

Senator HATCH. Thank you, Mr. Chairman. Welcome, Mr. Guttentag.

Mr. GUTTENTAG. Thank you.

Senator HATCH. Mr. Guttentag, as you know, our U.S. software industry is the best in the world and is continuing to develop wonderful new and innovative products. A large and growing portion of the sales of U.S. software companies, of course, is exported.

These exports, naturally, are very important to our economy. I understand the Commerce Department says that for every $1 billion in exports, that we create about 19,000 domestic jobs. So it seems to me that our tax laws should encourage exportation. This is what the Foreign Sales Corporation, or FSC, was designed to do.

However, the software industry is running into a big snag with the Treasury Department's temporary FSC regulations relating to exported software. Let me just show you two CDs here. One, is a musical recording CD of Utah artist Kurk Bester, and the other one is a WordPerfect software CD that also happens to play sounds and music along with the software.

Under Treasury's regulations, if I export the master of the musical CD for recording purposes, I will get FSC benefits for royalties earned on overseas sales or licenses. However, those same regulations would deny FSC benefits if I exported the master CDfor software.

So I have to say that I, for the life of me, cannot understand why the software CD industry should not get the same benefits as the music CD industry. I see very little different between the two.

Now, could you shed some light for me on Treasury's thinking on this problem?

Mr. GUTTENTAG. You indicated that Treasury drew this distinction. As we are aware, those decisions were made jointly by the Congress and by the Treasury.

Senator HATCH. But we always blame you. It is only fair to understand the game here.

Mr. GUTTENTAG. That is all right. [Laughter.]

All right. That is fair.

Senator HATCH. No, it is not fair. [Laughter.]

Mr. GUTTENTAG. The result is questionable, Senator, as far as encouraging exports. As you point out, it is the master recording that is sent overseas. In both cases the music and the computer disc are exported for the purpose of being reproduced overseas and sold eventually through retail channels. So, actually, the production of the physical object in both cases is done overseas in your example.

There is a question as to whether the FSC benefits, which relate to goods which are manufactured, produced, grown, or extracted in the United States—which is the language of the statute—should apply to either one of those products. However, the Congress did provide that films, records, and tapes, for reproduction abroad, would be included for the FSC benefits.

Because there was this question as to the overall coverage of the statutory language, our position was—and we have explained this, I believe, to the committee and the members previously—that if there was to be an extension of the Foreign Sales Corporation provisions to software, the same decision should be made by the Congress as was made with respect to the master recording, which you demonstrated. Accordingly, the Treasury does not oppose your proposal but believes that it is appropriate that it be done by Congress.

Senator HATCH. You believe you do not have the authority to make the decision that these two very similar but dissimilar products, one is treated preferentially and the other one is not?

Mr. GUTTENTAG. Because of the nature of the provision in the foreign sales corporation provisions of the Code.

Senator HATCH. All right. I think that is something we ought to change, Senator Packwood.

I think you would support that.

Mr. GUTTENTAG. Yes. We would not oppose that provision.

Senator HATCH. I share the same concerns that the distinguished Chairman of the committee does with regard to the current rules under Section 956A regarding PFIC rules, which actually encourage companies to invest overseas in overseas plants and equipment by granting what is, in effect, an investment credit for foreign investment.

So, I want to raise that issue as well, and just reemphasize what our Chairman has done. Thank you again for being here.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Mr. Chairman, I have no questions, but I would like to commend you for looking at this issue. From what I have heard and have been briefed about, I know there is an unintended consequence. The first time that I really had that explained to me was by the Chairman.

I think it is a mistake to keep laws on the book that are intended for good purposes—of raising revenue and keeping people from escaping their payment. Indeed, if there are unintended consequences, as it would seem are taking place, and that, indeed, we may be encouraging the keeping of assets and investments out of our country and encouraging them to invest, our own multinational companies, in foreign countries and escape the payment of taxes that some of them otherwise would have made, that certainly was not the intention, I am sure, of the administration or of those of my colleagues who voted for this legislation. I do not think I did. It is one of the things of which I am not sure, but I do not think I did.

I could understand where colleagues thought they were closing some loophole, but I would hope that we would be able to proceed in dealing with this, not on the business of what makes the best campaign rhetoric, but rather what makes the most sense.

So, I am looking forward to getting the facts and hopefully acting accordingly. I thank the Chair.

The CHAIRMAN. In lay terms, is this not the problem we face? You have an overseas company. If 25 percent of its assets are passive assets, then all of its income is taxed. Do I understand it correctly?

Mr. GUTTENTAG. The amount of its income that would be taxed would be dependent upon the relationship between the amount of the excess assets and the earnings.

The CHAIRMAN. Right.

Mr. GUTTENTAG. We do not tax any more than the earnings of the foreign corporation. That is, we do nothing more than eliminate the deferral.

The CHAIRMAN. Yes. The total deferral.

Mr. GUTTENTAG. We end deferral of tax on the amount of earnings invested in excess passive assets, that is right. Right.

The CHAIRMAN. All right.

Senator Grassley?

Senator GRASSLEY. Have you had a chance to study the plans for addressing today's foreign tax issues that have been proposed in the House of Representatives, and if you have, any comment on that approach?

Mr. GUTTENTAG. Senator Grassley, the various proposals that have been made—the proposed flat tax and the ones included in the Nunn-Domenici proposal—are generally consumption taxes. The international provisions have not been fully developed.

The drafting of those provisions, the thought given to them, has been primarily in their impact in the domestic area. We are, of course, continuing to study them, but we are really waiting for the international provisions to be more fully developed by the sponsors of that legislation.

Senator GRASSLEY. Well, do their plans, in order to be operative, have to be thought out in this area of foreign taxation? They would have to be, because you would not keep the existing tax law.

Mr. GUTTENTAG. Absolutely, Senator.

Senator GRASSLEY. Yes. That has to be worked out before they move ahead.

Mr. GUTTENTAG. If we were to go, for example, as some of them propose, to eliminate the income tax and just have a consumption tax, we would have to deal with a very basic question that is, while other countries tax income when it is earned, the United States would tax it when consumed. You can see serious problems there of having no taxes imposed or double taxation.

Senator GRASSLEY. Yes. One last question. What is the benefit of the grandfathering rule of Section 956A, which allows certain pre-1993 U.S. foreign investment gains to avoid taxes on excess earnings invested in passive assets?

Mr. GUTTENTAG. We believed when we proposed the Section 956A provisions that many companies had excess passive assets overseas. We decided that the provisions that the Congress finally enacted should subject the earnings of the company to tax to the extent the company continued to had the excess passive assets.

It was also decided at that time, however—and this was a very important decision, which you have noted—that even though there were excess passive assets over there in 1993 and substantial untaxed earnings, we would only apply these new rules, to profits earned after the enactment of the 956A provisions.

So earnings received before the effective date of that provision were not affected, even though there were excess passive assets abroad. Taxpayers had a chance to deal with those assets, to bring them back. There was no immediate tax. We thought that this so-called grandfathering provision was an appropriate balance in the application of this provision.

Senator GRASSLEY. Thank you, Mr. Chairman. I have no further questions.

By the way, Mr. Chairman. I will be across the hall at another hearing, if you need a quorum for the next portion of your meeting.

The CHAIRMAN. Thank you very much. We will have a rolling quorum.

Senator GRASSLEY. I am already part of a rolling quorum, right? All right.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

I, first, would like to associate myself with the question that Senator Hatch raised about foreign sales companies. If there is some way we could address that issue, too, I think it is an important one.

My question really goes to another area slightly off the track here, but it is really with respect to foreign tax credit as a preference item under AMT. There are a lot of companies who question the degree to which the FTC should be a preference item under alternative minimum tax.

I just would like to get your view, Mr. Guttentag, what you think about that, just generally the degree to which maybe that could be modified, if not eliminated, that is, as a preference item.

Mr. GUTTENTAG. The preference item to which you refer, for purposes of calculating the alternative minimum tax, limits the benefits of foreign tax credits to 90 percent. Treasury, at the time this provision was enacted as one of the preferences which was dealt with by the AMT, did not support the proposal. We would not oppose modifications—easing of it, or repeal—subject, of course, to an appropriate revenue offset.

Our position is driven, in part, by the international aspects of this provision. This is one of the preferences which obviously does have substantial international impact, as it relates to taxes imposed by foreign countries.

We believe that we should relieve our tax appropriately, in accordance with foreign taxes paid, subject to the various rules contained in the Internal Revenue Code and our regulations, which we think now provide an appropriate balance. Accordingly, we think it is important not to provide that limitation in the AMT.

Senator BAUCUS. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. I just want to make sure I understand a couple of your answers. I am operating under the impression that our taxation of income is worldwide, other than we have our deferral clause, but most of our competitors tax on a territorial basis. I sense your answer was, no, that is not the case.

Mr. GUTTENTAG. That is right. I do not know if I have any figures as to the number of our competitors and by importance of trading volume or a number of companies, but just based on my experience, Senator, looking at countries such as Japan, Germany, Canada——

The CHAIRMAN. They tax foreign-source income when it is brought home.

Mr. GUTTENTAG. They have rules, as I said, similar to our subpart F rules, they have a foreign tax credit system.

The CHAIRMAN. They tax the deferred income, not necessarily at the same rate as we do. They have different rates in different countries, obviously.

Mr. GUTTENTAG. Well, they have different rates, they have different economies. Everybody has to deal with it. Some of the countries, for example, in dealing with subpart F, use a white list or a black list to identify the countries which they consider to be tax havens.

The CHAIRMAN. Senator Roth?

Senator ROTH. Thank you, Mr. Chairman. It is a pleasure to see you here today.

The CHAIRMAN. Let me just announce something because I have noticed we have been going around turning the microphones on. We have new microphones, and everybody has a microphone. They all have switches on them, however, which you need to turn on to speak and want to turn off when you do not want to be heard. Mr. Guttentag, the Senators are very slow at learning new techniques.

Senator ROTH. Mr. Guttentag, one criticism that has been leveled against the Passive Foreign Investment rules is that they are overbroad and can even be read to apply to the so-called Special Export Incentive Companies established by Congress, namely your export trade corporations, and your Foreign Sales Corporations. It has been done in a manner that jeopardizes the unique tax advantages that have been granted to these entities.

Now, at a hearing held last fall by the Finance Committee's Subcommittee on Energy and Agricultural Taxation, Norman Richter, the former Deputy International Tax Counsel, expressed the view that FSCs should be exempt from the PFIC rules, but that ETCs should not. I have two questions I would like to ask you.

First, do you agree that PFIC rules should not be interpreted so broadly as to modify the special tax incentives afforded by Congress to export incentive companies?

Second, do you agree with Mr. Richter that the PFIC rules should apply to ETCs but not to FSCs? If so, how can you justify treating ETCs and FSCs differently when both of these were created by Congress for the same purpose, to encourage U.S.-xport sales by providing certain tax-related financial incentives?

Mr. GUTTENTAG. I would be glad to follow up and give you further explanation. I believe that the position taken by Mr. Richter is still the Treasury position. There is a difference between our old Export Trade Corporation, of which, as you know, there are just a few of them left, and they are entitled to deferral of their income, pursuant to elections which they were given in 1984.

But the foreign sales corporations operate in a different fashion. They provide for exemption of U.S. tax on an appropriate amount of export income, so I do not believe there would be any reason to tax them under the PFIC rules.

But, if there is a particular situation, I would be glad to provide a more complete response to you at length. I believe that our position, as taken by Mr. Richter previously with respect to this issue, is still valid, and our position.

Senator ROTH. Well, rather than take the time this morning, as I know it is limited, we can discuss this further at another time.

Thank you, Mr. Chairman.

The CHAIRMAN. I have no other questions. Anybody else?

Senator BAUCUS. Yes, Mr. Chairman.

The CHAIRMAN. Max, go ahead.

Senator BAUCUS. I am just curious, Mr. Guttentag, why the Treasury believes that there must be a legislative fix to this FSC question with respect to sales of software where there is right of reproduction, where the language in the statute refers to license of films, tapes, records, or other similar reproductions. I am just curious as to why you feel that the administration, on its own, cannot administratively, under that language, make this change.

Mr. GUTTENTAG. We believe, Senator, that the statutory language providing FSC benefits for those particular products can be interpreted to go beyond the purpose of the FSC provisions because those products are exported, but then the actual goods that are sold to customers overseas are manufactured overseas. That was the decision of the Congress.

Accordingly, if there is a request that this be extended to other products, that is, computer software that is produced in the United States and then sent overseas and reproduced and sold overseas, we believe that the Congress should have the opportunity to make that decision and again review the issue of whether this is an appropriate type of product and activity to be included within the FSC benefits. Treasury has no opposition to that decision, but we think it is one that Congress should make.

Senator BAUCUS. Even though FSC treatment is accorded to sales of videos that are reproduced. I guess your point would be that, because recordings are specifically referred to in the statute that that is fine, but since computer software is not specifically referred to in the statute, even though the phrase "other similar reproductions" exist, it is your view that that phrase refers more narrowly to licenses of films, tapes, or records; is that your position?

Mr. GUTTENTAG. Well, not only that, but the statute generally provides that the benefits are not granted with respect to the licensing of copyrights. In effect, the provisions to which you refer and which do permit the benefits are an apparent exception to that rule.

So it is not only that the software is not specifically included, but for us to include the software would be inconsistent with other provisions of the FSC benefits, which limit them, as I said, with respect to copyrights.

Senator BAUCUS. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. I want to just pursue once more, if I may, this foreign-source income and comparative taxation, because I think witnesses are going to come later that may disagree with your conclusion.

You are telling me that, as a rule of thumb, on foreign-source income, foreign countries roughly treat their foreign-source income the way we do. I am not talking about add-together laws or treaties that they may have. There is no comparative disadvantage for an American company with our deferral rules vis-a-vis an Australian company operating in Brazil, with Australia's foreign-source income rules.

Mr. GUTTENTAG. One, you cannot look at these in isolation, Senator, just looking at their deferral pattern, you have to look at their overall tax rules.

The CHAIRMAN. That is what I am asking. As a rule of thumb, not the specific laws, but adding together whatever treaties they may have had sparing them taxation in lesser developed countries, you are telling me that foreign corporations operating in third party countries with foreign-source income are treated roughly the same as U.S. companies doing the same thing.

Mr. GUTTENTAG. If I did say that, what I meant to say is that the deferral rules of our major trading partners are substantially similar to ours.

The CHAIRMAN. All right.

Mr. GUTTENTAG. You mentioned, Senator, tax-sparing treaties. Those tax-sparing treaties can provide, and are perceived to provide, a substantial benefit in encouraging investments in developing countries by countries that have such treaties.

The CHAIRMAN. Well, that is why I am asking as a rule of thumb, not as what is the actual law, what is the actual effect? I want to know if the actual effect is roughly equal or if the effect is unequal.

Mr. GUTTENTAG. One, you have to look at it country-by-country, industry-by-industry.

The CHAIRMAN. All right.

Mr. GUTTENTAG. We would be glad to provide further information on our views on those issues. But it is very clear that some countries have decided that they want to encourage foreign investment—this is true for many countries—as opposed to investments in their own country, and provide incentives for those kinds of investments.

The United States, as a matter of overall policy, has generally decided not to do that. It is very clear that, in those cases where those incentives are provided, there can be tax advantages. But taxes, again, are only one of the many factors involved, Senator, as you know.

The CHAIRMAN. Thank you very much.

Any other questions?

[No response.]

The CHAIRMAN. Mr. Guttentag, thank you very much for coming this morning. We appreciate it.

Mr. GUTTENTAG. Thank you.

The CHAIRMAN. We will take the next panel. We have Gary Hufbauer, the senior fellow at the Institute for International Economics, and professor Michael McIntyre, from the Wayne State University School of Law.

We will take you in the order that you appear on the witness list. So, Mr. Hufbauer, we will take you first.

STATEMENT OF GARY C. HUFBAUER, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Mr. HUFBAUER. Thanks very much, Mr. Chairman, for this opportunity to testify.

My remarks are based on a book that I authored with Joanna Van Rooij a couple of years ago entitled "U.S. Taxation of International Income." A central conclusion of our study was that the United States should adopt a territorial approach for taxing the foreign-source income of U.S. firms actively engaged in business overseas. My testimony this morning reflects that conclusion.

The CHAIRMAN. Out of curiosity, do you agree, roughly, with what Mr. Guttentag said, that, on balance, we are not at a disadvantage?

Mr. HUFBAUER. I disagree totally with that statement.

The CHAIRMAN. Oh, you do?

Mr. HUFBAUER. Yes.

The CHAIRMAN. All right.

Mr. HUFBAUER. Let me take the issues in order they were raised. First, the deferral question. An enormous amount of high-quality talent is wasted every year in administering the complex U.S. tax rules relating to the deferred taxation of income earned by U.S. firms operating abroad.

Very little income is raised by these rules, but they do employ hosts of people in the Treasury, the IRS, the private sector—law firms and accounting firms. For administrative reasons alone, the United States should adopt a territorial approach for the taxation of active income.

Let me briefly and extemporaneously say why I disagree with my good friend, Joe Guttentag. We have known each other for more than 20 years, and I respect his opinions. However, many foreign countries do have, in form alone, laws that are similar to the United States' laws in terms of worldwide taxation of their active business firms. But through a vast web of treaties, exemptions, and so forth, which keep accountants and attorneys in those countries employed, they gut their own laws.

The difference between the U.S. approach and, say, the German approach is not that our legal structure are so different, but in the fine tuning, the Germans have wiped out the effective application of taxation of foreign-source income of companies like Sieman's, Deutsche Bank and other household German names.

It is not that the United States collects a lot of revenue on our firms doing business abroad, but we do impose very heavy costs on them through these armies of accountants, lawyers, and IRS auditors. The Germans are much more pragmatic about these matters. Their exemptions are much easier to read, much easier to apply, and the armies of tax folk in Germany are much smaller.

If I may further eat into my time and yours, if I had been an income maximizer I would have spent my career in the tax field instead of the think tank world. The standard rate of pay is $250 an hour and up for people in this field. And it is not a particularly productive activity. It is not like writing software or doing other useful things. These are very bright people engaged in a zero sum game.

The CHAIRMAN. You mean, the consultants, the lawyers, charge $250 an hour. That is all?

Mr. HUFBAUER. Yes, and up to $500, $750. I mean, it is a mind-boggling system. We have tried to describe it in our book.

Now, let me move on very quickly to the two issues which are most in contention today. I think Joe Guttentag and I roughly agree on the current deferral system being all right, although I would say it is too complicated.

Let me turn, now, to Section 956A. This piece of legislation was enacted in 1993 to deliver on some rather ill-informed campaign promises. You know the broad context and the specific 25 percent test. Section 956A does not collect much revenue.

What it does do, at the margin, is encourage firms to act exactly as, in your questions, you suggested they might act. Any firm which is approaching this 25 percent test will be inspired to take some of those passive assets and invest them abroad rather than keep them in passive category. That way it will avoid the U.S. tax on the deferred income. So what Section 956A does is introduce a distortion without collecting any revenue.

The PFIC asset test came from the same campaign rhetoric and has the same result. You could say that it acts as a 35 percent investment tax credit for investing overseas. Again it is a distortion.

Turning quickly to Foreign Sales Corporation. They are fine. They do not need to be disturbed. However, I would disagree again with my eminent colleague, Joe Guttentag. I think, by regulation, the software problem could be dealt with.

Thank you very much.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Hufbauer appears in the appendix.]

The CHAIRMAN. Now we will take Professor McIntyre. I bet you could have made a lot more money if you had not gone into academic life.

Mr. MCINTYRE. I do not know. You have to work awful hard. [Laughter.]

STATEMENT OF MICHAEL J. McINTYRE, PROFESSOR OF LAW, WAYNE STATE UNIVERSITY OF LAW, DETROIT, MI

Mr. MCINTYRE. I would like to make some general comments about deferral, and then address the several issues that you requested specific comments on.

As you know, President Kennedy had proposed that American companies and American individuals operating overseas through a foreign entity be subject to current tax the same way those of us who earn a wage are subject to current tax and that there be no difference between our earning income through a foreign entity outside the country or earning it through activities here in the United States. This was good economic policy, and the fairness argument underlying this proposal has been unchallenged since the proposal was made in 1962.

There were some issues raised at the time about competitiveness problems in ending of the deferral of benefits that the law at the time provided. Congress responded to those issues by adopting a much more complicated set of rules, conceptually less clear, with less obvious fairness gains, and we have lived with those rules ever since. The rules, it turned out, were filled with loopholes, and lawyers exploited those loopholes on behalf of their clients, and the intent of those rules was undermined.

At the time that the United States did this, we were acting alone. None of our trading partners had rules of this type. It was over a decade before the first of our trading partners woke up to the fact that exempting foreign income in this way not only cost them some small amounts of revenue from overseas, but also cost them greatly in having their companies have an artificial incentive to move things outside the country.

So most of our trading partners have now gotten wise to this situation and have adopted legislation in this area. Some of it is broader than ours, some of it is narrower than ours. To compare, you have to go on a case-by-case basis.

In the foreign fund area, which is comparable to our PFIC rules, I think our foreign countries have done a better job than we have in handling the deflection of income to tax havens. I think we may be somewhat better in policing abuses by multinational corporations although the facts are not entirely clear on that point.

I would suggest that if fundamental reform is on the table—and we hear talk of that in Washington; whether it is real or just talk, I do not know yet—I think what we should face up to is that, in a world of open markets, that countries have to cooperate with each other to impose taxes in ways that are cooperative and supportive of each other.

A market system puts great pressures on taxing powers of countries that undermines their tax system. Much as we have seen with our State governments being whipsawed by companies threatening to move from one state to another, so also national governments face the same problem. It is an increasing problem with the globalization of markets, a coordinated response in which income is taxed once, and only once, around the world would be a magnificent reform. To do that, you have to start with a global system, not a territorial system.

The CHAIRMAN. You sort of want a Hugo Grotius of the international tax law.

Mr. MCINTYRE. No, sir. No, I am not suggesting any kind of a world tax system, I am suggesting that each government should coordinate its tax and trade measures the way we have started to do with NAFTA. We have to think of trade and tax in the same way. We do not want to have a global system, but we do want to have a global approach. I think those are very, very different.

Well, let me now address the specific topics that you asked me to make brief comment on.

First, Code Section 956A, which taxes certain income that has been held overseas by companies in passive form. I support this rule. As was suggested earlier, there is a grandfathering rule that is inappropriate, and that should be removed. As explained in my statement, it has two effects: it has a very small effect of encouraging purchase of assets overseas; it has a very large effect of encouraging purchase of assets in the United States.

The second point you asked me to comment on briefly, and my statement goes into it in more detail, is the merits of the PFIC provision. Every country that is serious about international tax now has a foreign fund rule. This is an essential feature of our system. There are ways in which you could be coordinated it better with 956A, and I have suggested some of those in my paper.

Finally, you asked for specific comments on the Foreign Sales Corporation provisions. I think anyone who has looked at this program understands that it is an ineffective subsidy; it is there for political reasons, not for tax reasons. Anyone who does a fully study of this export incentive will see that it ought to be repealed, not expanded.

[The prepared statement of Mr. McIntyre appears in the appendix.]

The CHAIRMAN. Did you learn from your brother, whom I see sitting there in the audience, or did he learn from you?

Mr. MCINTYRE. We have learned jointly from each other.

The CHAIRMAN. Well, we have had him before us many, many times over the years, and I expect we will in the future.

Let me ask you something about this international system of taxation. I will take an example today. You know the argument on trade. Those involved in foreign trade say the value added tax gives countries who export an advantage because it is rebatable to export, income tax is not.

Is that the kind of disparity you think we should try to harmonize so that one country's tax system does not give its trading companies an advantage over other countries' tax systems?

Mr. MCINTYRE. Well, first, I think that those that tell you that a value added tax provides an export incentive are unfamiliar with the literature. That is simply not the current view of economists. There was a very nice piece in "Tax Notes" from a couple of weeks ago—I will be happy to send you a copy—that disputes that view, and I think it is absolutely correct in its reasoning.

However, I do think that, just as the value added tax has been important in Europe as they coordinated their system to change the value added tax from the way it was to a different type of value added tax because of the disappearance of borders, I think the decreased emphasis on national borders creates the need for greater coordination in income tax.

The CHAIRMAN. I think I heard you say that the other countries are learning from their bad experience and are repealing, diminishing, tightening up their incentives to invest outside their own countries. Did I get that right?

Mr. MCINTYRE. That other countries are adopting anti-deferral rules the way we did in 1962, yes, I think that is the general trend.

The CHAIRMAN. Mr. Hufbauer, do you agree with that? It seems to me like your statement was almost the opposite.

Mr. HUFBAUER. Exactly. They are putting rules on the books, but they have no practical effect. And if I could speak to another area of law which I have some familiarity with.

In this country we have a Foreign Corrupt Practices Act, which everyone knows. We have tried, in the OECD and elsewhere, to sell this concept to other countries. Many countries, in form, have similar laws or make similar statements.

I know from talking to leading foreign ministers, including some even this week, that they regard this as a fatuous, moralistic exercise by the United States. So, in form, they go along with some of these notions that we have, partly to humor us, partly out of populist sentiments in their own country. But, in practice, they are far more pragmatic about such matters and recognize that there is an international marketplace and that they are really not going to apply these laws.

Now, I do not want to be interpreted as saying we should back off from our Foreign Corrupt Practices Act. I think that has a good and sound basis. But we should not delude ourselves that the British and other countries——

The CHAIRMAN. Well, should we not back off of it but kind of wink at it?

Mr. HUFBAUER. Well, I am not even saying we should wink at it. But I think we should be fully aware in that area that we do not have others marching behind us. But let us go to the tax area, where we do not have these same moral imperatives at work. Tax rules just comes down to a matter of revenue. We have embarked on a system which is, as I said, very costly, not very productive of revenue, and no other country is following it. It is a waste of time and we should change and get in step.

Mr. MCINTYRE. I just have to say that is an inaccurate statement. It is totally inaccurate. If you have talked with officials in these countries, they are very, very serious. I am not saying every country, but you cannot tell me that the Canadians do not care about international tax avoidance, that the Australians, who have spent an enormous amount of intellectual energy dealing with this subject, do not care about international tax avoidance. They have different approaches.

I would agree that they are more practical in some cases than we are, and I think we can learn from them. But that this is just a phony thing is just an outrageous statement and an insult to some very, very hardworking and dedicated people.

The CHAIRMAN. Let me ask you a question on individual income. We exempt, of course, the first $70,000 of income from Americans working overseas. Should we eliminate that also?

Mr. MCINTYRE. I have never seen a strong argument for that exemption, except in rather limited circumstances. For example, if you have a country with a relatively low income tax that has very high other types of taxes and people are living there and their standard of living is set by that country, I think that type of exemption at some level is an appropriate one. For Americans who are just going over for a short period, I do not think it is an appropriate subsidy.

The CHAIRMAN. Do you want to comment on that, Mr. Hufbauer?

Mr. HUFBAUER. I believe that we should be somewhat more liberal in our treatment of U.S. residents working abroad, even those working for short periods. They have very, very high housing costs in places like Singapore, Hong Kong, Tokyo, Paris, et cetera, and the allowances in our tax law are often inadequate. I think we should again conform our practices more to those of our competitors, Japan, Korea, and so forth.

The CHAIRMAN. Senator Roth?

Senator ROTH. Mr. Hufbauer, do you agree that the VAT with border adjustments would level the playing field, or do you think it makes no difference?

Mr. HUFBAUER. If I could take two minutes to answer. I have two parts to my answer. First, if you take a long period of time, that is, 5 years or more, whether a country has a VAT and adjusts it at the border, or has a VAT and does not adjust it at the border, over a period of time of five or 10 years, it does not make any difference. Whether or not there are adjustments for the VAT tax system will wash out in the exchange rate.

Senator ROTH. Over the long term.

Mr. HUFBAUER. Over the long term.

Senator ROTH. I think most people agree. Yes.

Mr. HUFBAUER. Let me come now to the short term in which we all live and breathe. In terms of changing the U.S. tax system from, say, the current income tax system that we have to a more consumption-oriented tax system such as the VAT, I think border adjustments are a fundamental adjunct because the transitional problems are very severe.

And if there are not adjustments at the border, such as those permitted under VAT—and, in my view, would be permitted under the Nunn-Domenici type of tax—the burdens on particular sectors, firms, and communities will be so heavy that, though otherwise they might be disposed to reform, they will oppose reform for international competitiveness reasons. I am writing a monograph on that subject and it will be published shortly.

I think my esteemed colleague, Mr. McIntyre, was possibly referring to an article by Ms. Lee Sheppard in "Tax Notes International." If that was the article he was referring to, I disagree strongly with the thrust of that article.

Senator ROTH. Would U.S.-based multinationals be able to compete more effectively if the U.S. switched to a territorial system of taxation? previous

Mr. HUFBAUER. Absolutely. They would be able to compete more effectively. They would be relieved of this very, very heavy burden of accounting and legal costs that I have already referred to. They would be relieved of the distortions which the system, in turn, imposes on their investment decisions. It would be a very welcome adjunct in the tax policy field, at hardly any cost to the U.S. Treasury—in fact, it might be a gain to the U.S. Treasury—of switching to the territorial system.

Let me be very clear-and we spent quite a bit of time in our wonderful little book on the taxation of portfolio income—we do believe that such income should be taxed on a resident basis. That is, U.S. citizens investing directly or indirectly abroad should be fully taxed on their portfolio income.

But I very much disagree with the spirit of PFIC and 956A, and all these other provisions which try to take an active business company and say a certain amount is portfolio and a certain amount is not. I much prefer a black/white approach. That is, the company is either portfolio investor or it is not, I do not want to leave the impression that I am going to advocate a system that would exempt portfolio income from the U.S. tax base.

Senator ROTH. What countries have so called territorial tax systems?

Mr. HUFBAUER. In form, Netherlands and France are two good examples. In reality, as I say, virtually every country. I could not disagree more—but there is no sense in prolonging the dispute—with what Mr. McIntyre said. I have no doubt that the Canadian tax officials are quite serious and they may have devoted their lives to closing loopholes. But I do talk to people on the other side of the fence and the closing of loopholes is not effective with respect to Canadian, or Australian companies. I spend a fair amount of time in Australia, as well as other Asian countries. Thank you.

Senator ROTH. Going back to the $70,000 exemption. Certainly, in government, we compensate Federal employees that serve abroad because of the additional expense. If we did away with that kind of an allowance or tax treatment of $70,000, would that affect small business ability to compete?

Mr. HUFBAUER. This is not an area in which I have worked as closely as in the corporate tax area. But it just seems to me, from traveling abroad, when the $70,000 number came in the Code some years ago—maybe 8–10 years ago—it was a pretty princely sum. But the reality today of trying to have a business representative in Singapore, or in Hong Kong on that salary, it is not going to work.

Senator ROTH. Any comment, Mr. McIntyre?

Mr. MCINTYRE. The problem with any tax subsidy of that nature is that it masks the true costs. If it is really that expensive to have a representative in Singapore, then we should know that and the company should make its economic decisions based on the real costs of putting someone there, and if it is not worth putting someone there, they should not do it. The United States Government should not be subsidizing them to do it. That is really the issue.

Senator ROTH. Do you think we should be promoting small business to become involved in trade?

Mr. MCINTYRE. I think that small business is becoming more and more involved in trade, and should be doing it. And I think if, by encouraging, you mean providing them with information about foreign markets, I think that is a useful thing for governments to do.

Senator ROTH. But not to subsidize.

Mr. MCINTYRE. I would not subsidize, outright, their activities, no.

Senator ROTH. Thank you, Mr. Chairman.

The Chairman. Senator Conrad.

Senator CONRAD. Thank you for holding this hearing. I think it is a very important hearing. I think this is an area that has received far too little attention.

I have a GAO report here that indicates 73 percent of foreign corporations doing business in the United States pay no income tax to the United States. That is for 1991.

The report found, "While the largest companies are more likely to pay than smaller companies, there is an increasing number of the largest companies, both foreign and U.S. controlled, who paid no tax from 1987 through 1991." The number of large, foreign-controlled corporations that did not pay U.S. income tax more than doubled in this period, from 297 in 1987 to 715 in 1991.

Frankly, I think this is a national scandal, that we are allowing businesses to come into this market, do very well in this market, and not pay a penny of tax. And anybody that says that transfer pricing is not an issue is in dream world. I used to be a tax administrator. I have reviewed personally the tax returns of multinationals doing business in this country not paying any taxes here.

I have seen every kind of scheme. I have seen them sell into their marketing subsidiaries in the Cayman's and show big profits there, and then sell into a marketing subsidiary in the United States and show no profits in the United States. They do not pay any taxes here. It is amazing how these companies are fighting to get into the U.S. market so they can lose money here. Just amazing.

That is really a way a company does well, is to fight to get into a market where they can lose money. They are not losing money, they are making tons of money in this market. They are not paying taxes because they are playing an enormous shell game. The shell game that they are playing is to under-report their profits in this country. There is no question about it.

Unfortunately, we are tied to an approach that is a guaranteed failure. We are trying to recreate arm's length transactions between the hundreds of commonly owned subsidiaries of a major multinational. There is no way you can do it. No taxing authority has the resources to be able to recreate arm's length transactions between the hundreds of subsidiaries that are commonly held. You cannot do it. It is an impossibility.

So, until and unless, in my judgment, we are willing to move to some sort of formula apportionment or some other means to fairly apportion the earnings of multinationals, we are going to continue to be in a circumstance in which we do not get the revenue that is due this country and we are going to put our companies, U.S.-owned companies, at a disadvantage in the fiercely competitive world market.

I would ask our two witnesses, do you believe there is substantial under-reporting of income to the United States from foreign-controlled corporations? Mr. McIntyre?

Mr. MCINTYRE. I do believe there is substantial under-reporting. I think there is under-reporting of gross income and there is over-reporting of deductions. Some of it is done in the legal and proper way, but the rules that allow them to do it are inappropriate. But the magnitude of it is very difficult to figure out.

The numbers that you were referring to, I did a piece, I think, in 1989, calling to someone's attention—and hopefully yours—the nature of that problem. I think we have learned a lot since then about the nature of that problem, and I do not think that it is going away. There has been some very minor progress with a few countries, but, overall, the problem is still there and not going away.

The problem politically, it seems to me, is that many of the steps that would force these companies to pay tax would also impact on some American companies which operate overseas with foreign branches and then import into the United States. Because of that, I think the Congress and the Treasury have been slow to respond to what you refer to as an outrage.

Senator CONRAD. Mr. Hufbauer?

Mr. HUFBAUER. First, I think it is a substantial problem. Second, I think the Treasury and the IRS would be far better served, and would serve this country far better, by embracing the territorial concept which I have outlined, and then focusing their resources—by which I mean audit and regulatory resources—on the transfer pricing issue. I think that is where the real money is over a period of time.

Third, I applaud the IRS and the Treasury for moving forward with the so called Advance Pricing Agreement system over the last few years. It was nascent when we wrote our book, and they have enlarged it. I would like to see more work on that system in the future, and much, much larger application of it. I think that is the way to go rather than a kind of one-size-fits-all formula approach for companies. Thank you.

Senator CONRAD. Mr. Chairman, if I might just conclude by saying, I have found, under all of these administrations—not a partisan issue—a great reluctance on the part of Treasury to really get at how big this problem is.

I have a series of recommendations here on how we could go about finding out how big the problem is. I do not think they want to find out how big the problem is. I do not think this Treasury does, I do not think past Treasuries have, because it opens up an enormous can of worms for them. I understand that. But it is not in the national interest to leave these questions unanswered.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman. I would simply say that Senator Conrad raises important issues. I think the opportunity to ask the Treasury about such matters is next on our agenda.

I am sorry I was absent, but I read the testimony. I thank our panelists.

The CHAIRMAN. Kent, did you have any other questions?

Senator CONRAD. No. I would be glad to withhold, Mr. Chairman.

The CHAIRMAN. Gentlemen, thank you very much. We appreciate it.

[Whereupon, at 10:35 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

STATEMENT OF
JOSEPH H. GUTTENTAG
INTERNATIONAL TAX COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and members of the Committee, I am pleased today to testify on the tax policy considerations relating to the deferral of United States income tax on earnings of U.S.-owned foreign companies, as well as on the tax treatment of foreign sales corporations (FSCs).

This Administration has been keenly aware of the importance of keeping U.S. companies competitive in the global marketplace. We approach the taxation of international income earned by U.S.-owned foreign companies with such awareness.

Simply and basically put, the United States allows most business income realized by U.S.-owned foreign corporations to be eligible for a deferral of U.S. tax until the income is remitted to the United States. The reason for taxing passive income currently and eliminating deferral with respect to excess passive assets is that there is no policy justification for allowing tax deferral for investment portfolios abroad that could just as well be located in the United States and that bear little or no relationship to the operation of an active business. Typically, these investment portfolios are held abroad in low or no tax countries.

In the international tax area one should consider at least three aspects of the rules governing taxation of outbound investment: the rules governing deferral of the taxation of income earned abroad, the rules governing relief from international double taxation, and the rules for sourcing income and expense. Accordingly, after a brief discussion of the problems inherent in international taxation, I will provide an overview of current law that focuses on the reasons for our existing policy before turning to two specific items under current law that play important roles in implementing this policy: 1) provisions relating to section 956A of the Internal Revenue Code; and 2) the tax treatment of passive foreign investment companies. Finally, I will discuss the tax treatment of FSCs.

Issues Inherent in International Taxation

As this Committee is well aware, there are many difficult issues that must be addressed in any tax system. With respect to the taxation of international income, additional issues arise because different countries have different tax rates and tax bases. These differences in tax rates and tax bases can distort decisions about where to conduct income-producing activities just as different tax treatment of different domestic investments may distort where income is invested domestically. Such distortions reduce worldwide economic welfare. It is impossible to eliminate these distortions completely. Our tax rules should be aimed at raising required revenue in an equitable, administrable fashion while at the same time minimizing the distortions.

The issues in designing international tax rules can be illustrated by examining two ways in which tax burdens can differ. First, an individual may face different tax burdens depending on whether he invests at home or abroad thus distorting the investors choice between investing at home or abroad. In the face of differing international tax burdens, the residence country can equalize its investors' choices, from a tax perspective, by taxing all investment currently and offering a full tax credit for any taxes paid abroad. (Eliminating this type of tax distortion is often referred to as capital export neutrality.) Under such a system investors will choose to fund the most productive activities regardless of where they are located (that is, in the United States or in a foreign country) and capital will not be diverted to less productive alternatives in low tax jurisdictions. There would be minimal incentive for foreign countries to grant tax holidays and more incentive to harmonize tax burdens.

A second way in which tax burdens can differ is if capital invested in a country is taxed differently depending on whether it comes from foreign or domestic sources. A country can ameliorate this distinction by exempting the foreign income of its resident investors from tax, so that their foreign investments are taxed only by the source country. (Putting foreign and domestic investors on an equal footing is often referred to as capital import neutrality.) Under such a system foreign and local investors in each country will face the same tax burden and no investor will have a tax advantage over another investor.

It is impossible to eliminate both types of tax differences in the face of differing tax rates and bases in different countries. A country with a moderate tax rate cannot equalize taxes paid by its residents on income from foreign and domestic investments, and at the same time allow those residents to pay a lower rate of tax, for example, on income from tax havens.

U.S. tax policy must cope with the reality that independent countries, in the exercise of national sovereignty, will inevitably have different tax rates and bases. The following section discusses the way that the United States approaches this challenge.

Overview of Current Law

Like most industrial countries, the United States claims income tax jurisdiction on the basis of both the residence of the taxpayer and the source of the income. Thus, the United States taxes its citizens and residents (including U.S. corporations) on both domestic and foreign source income, and it eliminates or reduces international double taxation by allowing a credit for foreign taxes paid or accrued on foreign source income. U.S. persons may earn foreign source income directly, for example through a foreign branch of a U.S. corporation. They also may earn foreign income indirectly through a foreign corporation that repatriates foreign profits by paying dividends to U.S. shareholders. A U.S. citizen or resident earning foreign source income directly generally is taxed in the year the income is earned. In contrast, the U.S. tax on foreign source income earned through a U.S.-controlled foreign corporation generally is deferred until the income is repatriated. Although such income is not permanently exempt from U.S. tax, this deferral can provide a substantial tax benefit in the form of the time value of the money. With unlimited deferral, the most relevant tax liability is the foreign (source country) tax, and U.S. shareholders bear an effective tax burden comparable to that borne by other investors in the source country.

Deferral provides no tax benefit where the effective foreign tax rate on the earnings of a foreign corporation is equal to or higher than the effective U.S. rate. In this situation, the foreign tax credit will completely offset U.S. tax, whenever that tax is imposed. In tax havens or low tax countries, however, the availability of unlimited deferral can operate as a strong tax incentive for foreign over domestic investment (and for investment through an affiliate of a foreign corporation rather than a foreign branch). In this case, the deferral could cause a U.S. multinational corporation to prefer foreign investments with pre-tax returns substantially below those of comparable domestic investments.

While the general rule over the history of U.S. tax law has provided for deferral of tax on income earned by foreign entities, numerous situations have been identified which require deferral to be limited or eliminated. Thus, the Code provides a number of "anti-deferral" regimes to tax currently the income derived from investments that are easily moved internationally, including passive investments (portfolio investments in debt or equity and rents or royalties in which there is no active management of the underlying property) and investments in certain active businesses that are easily moved, such as international shipping, insurance, and income from sales among related parties that are routed through third countries. The most important of the anti-deferral regimes is contained in subpart F of the Code which requires that 10 percent or greater U.S. shareholders of a controlled foreign corporation ("CFC") include in current income their pro rata shares of the CFC's income from passive investments and movable active businesses.

For foreign corporations (including CFCs) with predominantly passive income or assets, the passive foreign investment company (PFIC) rules of Code sections 1291 through 1297 impose an interest charge with respect to the deferred tax on all income of the foreign corporation that is not currently included under subpart F; alternatively, each shareholder, regardless of the size of its ownership interest, may make an election under which it currently includes in its income its pro rata share of all income of the PFIC. Other anti-deferral rules potentially applicable to foreign corporations with some degree of U.S. ownership are the foreign personal holding company rules of Code sections 551 et seq. and the foreign investment company rules of Code section 1246. The accumulated earnings tax of Code section 531 et seq. and the personal holding company tax of Code section 541 also apply to foreign (as well as domestic) corporations. We have been working with the tax-writing committees of Congress to simplify these rules by eliminating some of these overlapping regimes and better coordinating the regimes that would remain. We look forward to continuing to work with the Committee to implement such a simplification proposal. We view this effort as a very high priority.

The previously described rules restricted deferral with respect to taxes on <u>income</u> from certain passive assets. Pre-1993 law provided an inappropriate tax incentive to keep excess passive assets themselves overseas, outside U.S. tax jurisdiction. In 1993 Congress added section 956A to the Code to remove these benefits for excessive accumulations of passive assets abroad. Such accumulations are excessive when their purpose bears no reasonable relationship with the operation or expansion of any active business abroad, but merely avoid U.S.

tax. It is very difficult to justify deferral for such accumulations on grounds that they are needed to preserve international competitiveness, and Congress believed that neither subpart F nor the PFIC rules sufficiently restricted the benefits of deferral in such cases.

Current U.S. tax policy generally strikes a reasonable balance between deferral and current taxation in order to ensure that our tax laws do not interfere with the ability of our companies to be competitive with their foreign based counterparts. As noted at the outset, countries have different tax rates and tax bases. Therefore, it should come as no surprise that various countries have different approaches to the individual components of international taxation. Nevertheless in looking at the totality of the United States tax system, our rules are similar to our major trading partners whose tax laws provide for general deferral of tax combined with a foreign tax credit and anti-abuse provisions. Accordingly, many foreign competitors of U.S. multinationals are subject to tax regimes similar to the U.S. system.

The following sections describe in greater detail two regimes that were designed to eliminate investment distortions that can be caused by differential tax rates.

956A and Related Subpart F Rules

Subpart F represents the most significant exception in existing law from the general rule of deferral. Subpart F was originally enacted in 1962 and was substantially revised in 1986. The excess passive assets rules of section 956A were added to subpart F in the Omnibus Budget Reconciliation Act of 1993.

In general, under subpart F, a "U.S. shareholder" in a foreign corporation that was a "controlled foreign corporation" for an uninterrupted period of thirty days or more during the taxable year is taxed currently on its pro rata share of the corporation's "subpart F income," its earnings invested in U.S. property, and, after enactment of section 956A, its earnings invested in "excess passive assets." A "U.S. shareholder" is a U.S. person that owns 10 percent or more of the foreign corporation's voting stock (Code section 951(b)). A "controlled foreign corporation" ("CFC") is a foreign corporation in which such U.S. shareholders hold directly, indirectly, or by attribution more than 50 percent of the voting power or value on any day during the corporation's taxable year (section 957(a)).

"Subpart F income" consists primarily of insurance income and foreign base company income, which is income derived from passive investments and certain business activities considered to be easily movable and thus responsive to tax considerations. A "high tax" exception is available for income that would otherwise be foreign base company or insurance income if that income is subject to an effective tax rate greater than 90 percent of the maximum U.S. statutory rate (section 954(b)(4)).

In addition to taxation of subpart F income, the subpart F regime also requires U.S. shareholders of CFCs to include in income the undistributed, untaxed earnings that the CFC invests in U.S. property (section 956) or in excess passive assets (section 956A). Ordering rules ensure that earnings are not subject to tax under more than one regime and are not again taxed when distributed.

"U.S. property" for section 956 purposes is defined to include tangible property located in the United States, including real property, any stock in, or obligation of, a U.S. person, and any right to use intangible property in the United States (section 956(c)). Section 956 was generally designed to tax U.S. shareholders on transactions by the CFC that are analogous to the distribution of dividends and to prevent foreign earnings from returning to the United States without bearing full U.S. tax.

Under the excess passive assets rules of section 956A, U.S. shareholders must include in income their pro rata share of a CFC's earnings from tax years beginning after September 30, 1993 to the extent the CFC holds passive assets in excess of 25 percent of its gross assets. The 25 percent test is applied on a group basis to related CFCs; a group for these purposes consists of foreign corporations each of which is owned more than 50 percent (by vote or value) by another member of the group (other than the top-tier CFC).

Section 956A falls squarely within the parameters that over time have defined the circumstances in which restrictions on deferral have been determined to be appropriate. That is, within the context of an overall deferral regime, section 956A imposes a tax on foreign earnings where deferral would unduly influence and distort investment decisions. It ends deferral only where the accumulation of passive assets is so significant as to create a compelling presumption that earnings are no longer needed in the foreign business and are retained by the CFC primarily for tax reasons. Because the U.S. tax on a section 956A inclusion will be reduced by foreign tax credits, section 956A will have its greatest effect in cases where the underlying earnings were not subject to a significant foreign tax.

Prior to enactment of section 956A in 1993, it was possible to defer U.S. tax on large amounts of a CFC's non-subpart F earnings indefinitely, as long as the CFC paid no dividends and made no investment in U.S. property that would trigger a tax under section 956. For example, a CFC's return on its intangibles escaped U.S. tax not only in the year earned but in subsequent years, as long as those returns remained abroad. This extended deferral of U.S. tax on active foreign income could effectively amount to a tax exemption for that income. The opportunity for extended deferral of tax enhanced the incentive to locate business operations abroad. It also created a distinct incentive to retain an amount of earnings in excess of the reasonable working capital and expansion needs of the foreign business.

In many cases, the retained earnings were sitting virtually idle in passive accounts. Treasury research done at the time section 956A was enacted indicated that the average percentage of passive assets for all CFCs was 13 percent. Breaking this figure down for tax havens and non-tax havens, we found that while the average percentage of passive assets for companies in non-tax haven countries was only 7 percent of total assets, the average for companies in tax haven countries was 30 percent. Thus, the CFCs with the most significant section 956A problems tend to be those in tax haven or low tax jurisdictions.

The excessive accumulations of passive assets under pre-1993 law were difficult to justify on competitiveness or other policy grounds. In fact, taxpayers generally have not argued that their competitiveness with other foreign-based multinationals is premised on their ability to hold passive investments in excess of the 25-percent threshold of section 956A. We are satisfied that the 25-percent threshold generously accommodates working capital needs of most CFCs.

Some have suggested that section 956A is an incentive for foreign over domestic investment because, to avoid taxation under section 956A, taxpayers can simply move excessive passive investments into active foreign operations. According to proponents of this argument, jobs will thus be taken from the United States.

We believe this result is unlikely. Before enactment of section 956A, careful consideration was given to its impact on decisions involving the location of new active business operations. By reducing the opportunity for extended deferral of tax on foreign earnings, section 956A was intended to reduce the tax incentives for the transfer of capital--and the attendant jobs--from the United States for investment abroad. There was a greater incentive for investment in tax havens under pre-1993 law because it allowed taxpayers to escape U.S. tax not only in the year foreign earnings were generated but in subsequent years as well, as long as those earnings were retained in the low-taxed foreign country. Section 956A limits the extended deferral of tax on these earnings without completely denying the benefits of deferral. Taxpayers continue to enjoy the same pre-1993 benefits of deferral as long as they do not excessively accumulate earnings in passive assets.

Moreover, section 956A did not create a new incentive to choose active foreign over active U.S. investment of a CFC's earnings. Before enactment of section 956A, taxpayers who responded to the deferral incentive were not repatriating their earnings to invest directly in U.S. jobs or take advantage of U.S. business opportunities. To enjoy deferral, they left their foreign earnings in the CFC. Section 956A did create a new incentive to choose active investments over passive foreign investments of a CFC's earnings. The choice of an active foreign investment, however, depends not only on the tax results but also on the availability and suitability of investment opportunities and business objectives. Those taxpayers that chose passive over active foreign investments before enactment of section 956A may not have had active investment opportunities; given the relatively low rates of return on passive versus active assets, one could assume that CFCs would have exploited any genuine opportunities for active investments rather than passively investing an amount of earnings that far exceeds the reasonable needs of the business and that now exceeds the section 956A threshold.

In sum, section 956A clearly reduces the tax incentive to transfer abroad capital (and associated jobs) currently located in the United States. Congress struck a reasonable balance in 1993 by maintaining deferral while minimizing tax-motivated business location decisions and insuring that our tax laws do not jeopardize the competitiveness of U.S. industry. Consequently, we would strongly oppose any changes at this time to section 956A.

<u>Passive Foreign Investment Companies</u>

While the subpart F rules are the most significant exception from deferral for foreign subsidiaries of U.S. corporations, the PFIC regime is of most importance to U.S. persons holding portfolio investments in foreign corporations that earn primarily passive income.

Congress enacted the PFIC rules in 1986 to remove an incentive for U.S. persons to invest in passive assets through foreign corporations rather than domestic investment funds. Both the domestic and foreign investment funds can be structured to avoid a corporate-level tax on the passive income (in the case of domestic corporations, through the regulated investment company rules and, in the foreign context, by locating in a tax haven). However, investors in domestic funds generally are subject to tax currently on their share of the fund's income while, before 1986, U.S. investors in foreign investment funds generally were able both to avoid current taxation and to convert ordinary income to capital gain income.

To address these concerns, the PFIC rules provide that a U.S. person who owns stock of a PFIC must include in income currently the shareholder's pro rata share of the income of the PFIC, or be subject to additional tax upon disposition of the stock of the PFIC or receipt of "excess distributions" from the PFIC. The latter "interest charge" regime is intended to approximate the economic effect of current taxation of the investment income. A foreign corporation is a PFIC for any taxable year if 75 percent or more of its gross income for the taxable year is passive income or at least 50 percent of its assets produce passive income or are held for the production of passive income.

Because the purpose of the PFIC rules generally is to distinguish between "active" and "passive" companies, while the purpose of the subpart F rules is to prevent the deferral of taxation on income that is easily movable and therefore responsive to tax considerations, there are significant differences between "passive income" for PFIC purposes and "subpart F" income. For example, the "easily movable" subpart F income that arises from active businesses, such as shipping, generally is not covered by the PFIC rules. Similarly, income earned in the active conduct of a banking or insurance business by most foreign banks and insurance companies also is not passive under the PFIC rules. A similar exception applies to securities brokers and dealers that are also CFCs. Moreover, although both the subpart F and PFIC rules provide "look-through" rules that treat certain, otherwise passive, income or assets of a foreign corporation as active to the extent attributable to active income or assets of related persons, the PFIC rules do not include the subpart F requirement that the related person be organized in the same country. On the other hand, the PFIC rules provide no "high-tax" exception to the definition of passive income.

Although the PFIC rules use a narrower definition of "tainted" income than the subpart F rules, they apply to more shareholders. The PFIC rules apply to U.S. persons who own even a single share of the stock of a PFIC (or options to acquire such stock, including convertible debt), regardless of whether the PFIC as a whole is U.S.-controlled. This rule reflects the difference between subpart F's orientation toward foreign subsidiaries of U.S. companies and PFIC's orientation toward passive investments of individual U.S. investors. The rule also was intended to prevent taxpayers from avoiding the PFIC regime in the same ways that they avoid the other anti-deferral regimes.

For example, the subpart F current inclusion rules apply only to "U.S. shareholders" (that is, those who own 10 percent or more of the voting stock of the foreign corporation) and then only if more than 50 percent of the equity of the corporation (by vote or value) is concentrated in the hands of such U.S. shareholders. Accordingly, a less than 10-percent shareholder can avoid current recognition of income under subpart F. Similarly, the personal holding company rules and foreign personal holding company rules, which subject foreign corporations or their U.S. shareholders to either a penalty tax or current taxation on passive income, apply only if five or fewer individuals own (directly or indirectly) more than 50 percent in value of the stock of a foreign corporation. Thus, these provisions can be avoided by dispersing majority ownership among more than five individuals.

Congress enacted the broad PFIC provisions to limit tax incentives to invest in passive assets abroad. Prior anti-deferral regimes, which generally applied only to closely-held corporations, were inadequate to deal with the increasing problem of deferral by individuals. The PFIC rules are even more important now than they were in 1986, since more U.S. investors have become comfortable with the idea of investing outside the United States. Without the PFIC rules, every well-advised U.S. taxpayer would have substantial tax incentives to hold all of his investments in stocks or securities (other than stock in U.S. companies that currently pay dividends) through offshore corporations. Accordingly, the PFIC rules were not intended to affect overall U.S. savings levels, but rather to ensure that we do not inappropriately encourage U.S. persons to invest those savings overseas.

We recognize that the PFIC rules are complex. As noted above, we look forward to continuing to work with the Committee to simplify the PFIC rules and the other anti-deferral regimes.

Overview of Foreign Sales Corporations Provisions

The final topic that Treasury has been asked to testify on is the tax treatment of Foreign Sales Corporations.

Foreign Sales Corporations (FSCs) are foreign corporations that earn income from participating in U.S. export transactions. See Code sections 921-927. The FSC provisions provide a limited exemption from U.S. tax for income arising from certain export transactions. The FSC rules were added to the Code in 1984 to replace the domestic international sales corporation (DISC) rules, which were phased out in response to criticism by U.S. trading partners that DISCs violated the General Agreement on Tariffs and Trade (GATT). The FSC rules were designed to provide a tax treatment of income arising from export transactions that is compatible with the GATT.

Generally a FSC either purchases U.S. goods and sells them abroad (a buy-sell FSC), or it is paid a commission for participating in a sale or lease (a commission FSC). Although a FSC may purchase from (or provide services to) unrelated suppliers, generally a U.S. exporter forms its own FSC. That FSC will either buy and sell exclusively the exporter's property or function as an exclusive commission agent for the exporter. A FSC also must satisfy certain requirements (designed to make the FSC rules compatible with the GATT) including requirements that the FSC be managed outside the United States and that it carry on certain economic processes outside the United States.

FSC benefits are generally limited to income from the sale or lease outside of the United States of goods manufactured in the United States. Income from licenses of intangible property, including copyrights, is generally not entitled to FSC benefits but a statutory carve-out extends FSC benefits to licenses of films, tapes, and records. Treasury is aware of legislative proposals to extend FSC benefits to licenses of computer software for reproduction abroad. Treasury would not oppose such a proposal, assuming that appropriate offsetting revenue measures can be identified.

The "exempt foreign trade income" earned by a FSC is not taxed by the United States because it is characterized as foreign source income that is not effectively connected with the conduct of a U.S. trade or business. This income approximates the portion of the FSC's income that is deemed allocable to the foreign activities of the FSC. The income also is excluded from taxation under subpart F. See sections 951(e) and 954(d) and (e). Also, no U.S. tax is imposed on the exempt income when it is paid to U.S. corporate shareholders because they are allowed a 100-percent dividends-received deduction for dividends attributable to exempt foreign trade income. The only corporate-level tax that such exempt foreign trade income bears is foreign income tax, which ordinarily is minimal because a FSC is usually formed in a low-tax country or in a country or U.S. possession that exempts FSC income from tax. Other income earned by a FSC generally is taxed under regular U.S. rules. Accordingly, other FSC income is taxed either in the year in which it is earned or in a later year when it is repatriated as a dividend.

Virtually every FSC (whether a commission FSC or a buy-sell FSC) that deals with a related party determines its foreign trade income under one of two administrative pricing rules; i.e., rules that determine the price that the FSC is deemed to pay its related supplier or the commission it is deemed to earn. One administrative pricing rule (the 23-percent rule) determines a transfer price (or commission) such that the taxable income of the FSC attributable to the sale (or lease) does not exceed 23 percent of the combined taxable income of the FSC and the related person that is attributable to foreign trading gross receipts, the receipts from the export transaction (or group of transactions). The other rule (the 1.83-percent rule) determines a transfer price (or commission) such that the taxable income of the FSC attributable to the sale (or lease) does not exceed 1.83 percent of the FSC's foreign trading gross receipts from the transaction (or group of transactions). In each case, the FSC is allowed to treat 15/23 (65.22 percent) of its foreign trade income (gross income attributable to foreign trading gross receipts) as exempt.

Treasury is required to submit quadrennial reports to Congress on the operation and effect of the FSC program. The first such report was submitted in January, 1993 and covered FSC operations for the period from January 1, 1985 through June 30, 1988. This report discussed the history and operation of the FSC provisions, the effect of FSCs on U.S. trade and U.S. tax revenues. The report used a standard econometric trade model to calculate the effect of FSCs on U.S. trade and estimated the reduction in exports that would occur if FSCs were repealed. The report estimated that, overall, the FSC program increased U.S. exports by about $1.5 billion (or 7 tenths of one percent) in 1985 and 1986, and by 1.2 billion (or one-half of one percent) in 1988. The next report will be submitted by 1997 and will cover the operation of the FSC program up to June 30, 1992.

The FSC provisions should be considered in conjunction with the rules for determining the source of income for export sales, which also provide for the tax treatment of income arising from export transactions. Depending on a taxpayer's circumstances, the sales source rules may cause the greater tax savings to be realized by exporting directly rather than utilizing a FSC. In the case of inventory property that is purchased in the United States for export abroad, the source of income is determined under the title passage rule of section 862(a)(6), which generally sources such income entirely from the country in which the seller's right, title, and interest in the goods pass to the purchaser.

As described above, to avoid double taxation of foreign source income, U.S. taxpayers are permitted to claim a credit for foreign taxes, to the extent that the foreign tax does not exceed the U.S. tax that would be imposed on the taxpayer's foreign source income. No credit is allowed to the extent that a taxpayer has paid foreign taxes in excess of the amount of U.S. taxes that would be imposed on its foreign source income; such a taxpayer is said to have "excess foreign tax credits." Taxpayers with excess foreign tax credits will seek to increase their foreign source income at the expense of their domestic source income in order to reduce their U.S. tax liability. The sales source rules, which allow taxpayers the opportunity to plan the source of their export sales income, are a significant means by which taxpayers with excess foreign tax credits reduce their U.S. taxes.

Consequently, a taxpayer with excess foreign tax credits will generally prefer to export directly, without utilizing a FSC, in order to maximize its foreign source income and thereby minimize its U.S. tax liability. A taxpayer that does not have excess foreign tax credits will probably realize the greatest tax savings by exporting through a FSC.

Conclusion

The current U.S. international tax rules are the result of a series of compromises and of long experience with the incentives created by residence-based taxation coupled with a general system of deferral. The various anti-deferral rules, which were responses to specific abusive situations, involve complex and occasionally overlapping rules that may warrant simplification and rationalization but that generally reflect an effort to strike a middle ground between current taxation of all foreign source income and complete deferral of tax on that income.

Statement of

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Washington, D.C.

Thank you for the opportunity to address certain issues concerning U.S. taxation of foreign source income. My remarks today reflect the conclusions reached in a study I authored (with Joanna van Rooij) titled **U.S. Taxation of International Income**, published by the Institute for International Economics in 1992.

A central conclusion of our study was that the United States should adopt a territorial approach for taxing the foreign source income of U.S. firms actively engaged in business overseas.

My testimony reflects that conclusion.

Deferral

An enormous amount of high quality talent is wasted every year in administering the complex U.S. tax rules relating to the deferred taxation of income earned by U.S. firms operating abroad. Very little revenue is raised by these rules. For administrative reasons alone, the United States should adopt a territorial approach for the taxation of foreign source income earned by U.S. firms doing business abroad.

Attempts to go in the other direction and end deferral, and thereby tax foreign source income on a current basis, are completely misguided. If U.S. tax policy goes in this direction, two outcomes are all but certain.

In the first place, not much revenue will be raised. With the end of deferral it would be logical for the U.S. Treasury to rationalize its rules relating to the deduction of interest expense, with the result that more interest expense would be attributed to foreign source income. It would also be logical to allow the consolidation of foreign losses against U.S. income. Both collateral changes would erode any U.S. revenue gains. Beyond that, many foreign jurisdictions would simply raise their tax rates to capture (through the foreign tax credit) tax revenue that would otherwise go to the U.S. Treasury.

In the second place, in those few instances where significant revenue could be raised, the end of deferral would generally mean that U.S. firms were paying a higher total tax burden than their Japanese, German and British competitors. Over time, therefore, U.S. firms would reduce their overseas investment and lose market share. Consequently, U.S. exports would suffer. It is well documented that U.S. exports of manufactured goods are closely tied to the level of U.S. manufacturing investment in foreign countries. The same is true probably of U.S. exports of business services, such as telecommunications and finance.

To summarize: Territorial taxation is a very good idea. Ending or curtailing deferral is a very bad idea. The status quo is an o.k. idea.

Section 956A

This misguided piece of legislation was enacted in 1993 to make good on ill-informed campaign promises. The basic idea of Section 956A is to end deferral when related foreign affiliates (a "CFC group") hold passive assets to the extent of more than 25% of their gross assets.

In addition to the general problems with curtailing deferral already enumerated, Section 956A has the perverse result of encouraging firms to acquire plant and equipment abroad in circumstances when they might otherwise invest in the United

States. By investing abroad, they can avoid the 25% test and thereby avoid the tax penalty of losing deferral.

Section 956A should be repealed.

PFIC Asset Test

This was another bad idea emanating from the 1992 presidential campaign. Under the PFIC Asset Test, a single foreign affiliate is denied deferral when more than 50% of its assets, evaluated at adjusted basis, are classified as passive assets. While certain allowances are made for R&D outlays and royalty income, the general effect of the PFIC Asset Test is to understate the fair market value of intangible assets developed by foreign affiliates. The result is to characterize active foreign affiliates as if they were portfolio investors. In response, threatened foreign affiliates simply acquire more plant and equipment. Again, we have the perverse result that the PFIC Asset Test acts like an investment tax credit for foreign investment -- sometimes at the handsome rate of 35%!

The PFIC Asset Test should be repealed.

Foreign Sales Corporations

The Foreign Sales Corporation has a long history. Briefly, the FSC was designed to replace the old Domestic International Sales Corporation (DISC), because features of the DISC were found incompatible with the General Agreement on Tariffs and Trade (GATT). This history is spelled out in our book.

The FSC puts U.S. exporters on more or less the same tax footing as their European and Asian competitors. In a word, the FSC levels the playing field for the taxation of export income. It is appropriate, therefore, to recall the immortal words of Bert Lance: "If it ain't broke, don't fix it."

Statement of Michael J. McIntyre
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Before the Senate Finance Committee
July 21, 1995

In 1962, the Kennedy administration proposed to tax U.S.-based multinational corporations and American citizens and residents on the foreign source income they were earning through controlled foreign corporations. This reform legislation was opposed fiercely by American business interests and eventually by the Congress. In place of the comprehensive and relatively simply legislation proposed by President Kennedy, Congress adopted a much more modest and far more complex reform, popularly referred to as the subpart F legislation. That legislation sought to eliminate certain types of tax avoidance being accomplished primarily through foreign tax havens. The tax bar soon discovered many loopholes in the subpart F rules, and Congress was very slow to close them. Some modest steps to close loopholes were taken in the 1970s, and several important reforms were adopted as part of the 1986 tax reform act. International tax avoidance and evasion, however, have remained very much a part of the American tax scene.

This Committee is now considering making some revisions in the rules governing the taxation of income earned by U.S. residents (corporate and individual) through foreign entities. In my view, the overall goal of the committee should be to eliminate the special tax benefits that U.S.-based multinational companies and U.S. residents now obtain by earning income through a foreign entity. As requested by Senator Packwood, I will address the following four topics in this statement:

(1) The policy of allowing U.S. businesses operating overseas to put off indefinitely, or "defer," U.S. taxes on their income earned through foreign entities.

(2) The merits of Code Section 956A, adopted in 1993. That section imposes current tax on U.S. residents who have accumulated previously untaxed income in a controlled foreign corporation (CFC) and have invested that income in passive assets that are deemed not to be needed in the CFC's business.

(3) The merits of the Passive Foreign Investment Company (PFIC) rules, adopted in 1986. Those provisions impose current tax, or otherwise eliminate the benefits of deferral of that tax, on U.S. residents earning passive income though a foreign fund or, in some circumstances, a CFC.

(4) The merits of the foreign sales corporation (FSC) provisions. Those provisions generally allow U.S. residents exporting property produced in the United States to avoid tax on a portion of their export profits (typically 15 percent) by funneling the export sales through a foreign conduit corporation located in a tax haven.

Summary of Statement

The failure of Congress to tax U.S. resident individuals and U.S. corporations on income earned through foreign entities has encouraged international tax avoidance. Many U.S. corporations and wealthy individuals have been able to avoid paying their fair share of taxes, and many U.S. manufacturing jobs have been moved to foreign countries. Major parts of the financial services industries are now firmly established in offshore tax havens. A broad attack on the use of foreign entities to avoid U.S. tax would improve the fairness of the U.S. income tax and would enhance the competitiveness of the U.S. economy.

In 1993, Congress took a promising step toward ending deferral by imposing tax on certain accumulated foreign profits earned through a CFC. Code section 956A would be unnecessary if Congress were to impose current tax on all income earned through a CFC. In the absence of such sweeping reform, however, Code section 956A should be retained, with some amendments to extend its scope and simplify its operation.

The PFIC rules impose tax on certain foreign passive income earned by U.S. resident individuals and U.S. corporations. They overlap somewhat the anti-deferral provisions of Code section 956A. With appropriate amendments of Code section 956A, the PFIC rules could be targeted at foreign income earned by U.S. resident individuals and U.S. corporations though foreign funds. The goal should be to create a level playing field for U.S.-based and foreign-based investment funds. To that end, U.S. taxpayers having investments in a foreign fund organized in a tax haven or in a country that gives special treatment to investment funds should be fully taxable, without exceptions, on the income earned by that fund.

The foreign sales corporation rules should be repealed. They were adopted in an attempt to provide a tax subsidy to exports. It is now widely recognized, however, that the intended export subsidy is offset by changes in the currency exchange rates. The FSC rules are contrary to free trade and violate the spirit of our international trade agreements. They distort U.S. trade flows and unfairly enrich certain tax avoiders and their legal advisors at the expense of the American taxpayers.

1. Ending Deferral for Income Earned by U.S. Taxpayers Through Foreign Entities

A complete end to deferral of tax on income earned by U.S. taxpayers through a controlled foreign corporation (CFC) unquestionably would improve the fairness of the income tax. The goal, as articulated by the Kennedy administration in 1962, is to subject U.S. taxpayers earning income through a CFC to the same tax burdens as otherwise similarly situated persons earning income through a domestic corporation. Over the past three decades, no one has advanced a serious challenge to the fairness case for ending deferral that President Kennedy articulated in 1962.

Of course any attempt to end deferral of foreign income by taxing American residents and U.S. corporations currently on income earned through a foreign entity will be met with strong political opposition. Some of the most powerful companies in America are major beneficiaries of deferral, and many wealthy and influential individuals also avoid U.S. taxes by earning income though the use of foreign entities. In recent years, however, Congress has shown itself willing to face down that political pressure and to take some significant steps toward curtailing the benefits of deferral. Many of the major loopholes in the subpart F rules were closed in 1986, and adoption of the PFIC rules in 1986 and Code section 956A rules in 1993 were significant steps toward ending deferral for passive investment income.

Opponents of ending deferral have argued that current taxation of the foreign income of U.S. taxpayers would put American businesses at a competitive disadvantage in the global marketplace. Congress responded to that argument in 1962 by attempting to distinguish between deferral of tax on genuine business income, which it was prepared to tolerate, and deferral of tax on passive investment income and on income artificially deflected to a tax haven, which it was prepared to curtail or stop. The unfortunate result was an exceedingly complex set of rules that did not achieve their intended purpose very well. What makes that result particularly unfortunate is that the competitiveness argument made against a comprehensive attack on deferral was unproven and implausible in 1962 and remains unproven and implausible today.

A strategy for ending deferral with minimal impact on the competitive position of U.S. businesses should include the following two parts. First, the anti-deferral rules should be designed so as to attract support from our major trading partners. If all of our major trading partners adopt effective anti-deferral provisions, then none of them will suffer a significant competitive disadvantage. Second, the major emphasis should be on blocking the flow of investment capital to tax havens. Countries that adopt beggar-thy-neighbor policies by acting as tax havens are the fiscal enemy of the rest of the world and should be so treated. U.S. policy makers should understand that tax havens are like the tax shelters of the 1970s and 1980s. They are a significant threat to the integrity of the income tax and must be overcome if the income tax is to continue to serve as an effective and fair way to raise revenue.

In 1962, the United States stood alone when it proposed a general elimination of deferral. Today, many of its major trading partners have adopted anti-deferral legislation. Some of that legislation is at least as effective as the U.S. provisions dealing with passive investment income, although the United States is more aggressive than most countries (probably second to New Zealand) in attacking schemes for deflecting business income to tax havens.[1] Policy makers in many of these countries clearly understand that tax haven abuses are a major threat to their tax systems.

To get support in other countries for an anti-tax haven initiative, the United States must convince its trading partners that it is not engaging in tax competition with them — that the enemies are the tax havens. We must also pay much greater attention than we have in the past to administrative issues and problems of complexity. We cannot expect other countries to follow our lead if we adopt complex anti-haven rules that no other country can hope to implement. Finally, Congress must really, really mean business. The anti-tax shelter legislation of 1986 was a great success in large part because Congress took the position in drafting that legislation that it could not afford to fail. It must take the same position with respect to anti-haven legislation. If the United States demonstrates that it can successfully block tax haven abuses, it can expect other countries to take serious notice.

2. Evaluation of the Anti-Foreign Accumulation Rules of Code Section 956A

Many U.S. corporations that have operated profitably abroad for an extended period through foreign controlled corporations (CFCs) have accumulated large amounts of passive assets not necessary for their business activities. Some of these corporations were subjected to current taxation (or to a deferral charge) on passive income derived from such assets by the PFIC rules adopted in 1986. In 1993, Congress made a concerted attack on the use of CFCs to defer U.S. tax on profits accumulated beyond normal business requirements by adding section 956A to the Code. That section provides that certain undistributed and previously untaxed profits of a CFC invested in "excess passive assets" are currently taxable as a constructive dividend to the U.S. shareholders of the CFC.[2] Because the subpart F rules take priority over the PFIC rules, a CFC that invests a substantial percentage of its accumulated earnings in passive assets is likely to be taxable under Code section 956A rather than under the PFIC rules. In some circumstances, however, it will be subject to tax under both sets of rules.

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[1]For discussion of the anti-haven rules of other countries, see Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, Kluwer (1995).

[2]For a more detailed explanation of the operation of Code section 956A, see Michael J. McIntyre, *The International Income Tax Rules of the United States*, Butterworth Legal Publishers, 2-vol. looseleaf treatise (1989 with current updates), chapter 6/E.

The deferral benefits obtained by U.S. corporations from operating abroad through a CFC tend to lock the profits of CFCs abroad almost indefinitely. A primary goal of the excess passive assets provisions is to unlock those profits by removing the deferral privilege with respect to profits accumulated beyond the presumptive needs of the business. An undesirable side effect of those provisions is to encourage a CFC holding excess passive assets to invest at the margin in foreign active business assets rather than in domestic assets, passive or active. By so doing, the CFC reduces the amount of its passive assets treated as "excess." This undesired incentive is probably a weak one in most cases because owners of CFC stock that are already investing substantial amounts in foreign passive assets typically will not have unutilized opportunities for making additional foreign business investments through a CFC.

Congress was certainly on the right track in seeking to end deferral when income is held abroad beyond the reasonable needs of the foreign business. The following three changes should be made in the section 956A rules, however, to extend their reach and simplify their operation. First, the grandfathering rule is a mistake and should be repealed. Under that rule, excess profits accumulated in taxable years beginning before September 30, 1993, continue to enjoy deferral. There is no good reason not to tax such accumulations on a current basis. Deferral is a privilege to which taxpayers have no vested rights.

Second, amounts taxable to U.S. shareholders under Code section 956A should be treated as passive income for purposes of the credit limitation rules of Code section 904(d). Under current law, certain look-through rules may apply in determining the limitation on the foreign tax credit.

Third, I would attempt to fold the PFIC rules, as they apply to a CFC, into the section 956A rules. I realize that there are some formidable technical problems in doing so, to which I do not have any ready solutions. The goals of the PFIC rules and the section 956A rules are sufficiently different that the rules cannot be combined unless some changes are made in those goals. The direction I would move in would be to tax CFCs that are classified as PFICs under current law on their entire accumulated income under section 956A unless that income had been previously taxed. The overall goal would be to end deferral for CFCs that have accumulated passive income unreasonably in past years or in the current year. This change would provide some bright lines for many taxpayers. It also would allow Congress to redraft the PFIC rules so that they are focussed more directly on tax avoidance through foreign funds.

Code section 956A provides a workable model for a very broad attack on deferral. For example, if Congress is prepared to mount a major attack on tax haven abuses, it might extend the rules of Code section 956A to cover all the previously untaxed accumulated income of a CFC if that CFC is located in a designated tax haven country. Drawing on the experience of such countries as Australia, Japan, New Zealand, Sweden, and the United Kingdom, Congress might define a tax haven as any country other than certain designated countries that are known to impose high income taxes on resident corporations.

3. Evaluation of the PFIC Rules

A major flaw of the subpart F rules adopted in 1962 was their failure to create a level playing field for domestic and foreign investment funds. U.S. residents investing in a domestic fund generally would be subject to current taxation even if that fund invested abroad. In contrast, taxes on income derived by U.S. residents through a foreign fund could be deferred indefinitely. In addition, a U.S. resident often could cash in his or her accumulated earnings from a foreign fund at capital gains rates. The foreign funds typically were not taxable as a CFC under subpart F because the ownership of the funds was widely dispersed. To be a CFC, over 50 percent of the shares of a foreign corporation (by vote or value) must be owned by U.S. persons owning at least 10 percent of the voting shares of the foreign corporation.

The passive foreign investment company (PFIC) provisions are designed to eliminate the special tax benefits that U.S. resident individuals and U.S. corporations previously could obtain from investing in a foreign fund. The PFIC rules also cause the U.S. shareholders of a CFC to pay current tax on their share of the entire income of the CFC in some circumstances. A foreign corporation is treated as a PFIC if 75 percent or more of its income is passive income or if 50 percent or more of its assets generate passive income.[3] The latter test is the one most frequently applicable to CFCs.

The PFIC rules are extremely complex — far more complex than the foreign fund rules adopted by other countries. The rules could be simplified if they were focused on the foreign fund problem. It is important for tax policy reasons, however, to impose current tax on bloated CFCs that have accumulated large amounts of passive assets. If that goal were to be accomplished under the section 956A rules, as suggested above, then some major simplification of the PFIC rules would be possible.

Much of the complexity of the PFIC rules is due to the provisions for taxing PFICs that do not distribute all of their income currently and do not provide their shareholders with information on the amount of their accumulated income. Those complex provisions were adopted by Congress to avoid the charge of unfairness to shareholders who were not in a position to report their actual income on an accrual basis. Accrual taxation, however, is the fair and simple way to tax income from a foreign fund. Thus I suggest that Congress simplify the PFIC rules by forcing all U.S. shareholders of foreign funds to report their

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[3]See *id.*, chapter 6/F.

income on an accrual basis. Following the lead of New Zealand, Congress should require U.S. shareholders who can not obtain the information needed to report the actual accrued income to report some deemed amount, such as some fixed percentage of their invested capital. The percentage should be set high enough that U.S. residents would find little advantage in investing in foreign funds over domestic ones.

4. Repeal of FSC

On July 23, 1975, I appeared as an invited witness before the House Committee on Ways and Means to discuss the merits of the Domestic International Sales Corporation (DISC) provisions of the Code. The panel of witnesses included about a dozen other members, all representatives of U.S. companies benefitting from DISC. In my opening remarks, I suggested that DISC was an ineffective and wasteful tax subsidy. The reply from the supporters of DISC was that its repeal would constitute Unilateral Economic Disarmament. In rejoinder, I made two points that were controversial at the time but have proven to be correct.

First, I asserted that DISC violated both the spirit and the letter of U.S. obligations under the General Agreement on Tariffs and Trade (GATT). Although Treasury officials and proponents of DISC claimed that DISC was consistent with GATT, their legal arguments were weak. A case was brought against the United States under the GATT rules by some of its treaty partners, and the case was decided against the U.S. position. Congress ultimately repealed most of the DISC legislation in order to comply with GATT. Unfortunately, it enacted FSC in its place.

FSC is consistent with the letter of GATT and with U.S. obligations under the new World Trade Organization. As an export subsidy, however, it is inconsistent with the spirit of our trade agreements. In a nutshell, if free trade is good, then FSC is bad.

My second point was that DISC had became obsolete almost from the day of its enactment in 1971 because of the abandonment by the United States in that year of fixed exchange rates for the U.S. dollar. In a world of floating exchange rates, I suggested, DISC would distort certain trade patterns but would not have a significant impact on U.S. trade balances. Some taxpayers might get rich, but the overall impact on U.S. welfare would be negative. At the time, this point was not being made in discussions of the DISC legislation. It is now the accepted view.[4] This argument against DISC is fully applicable to FSC.

As I suggested in 1975, the abandonment of a wasteful export subsidy constitutes "Unilateral Economic Disarmament" only in the sense that the disbandment of the U.S. horse cavalry during World War II constituted Unilateral Military Disarmament.[5] FSC is bad for the world and bad for the United States. It results in unfair and inefficient misallocations of tax burdens. Repeal would increase Federal tax revenues, reduce economic distortions of trade flows, simplify the tax laws, and improve the fairness of the federal tax system.

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[4]For a recent illustration, see U.S. Department of the Treasury, *Report to the Congress on the Sales Source Rules* (1993) (adopting the position that any stimulation in exports resulting from the passage of title rule for export sales will be offset, through adjustments in the exchange rate for the U.S. dollar, by a stimulation of imports.)

[5]See "DISC After Four Years: Reassessment Needed," *Tax Notes*, September 29, 1975, pp. 9.

COMMUNICATIONS

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE

SUBPART F SHOULD BE CHANGED TO ALLOW U.S. LIFE COMPANIES TO COMPETE GLOBALLY; H.R. 1690, WITH TECHNICAL MODIFICATIONS, WOULD LARGELY SOLVE THE PROBLEM

The American Council of Life Insurance (ACLI) is the major trade association representing the life insurance industry. The ACLI has over 600 members that hold over 90% of the life insurance in force. Their assets represent nearly 90% of all U.S. life insurance companies and over 93% of the insured pension business with such companies.

Background

U.S. shareholders generally are not taxed on the undistributed income of foreign corporations. However, U.S. shareholders are taxed currently on the undistributed subpart F income of controlled foreign corporations ("CFCs").

The subpart F income of a life insurance CFC includes investment income earned under policies insuring residents of its home country, and all income earned under policies insuring residents of other countries. In contrast, a CFC engaged in manufacturing, sales or nonfinancial services does not have subpart F income from its dealings with unrelated parties, wherever they are located.

Problems

Subpart F tilts the playing field against U.S. life companies competing abroad. Life insurance CFCs are taxed more heavily than their foreign competitors are taxed, and also more heavily than manufacturing and nonfinancial services CFCs are taxed.

The subpart F treatment of life insurance CFCs is based on the misapprehension that they are tax haven operations designed to avoid tax on investment income. In fact, however, life insurance CFCs operate where their policyholders live, and their investment income is needed to fund their obligations to these policyholders. There is no tax avoidance.

Life insurance CFCs create skilled jobs and other economic benefits in the United States, and do not export jobs overseas. Meanwhile, foreign competitors are increasingly penetrating the U.S. market. if subpart F continues to impede U.S. life companies' ability to compete, other countries will reap these economic benefits instead of the United States.

The subpart F rules for life insurance CFCs are highly complex. The allocation of income and expenses between same-country and other insurance and between investment and premium income imposes severe compliance burdens.

Solution

CHANGES ARE NEEDED IN SUBPART F TO ALLOW U.S. LIFE COMPANIES TO COMPETE ABROAD, AND TO EQUALIZE THE TREATMENT OF LIFE INSURANCE CFCS WITH CFCS IN OTHER INDUSTRIES. IN PARTICULAR, ALL OR MOST INCOME OF LIFE INSURANCE CFCS SHOULD BE EXCLUDED FROM SUBPART F.

H.R. 1690 largely solves the problem (and similar problems of bank and casualty insurance CFCs) by excluding investment income earned on reasonable reserves and surplus held for home-country insurance. H.R. 1690 (which also contains other salutary international tax provisions) should therefore be enacted. However, a few technical modifications are needed for it to operate as intended.

Specifically, H.R. 1690 excludes only interest, dividends and gains on stock and securities. Moreover, the source of these amounts must be in the CFC's country of incorporation to qualify for the exclusion. Life insurance CFCs with well-balanced portfolios, however, also may earn other types of investment income (such as rents), and may invest in other countries. To prevent the application of subpart F in these cases, the exclusion should be expanded to cover all investment income, regardless of its type or source.

In addition, H.R. 1690 uses "earned premiums" to compute the exclusion for income derived from the investment of surplus. While this concept may be an appropriate measure of reasonable surplus for property and casualty insurance contracts (as well as health insurance contracts), it is not for life insurance and annuity contracts. It will result in an arbitrarily high or low life insurance and annuity exclusion depending on circumstances having nothing to do with the company's need for surplus. To more accurately reflect the need for surplus, the exclusion for life and annuity contracts should be based on the greater of 10 percent of reserves (a reasonable surplus level for the risks involved) or ten million dollars (to provide for start-up companies that need greater surplus).

Written Statement of
American Council of Life Insurance
before the
Committee on Ways and Means
U.S. House of Representatives

This statement is submitted on behalf of the American Council of Life Insurance (ACLI). The ACLI is comprised of 611 companies holding 91.9 percent of the assets owned by the U.S. life insurance industry.

The ACLI applauds Chairman Rostenkowski and Mr. Gradison for their efforts to open serious debate on the tax treatment of international business with the introduction of H.R. 5270, the "Foreign Income Tax Rationalization and Simplification Act of 1992." The ACLI has been concerned for some time about the adverse impact of the tax code on the foreign operations of our member companies, and has testified about our concerns before your committee during the hearings on international competitiveness that were held in 1991.

We appreciate that this is a very complex area and that any comprehensive reexamination of the international tax provisions may ultimately require some balancing and trade-offs of competing considerations. However, it should be noted that the Tax Reform Act of 1986 substantially increased the U.S. tax burden on U.S. life insurance companies which do business in foreign markets. As stated in our 1991 testimony, the ACLI believes that some of the 1986 Act changes represented anoverreaching and have made it difficult for U.S. life insurance companies to compete in foreign markets.

Specifically, we raised four concerns which continue to be a problem for our industry. First, we challenged the tax policy rationale for repeal of deferral on all investment income and all but so-called same country underwriting income. This not only has increased our tax costs relative to our local competition, but has created a tax compliance nightmare. The IRS, the Treasury Department and the industry is currently struggling with over 100 pages of proposed regulations directed at defining what is insurance income under Section 952 of the Code. We recognize that H.R. 5270 would repeal deferral for all industries. This would at least put us on an equal footing with the rest of corporate America. However, we continue to believe that the sounder course of action is to restore deferral for insurance income including necessary investment income, so that we are on equal footing with our foreign competitors.

With or without repeal of deferral, we support the provision in H.R. 5270 which would allow an election to include all controlled foreign corporations in a U.S. consolidated tax return. However, consideration should be given to making this a company-by-company election and extending the period for taking into account undistributed profits from four to ten years. In addition, clarification is needed as to the interaction of this election with the election in existing Section 953(d).

Second, we expressed concern over the potential extraterritorial effect of U.S. tax definitions of life insurance an annuities, specifically the provisions of Code Sections 72, 817 and 7702 which were enacted to address U.S. tax policy concerns regarding the taxation of U.S. policyholders. They should have no bearing on the proper determination of taxable income of foreign insurance companies to the extent that companies are not selling policies to U.S. residents. This issue was reserved in the proposed Section 953 regulations. We believe that there is authority to favorably resolve this by regulation. We would welcome support from your committee that as a matter of policy these sections should not have extraterritorial application.

Our third concern is a technical problem which may arise in some foreign jurisdictions where a life insurance company invests in a mutual fund. Under local law the income of the mutual fund is treated as part of the income of the life company. However, for U.S. purposes the mutual fund may be considered as a separate taxable corporation with the result that the income of the mutual fund "hopscotches" over the foreign life company and is taxable to the U.S. parent. At the same time, this income belongs to the policyholders and reserves have been set up in the foreign life company. Unless there is an ability to offset the deduction for reserves against the mutual fund income there will be a mismatch of income and expense and U.S. taxation of "income" which is not economic income of the company. Section 201 of H.R. 5270 would provide some relief in that it would allow an offset against Subpart F income in years beginning with January 1, 1993 for deficits in the same chain. We believe that under the particular fact pattern we have presented that this offset should be allowed for all years and irrespective of whether or not there is a repeal of deferral.

The fourth issue which we brought to the committee's attention was the threat that U.S. withholding taxes might apply to amounts paid to foreign policyholders by foreign branches of U.S. life insurance companies. Some of our member companies have initiated efforts with the Treasury Department to resolve this issue through the regulatory process. If administrative relief is not forthcoming a legislative remedy may be necessary to remove this impediment to U.S. life insurance companies' ability to sell products in foreign markets. Such a remedy may be possible in the context of the reconsideration of withholding obligations for foreign subsidiaries electing to be taxed as U.S. companies

With the exception of the proposed changes in the chain deficit rule, H.R. 5270 does not provide relief from the problems which the ACLI has previously raised with the committee. Generally, though, we applaud the thrust of Title I to provide some relief to U.S. multinationals from the problems created by the Tax Reform Act of 1986 and hope that the concerns we have raised could also be addressed when a revised version of this bill is introduced in the next Congress.

Moreover, we oppose the proposal to raise the rate of the foreign excise tax on property and casualty reinsurance from one to four percent for the general reasons set forth in the Testimony of the Department of Treasury and the joint testimony of the National Association of Independent Insurers, Alliance of American Insurers, American Insurance Association and National Association of Mutual Insurance Companies presented to the committee during these hearings.

We are also concerned that the other proposals in Title III run counter to generally accepted norms of international taxation, would discriminate against foreign owned businesses and would invite retaliation by foreign governments.

In summary, we commend your effort to open up debated on the international tax provisions. We look forward to working with the committee as consideration of this legislation moves forward

STATEMENT BY THE AMERICAN PETROLEUM INSTITUTE FOR THE PRINTED RECORD OF THE JULY 21, 1995 HEARINGS BEFORE THE COMMITTEE OF FINANCE U.S. SENATE ON FOREIGN TAX ISSUES

The American Petroleum Institute (API) represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining and marketing. API members, many among the leaders in the global petroleum production, processing, and distribution market, experience the complex and costly features of U.S. taxation of foreign operations as a stifling disadvantage vis a vis their foreign competitors. On the other hand, because of the continuing depletion of U.S. petroleum reserves and enduring environmental restrictions, foreign exploration and production are not choices for U.S. petroleum companies, but "musts" to assure reserve replacement and to avoid gradual liquidation. In addition, a persistent, strong foreign presence of U.S. oil companies maintains foreign employment of U.S. personnel and utilization of U.S. technology in foreign markets. In view of these pressures, API members applaud your Committee's Hearing on Foreign Tax Issues and welcome the opportunity to comment. Our submission briefly addresses our position on the main topics of the Hearing and then offers other simplification and reform proposals currently of great interest to the industry.

I. SECTIONS 956A, PFICs, AND FSCs

A. Section 956A

Already during the genesis of this provision in 1993 API opposed this additional, unnecessary exception to one of the basic principles of U.S. taxation that a U.S. shareholder is not taxed on the earnings of a foreign corporation until repatriation. We questioned then, and still question, the rationale of section 956A: "to limit the deferral of U.S. tax for [Controlled Foreign Corporations ("CFCs")] that accumulate earnings without reinvesting them in active business assets."[1]

First, passive investments are unattractive from the opportunity cost perspective of a business; this is not changed by perceived tax advantages. Retention of passive

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[1] Staff, Joint Committee on Taxation, Description and Analysis of Present-Law Tax Rules Relating to Income Earned by U.S. Businesses from [Forei]gn Operations, July 1995 (JCS-20-1995)

type assets at any given time by a CFC is not driven by tax avoidance; a holding of passive assets occurs mostly during periods of evaluation of active investment alternatives. Second, the increased current taxation of undistributed earnings by Code section 956A further widened the gap of the basic rules of home country taxation for U.S. companies vs. their foreign competition. As summarized by the Joint Committee Staff[2] none of our major trading partners (U.K., Germany, or Japan) burden the foreign operations of their businesses with such a regime, in fact none of them taxes currently undistributed earnings in any extent close to subpart F.

Accordingly, a repeal of section 956A would merely restore a more workable regime for foreign operations of U.S. companies, allowing CFCs a "wait and see" period with respect to reinvestment of accumulated earnings in active business ventures.

B. PFICs

The Passive Foreign Investment Company (PFIC) regime was enacted to curtail perceived avoidance of the subpart F anti-deferral "net or screen" through ownership arrangements which either undercut U.S. shareholder control or split single U.S. person holdings below the 10% ownership threshold. It was designed to complement, but not to duplicate, or overlap with, subpart F. However, as enacted, for CFCs the PFIC regime represents a duplication of "deferral denial" and a sweeping extension of current taxation even to active business income, resulting in unjustified income acceleration, Byzantine record keeping and unnecessary compliance burdens, without producing any significant revenue.

Because of the overlap under present law, API advocated in the past, and continues to advocate, an exception of CFCs from the PFIC regime.

C. FSCs

API supports the Foreign Sales Corporation (FSC) rules as a means of placing the U.S. exporter on a more equal footing with its foreign competition. While of importance only to a limited extent to some of our members, API believes that good tax policy dictates the retention of the FSC. As the replacement for the Domestic International Sales Corporation in DRA '84, the FSC has become an effective export booster and equalizer. Only to the extent other countries fully tax their exports, as under the basic U.S. tax rules, should the FSC regime be curtailed, on a per country basis.

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[2] See JCS-20-95, supra, at 57 et seq

II. TAX REFORM PROPOSALS OF DIRECT INTEREST TO THE INDUSTRY

A. Update the Foreign Tax Credit Carryover Rules

According to Code section 904(c), any excess Foreign Tax Credit (FTC) may be carried back to the two preceding taxable years, or to the five succeeding taxable years. If the credits are not used within this time frame, they expire. Similarly, section 907(f) limits carryover of excess foreign oil and gas extraction taxes to the periods of section 904(c).

Because of the ever increasing limitations on the use of FTCs, coupled with the differences in income recognition between foreign and U.S. tax rules, excess credit positions are frequent during particular periods, even though over time the same effective tax rates would apply between the host country and the United States. Present law's short 7 year carryover period easily results in credits being lost, most likely resulting in double taxation.

It would be clearly within the rationale of the FTC (avoidance of double taxation) and the rationales for other comparable carryover periods in the Code (see extension of carryover period for Net Operating Losses [NOLs] and the former Investment Tax Credit [ITC] in ERTA, P.L. 97-34) to extend the carryover periods for the FTC as well, allowing a 3 year carryback (elective) and a 15 year carryforward.

B. Repeal of Section 907 - "Special Rules in Case of Foreign Oil and Gas Income"

The salient rules of section 907 were enacted between 1975 and 1982: Section 907(a) imposes a separate, annual utilization limitation on foreign taxes on foreign oil and gas extraction income (FOGEI): FOGEI multiplied by the current corporate tax rate. FOGEI is income from the extraction of oil and gas outside the U.S., or from the sale of assets used in such extraction activities. Under section 907(f), excess credits may be carried back 2 years and carried forward 5 years, with the creditability limitation of section 907(a) being applicable for each such year. - Section 907(b) authorizes the Service to issue regulations which prescribe the criteria under which a foreign tax on foreign oil related income (FORI) is disregarded to the extent the foreign tax is materially greater than the amount of tax imposed on income other than FORI or FOGEI. The amount disqualified as tax is allowed as a deduction. FORI is income derived from the foreign refining, transportation, and distribution, of oil and gas and its primary products. - According to section 907(c)(4), if the taxpayer has an overall foreign extraction loss in a year that reduces nonextraction income, a corresponding amount of FOGEI in a subsequent year has to be recharacterized as income which is not FOGEI.

According to their *ratio legis*, the FOGEI and FORI rules purport to identify the tax component of payments by U.S. oil companies to foreign governments. The goal was to limit the FTC to that amount of the foreign government's "take" which was perceived to be a tax payment vs. merely a deductible payment for an economic benefit. The difficulty in distinguishing between deductions and credits first arose from the fact that in foreign countries the sovereign usually retains the rights to natural resources in the ground; for a taxpayer involved in extraction, etc., this raises the question how much, if any, of the payment to the government is for the grant of a specific economic benefit and is not a general tax payment. Moreover, once the tax component is identified, Congress wanted to prevent oil companies from using excess credits to shield the U.S. tax on certain low taxed other foreign income, such as shipping.

Subsequent administrative rulemaking under section 901 and amendments to section 904 addressed these concerns underlying section 907 in a more comprehensive manner. First, T.D. 7918, 1983-2 C.B. 113, brought the dual capacity taxpayer regulations, which are intended to separate the payment to the foreign government into (i) the compensation for a specific economic benefit, like the right to exploit natural resources, and (ii) the income tax element (Treas. Reg. section 1.901-2A). Second, the TRA '86 fragmented foreign source income into more than nine categories among which there can be no cross-crediting; this includes establishing shipping income as a separate "basket." The fragmentation extends to the loss recapture mechanism under section 904. Under section 904(f)(5), if income is subsequently earned in a loss basket, it is recharacterized as that type of income that was previously reduced by the loss being recaptured.

Since the section 907 legislation has been duplicated and improved by the post-1982 developments, section 907 should be repealed as obsolete. This would remove a substantial administrative burden of essentially duplicative tracing and accounting efforts. Because of the new safeguards under Treas. Reg. section 1.902-2A and section 904(d), a repeal of section 907 should have no revenue effect.

C. Recapture of Overall Domestic Losses

Whenever foreign source losses reduce U.S. source income (overall foreign loss or "OFL"), Code §904(f) requires that the OFL be recaptured by recharacterizing future foreign source income as U.S. source income. This recharacterization reduces the ratio of foreign source income to total income, thus also reducing the ratio of tentative U.S. tax which can be offset with foreign taxes. However, if foreign source income is reduced by U.S. source losses, there is currently no parallel system of "recapture." The U.S. losses can give rise to excess FTCs which may expire unused. Only a correspondi-ng recharacterization of future domestic income as foreign source income will reduce the risk that FTC carryovers do not expire unused. Even if unused FTCs can be carried forward, only Domestic Loss Recapture will in many cases keep the loss in the present value of the credits within an acceptable range. Proposals as found in H.R. 5270 (103rd Cong.) in 1992, and recently in H.R. 1690, solve these problems by adopting an overall domestic loss recapture rule which basically mirrors the present law OFL rule of §904(f).

D. Extended Look-Thru to Income Streams from Noncontrolled Section 902 Corporations

Under Code section 904(d)(1)(E) dividends received by a U.S. corporation from each stockholding of at least 10 percent, but not more than 50% (a noncontrolled section 902 corporation) fall into a separate limitation category with respect to each such non-controlled section 902 corporation. Congress saw no economic identity among the businesses carried on by the U.S. shareholder and the various noncontrolled section 902 corporations; such economic identity is assumed to be a prerequisite for allowing crosscrediting. In contrast, if the U.S. corporation owns more than 50% of the foreign corporation (a CFC) then the U.S. corporation "looks through" the dividend and categorizes the payment, in determining the FTC "baskets", according to the underlying earnings and profits.

The accounting for each qualified stock investment as a separate basket can be very complex; but more importantly, separate limitations do not reflect economic realities of the foreign corporate joint venture scenarios in many foreign arenas. Unavoidable forms of foreign business participation must not result in a denial of crosscrediting for active business income. For example, the recently opened East Block markets are primarily accessible through corporate joint ventures with host country entities. Competitors from other countries will enjoy a significant advantage over U.S. corporations which are currently burdened with the separate basket regime (high exposure of tax credit loss with ensuing double taxation).

Moreover, the compliance simplification envisioned from the separate basket approach (H.R. Rep. No. 841 (Vol II), 99th Cong. 2d Sess. 583 (1986)) never materialized: a taxpayer is already required to look-through to the noncontrolled section 902 corporation's earnings to determine if there is high withholding tax interest or foreign oil and extraction income; also, a U.S. shareholder must analyze the accumulated earnings and profits the foreign corporation under U.S. principles for purposes of calculating the deemed paid FTC.

The replacement of the separate basket regime with a look-through approach, allowing the use of FTCs according to the underlying earnings of all dividends, would remove a substantial competitive disadvantage and simplify compliance.

E. Extend Look-Through Treatment to the Sale of Partnership Interests

Treas. Reg. section 1.904-5(h)(3) allows a look-through with respect to distributions to a 10%, or greater, partnership interest; the distribution is treated as the distributive share of income earned or accrued by the partnership. On the other hand, no look-through applies to the gain on the sale of a partnership interest. Code section 954(c)(1)(B) treats the gain as passive income. Without questioning, at this point, the appropriateness the subpart F income characterization, for FTC limitation purposes the gain should not be treated as passive income, but the look-through rules should apply, as in the case of partnership distributions.

Economically, any gain on the sale of the partnership interest is attributable to undistributed earnings; thus, the legal form of the value realization (sale of participation interest vs. earnings distribution) must not affect the FTC basket characterization. Accordingly, for a 10% or greater partnership interest, look-thru must apply to the gain as it applies to the distributive share of partnership income.

F. Eliminate Mis-Allocation of State Taxes to Foreign Source Income

For purposes of determining U.S. and foreign source income, respectively, the Code provides rules for the allocation and apportionment of certain items; Code section 863(a) authorizes the Service to issue regulations on the allocation and apportionment of all other items of income, deductions, expenses, losses, etc.

Based on the general regulatory authority of section 863(a), in 1991 the IRS issued regulations [T.D. 8337, 3/11/91, Treas. Reg. section 1.861-8(d)] that allocate State income and franchise taxes to foreign source income (thus reducing the numerator of the FTC limitation fraction), if the total amount of taxable income determined under State law exceeds the amount of taxable income determined under the Code.

This rule is flawed: First, the U.S. Constitution proscribes State taxation of foreign source income; second, State tax on foreign source income is counterintuitive since foreign operations have no nexus with the State. Moreover, the factors affecting the computation of taxable income for State v. Federal purposes are not comparable since the respective systems may substantially differ in scope, definitions, timing, and inclusiveness.

Preempting the regulatory authority under Code section 863(a), a new Code section 864(g) should provide that, for purposes of subchapter A, State income and franchise taxes are allocable only to gross income from sources within the U.S.

G. U.S. Computation of FTC Limitation for AMT

In addition to the FTC limitations of Code section 904, under section 59(a) the FTC cannot be used to reduce the tentative minimum tax to less than 10% of the tax before FTC ("AMT FTC Cap"). Excess credits are eligible for carryover under the rules of section 904(c). The AMT FTC Cap was part of a general floor for the use of NOL and ITC carryovers. But the FTC serves a function distinct and different from NOLs or the ITCs, the other tax attributes whose utilization is limited for AMT purposes.

The NOL carryover rules are designed to overcome any hardships resulting from the annual accounting concept. The ITC is a tax expenditure to foster investment in productive capital. Both provisions developed only over time and do not have the systematic cogency of the FTC. As the logical and systematic result of the U.S. claiming worldwide taxing jurisdiction over U.S. corporations, the FTC has been a fixture of the U.S. tax system since 1918. Concurrently with the adoption of worldwide taxing jurisdiction, the U.S. ceded primary taxing jurisdiction to the host country. To deny a full offset of AMT with FTC violates this principle of secondary U.S. taxation of foreign source income.

The AMT's rationale to assure U.S. tax payments on economic income is inappropriate with respect to foreign source economic income if the result is double taxation. While the AMT envisions acceleration of tax payments which otherwise would become due in the future (only deferred because of preferences or tax attributes like NOL and ITC), the availability of FTCs reflects that an appropriate tax already has been exacted from the taxpayer. To the extent of FTCs, there is no economic income which escapes taxation. The double taxation concern led to a partial relief from AMT FTC Cap in OBRA '89. The same rationale applies outside that exception now found in Code section 59(a)(2)(C). Accordingly, the AMT FTC Cap should be repealed.

H. Repeal of Code Section 901(j), Which Denies Foreign Tax Credit with Respect to Terrorism Supporting Countries, Etc.

Code section 901(j) denies a credit or a deduction for taxes paid to foreign countries which the U.S. does not recognize, or with which the U.S. does not entertain diplomatic relations, or which have been identified as supporting acts of international terrorism. The Secretary of the Treasury, in cooperation with the Secretary of State, maintains and periodically publishes a list of such countries.

The global political landscape has changed considerably since the enactment of this provision in 1986, P.L. 99-509. Not only are confrontational polarizations into opposing power centers fading, so is terrorism as a means of international politics. International barriers have come down so fast that the establishment of diplomatic relations cannot keep up with the growing global integration. Any rationale for using a dilution or denial of a credit or a deduction for taxes paid to countries still listed has gone away. It is no longer necessary to use the FTC as a tool for curtailing relations with certain countries. Section 901(j) should be repealed.

I. Reduction to Two FTC Baskets

The "FTC limitation formula" of section 904(a) limits the allowable FTC to that portion of the tentative U.S. tax which corresponds to the ratio of the taxpayer's foreign source income to worldwide income (i.e., the sum of domestic and foreign source income). Foreign source income is fragmented into more than nine "baskets" and the limitation has to be computed separately for each of these nine, or more, types of income.

Code section 904(d)(1) by itself establishes nine basic baskets. Additional separate baskets are required by sections 904(g)(10) [per treaty limitation], 901(j)(1)(B)[per "terrorism-supporting" country], 904(d)(2)(E)[a separate basket from dividends from each noncontrolled section 902 company], 904(d)(2)(A)(iii)(III)[high-taxed income kick-out], and section 1291 [income inclusions from Passive Foreign Investment Companies]. Moreover, taxpayers have to account separately for foreign oil related income, Code section 907(b), and foreign oil and gas extraction income, Code section 907(a).

Taxpayers in the active conduct of a trade or business should not have to divide their active business income into multiple baskets, with the concomitant inability to cross credit. Foreign taxes on active business income should be available for cross-crediting, making up for the differences in timing and the mutations of the income/expense profiles, etc., of the tax regimes of the host countries. We must return to the roots of the FTC and allow full credit against U.S. taxes on foreign business income for all foreign taxes and not limit their use through the imposition of a schedular regime which further widens the gap between the U.S. and the host country tax systems.

Any undesirable shielding of U.S. tax on offshore passive income would still be prevented by keeping passive income in a separate, second basket. This active/passive income dichotomy should also be used in the application of the anti-deferral rules.

J. Exempt Foreign Operations of Foreign Persons from the Uniform Capitalization Rules under Section 263A

Section 263A is designed to assure that 1) all production costs are capitalized, and 2) the same rules apply to all productive activities. Perceived tax accounting differences among industries and activities were seen as unwelcome factors in resource allocations and structural alignments. Moreover, it was argued that a better matching of income and expenses would also prevent the unwarranted deferral of Federal income taxes.[3]

The application of the UNICAP rules to foreign persons was not a concern of Congress; it emanated from the Service's regulatory implementation[4] which would appear to violate all criteria of sound tax policy, *i.e.*, simplicity, equity, efficiency and viability.

As to simplicity, the superimposition of UNICAP compliance rules creates unnecessary additional complexity. While the rationale of UNICAP *per se* is equity, the attempt to equalize the tax postures of foreign persons is futile because of the ever changing tax regimes imposed by the foreign sovereigns. Nor is the extension of UNICAP criteria to foreign persons, without effectively connected U.S. income, cost effective; the additional administrative costs are evident, but any U.S. tax revenue acceleration is extremely doubtful. In fact, the prevailing excess FTC position of U.S. taxpayers with foreign operations cancels out any U.S. tax acceleration from increased earnings and profits in foreign corporations due to a deferral of cost recovery because of an overreaching application of the capitalization rules.

When it comes to testing the effectiveness in promoting the nation's economic goals, burdening foreign operations with UNICAP rules in addition to the local cost recovery regimes is counterproductive in that it places the foreign operations of U.S. taxpayers at a competitive disadvantage. Finally, in the context of international operations uniformity in application of U.S. costing rules (as a means to neutralize any differences in tax treatment as an investment criterion) is meaningless in view of host country rules which in themselves create insurmountable differences affecting the investment decisions.

Accordingly, foreign operations of foreign persons should be excepted from the UNICAP rules. Note in this context that H.R. 1690, section 4, would fail to bring the intended relief: it would continue to apply UNICAP to the determination of subpart F income; since CFCs have to keep their tax books with the capability of determining subpart F income, a failure to except subpart F income would continue to burden them with UNICAP compliance.

K. Limit the Overreaching IRS/Treasury Regulations on Dual Consolidated Losses

Code Section 1503(d) provides that a net operating loss of a consolidated return company cannot be used in the computation of the taxable income of the consolidated group if such company is subject to a foreign country's tax on worldwide income or on

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[4] Preamble of Temp. Reg. section 1.263A-1T, 52 F.R. 10059)

a residence basis. Section 1503(d)(2)(B) authorizes regulations to except U.S. corporations from this loss disallowance to the extent the losses do not offset the income of another foreign corporation under the foreign tax law. Despite this statutory exhortation and remonstrations by taxpayers in comments on the drafts of the regulatory implementation (the temporary and proposed regulations) the final administrative rule continues to jeopardize any deduction on the U.S. consolidated return of a U.S. affiliate's loss from a foreign business operation unless unreasonable administrative undertakings are stipulated. Treas. Reg. section 1.1503-2 creates a regime that allows little or no exception to the loss disallowance rule for such "dual resident corporations" (DRC). Both the definition of a DRC and the possibility of loss benefit to another foreign company are very broadly drafted. Under the regulations, any branch or an interest in a foreign partnership can taint the U.S. corporation as a DRC. Similarly, there is practically no situation where another company in the host country would not be considered to be able to avail itself of the loss.

Because of the far reaching definitions and rules of the regulations, a U.S. consolidated return corporation with foreign nexus, including a mere interest in a foreign partnership, can use a loss in the computing consolidated return income only if it enters into a burdensome agreement with the Service which requires annual reports and monitoring. Short of such agreement the loss will be disallowed. The rules are an unintended trap for the unwary. A statutory clarification of the intended operation of the rule is needed, to force a roll-back of the burdensome and overreaching administrative regulation.

The End

C:\FOREIGN\COMMENTS\DRAFT11.

ICC NO MC 127227

BIRDSALL, INC.

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TELEPHONE (407) 881-3900 • FAX (407) 881-3911

August 4, 1995

VIA HAND DELIVERY

The Honorable Bob Packwood
Chairman, Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Restoration of Exclusion of Foreign Base Company Shipping Income from Subpart F Income

Dear Mr. Chairman:

This statement is submitted for the record of your July 21 hearing on foreign tax issues. I am writing as a current Director and former CEO and Vice Chairman of Birdsall, Inc. ("Birdsall"), a U.S. corporation which owns 100 percent of the stock of Tropical Shipping & Construction Co., Ltd. ("Tropical"), a Bahamian shipping corporation.

Tropical was established thirty-three years ago when my father bought a small "Roll-on Roll-off" vessel from a Tampa shipyard and initiated a service to carry construction materials and equipment between South Florida and the Bahama Islands. Since then, Tropical has become a major carrier in the Caribbean region. The company owns 14 container ships and serves 23 locations throughout the Bahamas and the Caribbean Basin. Last year, through Tropical, Birdsall transported more than $1 billion worth of various U.S. exports to the Caribbean basin, competing against both foreign- and other U.S.-owned carriers.

Our vessels are engaged in a liner-type service -- meaning they depart for various destinations on a fixed schedule from Riviera Beach, Florida, where we maintain substantial terminal facilities for the receiving, handling and loading of cargoes. We also operate a cargo depot in Miami, Florida, and through agency relationships, maintain cargo-receiving locations in Roselle Park, New Jersey and Houston, Texas. Birdsall's headquarters are in Riviera Beach, and we employ over 500 people in the South Florida region.

U.S.-Owned Shipping Operations Cannot Continue To Compete with Foreigners Under Current U.S. Tax Law

Despite our past success, Birdsall's ability to continue competing with foreign owners under the current tax rules is

The Honorable Bob Packwood
August 4, 1995
Page 2

seriously threatened. From the time we started our business until 1975, we were taxed, like our major foreign competitors, only when shipping income was repatriated. In 1975, however, changes in the tax code placed us at a serious disadvantage when shipping income which was not reinvested in shipping assets was included in Subpart F and taxed currently. That disadvantage was expanded in 1986 when the tax law was further amended to subject U.S. owners to an immediate tax on all shipping income from their controlled foreign corporations. These rules are unquestionably the harshest of any major maritime nation. Our foreign competitors either pay no tax or are permitted to defer tax indefinitely. This means that we are subject to an immediate tax of 35 percent while our competitors pay no current tax.

Birdsall, and, I believe, others, cannot compete under this yoke. Since the law was changed, U.S.-owned shipping companies operating international flags have lost a significant portion of their markets. According to an attached recent Price Waterhouse survey, from 1975 to 1993, the size of the U.S.-controlled open-registry fleet in gross tonnage (in absolute terms) has shrunk in half while the foreign-controlled fleet virtually tripled in size. During the same period, the U.S. share of the open-registry fleet has declined from more than 25 percent to approximately 6 percent. Prominent industry members -- for instance, Skaarup Shipping (a bulk operator headquartered in Greenwich, Connecticut) -- have either sold majority interests in a sizable portion of their fleets to non-U.S. persons or otherwise "decontrolled" their operations in order to maintain their companies' ability to compete. Unless Congress corrects this problem soon, Birdsall will be forced to sell out to foreign competitors who operate free of any current income tax.

I am also convinced that, if Congress fails to act, other U.S.-owners will have no choice but to follow suit. When that happens, foreigners will control who carries all U.S. imports and exports and, as a result, will wield substantial control over our country's economic well-being. This would be particularly ironic given that international trade is expected to expand significantly with new trade agreements in effect. The likelihood is that U.S.-owned shipping operations will carry almost none of that increased trade. Whatever the original motivation for the current tax rules, it does not make sense to continue this trend and concede carriage of our waterborne trade to foreign control.

The devastating impact of the tax changes has been decried in newspapers from around the country. Two examples, an April 26, 1993 editorial in the Tampa Tribune and a commentary by economist Gary Hufbauer published on May 6, 1993 in the Port Arthur News, are attached.

I note with particular concern the statement by Assistant Secretary Samuels in 1993 when this proposal was last the subject of Congressional hearings (then before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means) that it "would be premature to propose any change in these rules at this time" because "an inter-agency task force is reviewing our shipping program". Another two years has passed since that statement and, to my knowledge, the Administration has not proposed any reform. With all due respect, evidence of the harm caused by the repeal of the reinvestment rule is clear and convincing. By the time additional Administration studies are done, Tropical and others will be in foreign hands. The time to act is now!

Restoring the Subpart F Exclusion Will Level the Playing Field and Permit U.S.-Owned Shipping Operations To Compete

Our proposal would put U.S.-owned shipping operations back on a competitive footing with foreign competitors. As described by the Staff of the Joint Committee on Taxation in connection with recent hearings before the House Committee on Ways and Means (JCS-19-95, p. 154), the proposal essentially would restore the tax law in effect until 1975 by requiring U.S. owners to pay tax on the shipping income of their controlled foreign corporations when that income is repatriated. Unlike the pre-'75 law, however, the exclusion would be available only for (i) owners that operate at least four U.S. flag ships of 10,000 deadweight tons or more or (ii) derive at least 90 percent of their income from operations in the Caribbean.

Although prior proposals advocated simply restoring the law in effect prior to 1986 (under which the exclusion from Subpart F was conditioned on reinvestments in qualified shipping assets), such half-measures would be inadequate. In many markets, there may be little or no opportunity for economic reinvestment in a given year. For U.S.-controlled carriers operating in such markets, simply restoring pre-'86 law would mean that income held in reserve or put to some other business use would automatically be subject to current U.S. tax. Because foreign competitors do not operate under any such restrictions, the limitation would unfairly penalize those operations that are not in a position to reinvest every year. Finally, for financial accounting purposes, a U.S. company must currently recognize deferred tax liabilities on reinvested amounts under the pre-'86 law which, in turn, would decrease earnings. Under the pre-'75 law, however, tax liabilities should only be "booked" upon repatriation. Both aspects of the pre-'75 law are important to the continued viability of U.S.-controlled shipping.

Exclusion From Subpart F Would Be
Consistent With General U.S. Tax Principles

The changes made in 1975 and 1986 regarding the taxation of shipping income were contrary to general U.S. tax principles. Stated simply, stockholders typically are not taxed until corporate earnings are distributed. This straight-forward general rule is based on the fundamental principle that one should not be taxed on income until it has been received. This same rule applies to an individual who owns a few shares of AT&T and Ford Motor Company's ownership of foreign manufacturing subsidiaries. Thus, the restoration of the pre-'75 law would simply bring U.S. controlled shipping back within general U.S. tax principles.

The requirement that recipients generally operate at least four large U.S. flag ships is intended to help preserve the dwindling U.S. flag fleet and those businesses and seaman who rely on it. The provision for Caribbean-based operations recognizes the special attributes of shipping in that region, among them America's historical dominance of trade in that region. The Caribbean is the one area in the world where U.S.-owned shipping operations continue to carry the majority of goods and, not coincidentally, it is also the one area where the U.S. enjoys a favorable balance of trade.1/ Without the ability to compete against our foreign competitors, these collateral benefits of U.S. controlled shipping will almost surely also fade away.

Conclusion

If Congress restores the exclusion of foreign base company shipping income from Subpart F, I am confident that Birdsall will not only hold its own, but also expand its operations over time. More generally, this will permit the U.S.-owned fleet to save itself from foreign acquirors and to participate in expanding world trade. These opportunities will all disappear, however, if Congress waits much longer to act.

Respectfully,

John H. Birdsall, III

1/ U.S. carriers act as salesmen for U.S. exports in an effort to increase the demand for their shipping services. Foreign owners who replace the likes of Birdsall are more likely to market exports from their own nations, and thus further erode our balance of trade.

Merchant Shipping Fleet in Open-Registry Countries: 1975, 1986, and 1993
(thousands of gross tons)

Ownership by Registry	1975	1986	1993	Percentage Change 1975-86	1986-93	1975-93
Total Fleet in Open-Registry Countries:						
Panama	13,667	41,305	55,053	202	33	303
Liberia	65,820	52,649	54,919	(20)	4	(17)
Cyprus	3,221	10,617	21,665	230	104	573
Bahamas 1/	-	5,985	20,920	n/a	250	n/a
British Dep. Territories	1,887	12,928	16,491	585	28	774
Malta	36	2,015	12,584	5,497	525	34,856
Honduras	n/a	555	1,081	n/a	95	n/a
Total Open-Registry Fleet	84,631	126,054	182,711	49	45	116
U.S.-Owned Fleet in Open-Registry Countries:						
Panama	2,558	2,884	475	13	(84)	(81)
Liberia	19,145	11,360	6,867	(41)	(40)	(64)
Cyprus	0	2	0	n/a	n/a	n/a
Bahamas 1/	-	2,075	2,798	n/a	35	n/a
British Dep. Territories	59	752	1,159	1,175	54	1,864
Malta	0	0	32	n/a	n/a	n/a
Honduras	47	23	0	(51)	n/a	n/a
Total U.S.-Owned	21,809	17,096	11,331	(22)	(34)	(48)

	1975	1986	1993
U.S.-Owned Share of Open-Registry Fleet	25.8%	13.6%	6.2%

1/ Bahamas was part of the British Dep. Territories in 1975.

Sources: Price Waterhouse LLP calculations based on Lloyd's "World Fleet Statistics," and the Maritime Administration's "Foreign Flag Merchant Ships Owned by U.S. Parent Companies," and "Merchant Fleets of the World;" various years.
Figures are mid-year values except for U.S.-owned fleet figures for 1975 which are as of December 31.

THE TAMPA TRIBUNE

The Tampa Tribune, Monday, April 26, 1993

6-Nation/World

EDITORIALS

Fair play for U.S. shipping

The American shipping industry is sinking. Since 1986, the U.S.-owned registry fleet has declined by 42 percent. Foreign-owned shipping companies carry more than 75 percent of America's waterborne trade.

The scuttling of the ship industry has eliminated thousands of job, hurt hundreds of related businesses and cost the nation millions of dollars in local, state and federal tax revenues.

While a number of factors may be involved, there is no doubt that the major culprit is the federal tax revision of 1986.

It is another case of how government meddling, and money-grabbing, throttles American competitiveness.

Some background:

In the Tax Reform Act of 1986, Congress killed the tax deferral on the foreign earnings of the U.S. shipping fleet. Previously, companies had been able to defer foreign shipping income that was reinvested in fleet improvements. The elimination of the deferral, which slipped through the House with no debate, was supposed to raise $40 million a year.

Instead, it virtually scuttled the industry. The reason? Foreign countries do not tax the foreign earnings of their shipping corporations.

Companies in the capital-intensive shipping industry now must set aside about a third of their income for U.S. taxes before they can put money back into their fleets. Not surprisingly, they are dead in the water in global competition.

None of America's shipping competitors, which include Japan, Taiwan, Britain, Norway, Germany and Greece, must meet such an expense. In other nations, the shipping industry is either untaxed or tax-deferred.

Studies by the Institute for International Economics, the Massachusetts Institute of Technology, Price Waterhouse and even the government's General Accounting Office document how the elimination of the deferral instigated the decline of the U.S. fleet.

The solution is simple. Restore the deferral. This would not represent a tax break. It would simply allow companies to defer paying taxes on income that is used for maintenance and expansion.

The change would cost the federal treasury little, since the tax has not generated nearly what was expected.

The 1991 MIT study, which was funded by the shipping industry, concluded, "The cost to the U.S. society of helping the U.S.-owned flag fleet is probably zero or close to it, since tax revenues from the industry segment have actually decreased since the passage of this act."

Indeed, without a tax revision, the nation's fleet likely is doomed, and with it many ancillary businesses.

Important, too, is that the return of the tax deferral would bolster the nation's anemic shipbuilding industry, since it would give shipowners an incentive to use U.S. shipyards for maintenance and drydocking. This obviously would help Tampa's shipbuilding industry and generate more local jobs.

But there is more than parochialism involved. If the United States is to remain a economic powerhouse, if it is to be internationally competitive, and if it is to stop the exporting of American jobs, it must put an end to foolish and self-destructive policies and taxes. Congress can begin the march to economic sanity by reviving the tax deferral for the shipping industry.

Port Arthur News
In our 97th year of publication
Editorial
Thursday, May 6, 1993

Tax on foreign earnings sinking U.S. shipping

GARY HUFBAUER
Opinion

WASHINGTON — As Congress struggles with the first Clinton budget, it should recall a lesson from 1986 when members last wrestled with major changes in the U.S. tax system.

Congress presumably did not want to tax the U.S. ocean-going shipping fleet out of business. It just wanted to raise a little extra money. But Congress forgot the laws of international competition, and the result was to push the U.S.-controlled shipping fleet rapidly toward extinction.

Arthur Laffer may have claimed too much for his famous curve when he argued that lower tax rates would raise U.S. tax revenues across the board. Yet Laffer was surely right about one thing: In important instances, higher tax rates actually curtail the amount of tax collected. This happens because the tax base shrinks as employees and owners play avoidance games, reduce their work effort or simply go out of business.

In the Tax Reform Act of 1986 Congress managed to enact a tax that vindicates Laffer's basic proposition. In its last-minute rush to balance the revenue figures (if only on paper) Congress enacted a gaggle of complex foreign tax provisions, all designed to squeeze revenue out of offshore activities. Most of them were misguided.

Among those measures, the most conspicuous failure was the tax on foreign earnings of the U.S.-controlled shipping fleet. According to a study by the General Accounting Office, the new shipping tax failed miserably to raise the revenue promised — an additional $160 million to $240 million over five years, or about $40 million a year. Instead it nearly sank the last vestiges of the U.S.-controlled merchant fleet.

While the tax details are mind-numbing, and mainly of interest to insomniacs, they are:

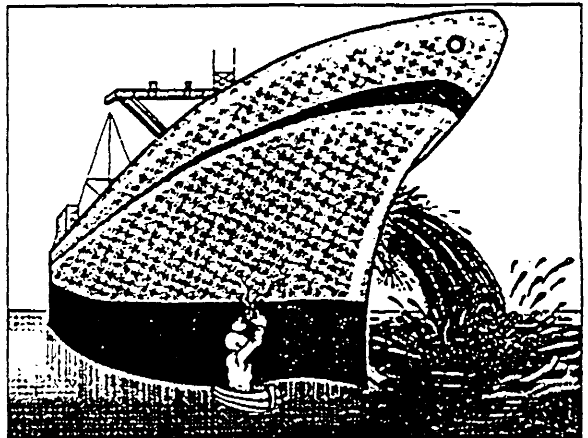
- Before 1986, under Subpart F of the U.S. Revenue Code, U.S.-controlled ships paid U.S. tax on their foreign earnings at the normal corporate rate if not reinvested.

(T)he new shipping tax failed miserably to raise the revenue promised — an additional $160 million to $240 million over five years, or about $40 million a year. Instead it nearly sank the last vestiges of the U.S.-controlled merchant fleet.

- But in 1986 the United States disallowed deferral (i.e., postponement, but not forgiveness) of U.S. taxes for earnings reinvested in the shipping industry.

This change was rushed through Congress on the superficial argument that shipping should be taxed like any other industry. The problem is that shipping is not any other industry. U.S.-controlled ships compete for cargo with ships controlled by Taiwanese, Danish, British, German, Norwegian, Japanese, Greek and other owners. The shipping industry is highly capital intensive, so collection of the U.S. tax, whether or not earnings are reinvested, significantly adds to the cost of business.

While the details of foreign tax codes are almost as mind-numbing as the U.S. revenue code, the bottom line is exceptionally simple: Foreign countries simply do not tax the foreign earnings of their shipping corporations.



Hence, with repeal of the reinvestment rule in 1986, the U.S.-controlled fleet has operated at a significant cost disadvantage in comparison with its foreign competitors — not because it is less efficient, but purely because of the hasty-drawn U.S. tax rules.

The outcome is not surprising. Shortly after the United States repealed the reinvestment rule and started to tax its merchant ships, the U.S.-controlled fleet began to vanish. Between 1986 and 1991 it dropped from 17.1 million gross tons to 12.3 million gross tons, a 18 percent decline.

The problem was not a shrinking shipping industry worldwide. During the same period the world fleet rose 25 percent, from 126 million gross tons to 157 million gross tons. Today only 10 of the top 100 container carriers that transport general cargo in the U.S. foreign trade are still U.S.-owned.

With quick action, the endangered U.S.-controlled fleet can be saved. Congress can undo the damage inflicted in 1986 with a simple step: Reinstate the reinvestment rule. Since the 1986 law raised little revenue, its reversal should be scored as costing little revenue.

But if a careful evaluation shows an offsetting revenue pickup is needed, there is one way that taxes might be gathered without decimating the U.S. shipping industry. A very low excise tax on gross tonnage could be imposed on all vessels clearing U.S. ports, whatever the flag and whatever the ownership. For example, a tax of 10 cents per ton would raise about $50 million annually.

There is not such thing as a perfect tax, but a 10 cent tonnage tax, coupled with the reinvestment rule for the U.S.-controlled fleet, would at least solve the problem of vanishing ships and disappearing revenue.

Gary Hufbauer is a senior fellow at the Institute for International Economics. He is a former director of the international tax staff of the U.S. Treasury Department. [illegible]

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August 3, 1995

Mr. Joe Gale
Minority Staff Director
United States Senate
Committee on Finance
Washington, D.C. 20510

RE: **Foreign Tax Issues; July 21, 1995 Hearing**

Dear Mr. Gale:

We are writing to express our interest and concern regarding the treatment under the Internal Revenue Code of active foreign financing and credit services businesses. By way of background, in 1993 Subpart F was amended to restrict the benefits of deferral of U.S. tax in the case of certain "excessive" accumulations of assets overseas. In this regard, deferral was eliminated to the extent a controlled foreign corporation (CFC) invests its earnings in "excess" passive assets; i.e., more than twenty-five percent of total assets of the CFC.

Under Subpart F, certain "excess passive asset" income that might otherwise be considered to be passive is excluded if it is derived in the conduct of banking, insurance or securities businesses. This exclusion was provided because these are active overseas businesses, despite the inherently "passive" nature of the underlying earnings and assets. However, when enacted, this exclusion was not explicitly extended to income derived in the active conduct of other financing and credit services businesses. Nevertheless, Congress recognized that financing and credit services businesses are similar in nature to banking, insurance and securities businesses. Accordingly, Congress directed the Treasury Department to:

> "... study the tax treatment of income derived in the conduct of financing and credit services businesses, and provide the House Committee on Ways and Means and the Senate Committee on Finance with a report of such study by March 1, 1994. The study should include Treasury's views and recommendations

Mr. Joe Gale
August 3, 1995
Page 2

as to whether the PFIC rules and the excess passive asset rules should be amended insofar as they related to the treatment of such income, along with a discussion of the merits and consequences of any such amendment." (Conference Report to the Omnibus Budget Reconciliation Act of 1993, Report 103-213, p. 641.)

The Treasury has not yet submitted this report to Congress. However, it is clear that in the current situation U.S.-owned active foreign financing and credit services businesses are unfairly disadvantaged *vis-à-vis* their foreign competitors, such as foreign commercial banks and foreign-based finance and credit services businesses, because of the current U.S. tax treatment. This competitive disadvantage is particularly harmful when the U.S.-owned foreign affiliate needs to provide financing to would-be customers for the group's products. In these cases, the U.S.-based multinational may lose product sales when it competes against foreign-based multinationals because the U.S.-based multinational is disadvantaged by U.S. tax laws on the financing it would like to offer its customers. Thus, we urge Congress to eliminate this current competitive inequity.

Thank you very much for your consideration of this manner. If you have any questions on this matter, please call Steven Hannes (202/879-4988).

Sincerely,
Steven Hannes for
Deloitte & Touche

cc: Editorial Section
United States Senate
Committee on Finance

Deloitte &
Touche LLP

Written Testimony of

DOVER CORPORATION

by Charles Goulding
Director of Taxation

Before the

COMMITTEE ON FINANCE
UNITED STATES SENATE

HEARING ON FOREIGN TAX ISSUES

July 21, 1995

Mr. Chairman and members of the Committee, as part of the Committee's hearing on foreign tax issues, it is my privilege to testify on the importance of our country's Foreign Sales Corporation (FSC) program and its impact on companies like mine, the Dover Corporation. Dover is a diversified, U.S.-owned manufacturer with 23,000 employees and facilities throughout the country. We specialize in manufacturing highly engineered products principally from U.S. locations. Our successful products result from a combined company annual U.S. R & D budget exceeding $100,000,000. We also are proud to include within our family 53 businesses of varying sizes, many small, with combined export sales projected at $800,000,000 for 1995.

Dover Corporation's Use of FSC Program

We view the FSC program as an important part of a team effort between government and industry to encourage exports and foster fair competition with large foreign entities that rely on a far greater level of government support in their host countries than we do in the U.S. We strongly support the Administration's efforts to target trade with the big emerging markets, including China, Taiwan, Hong Kong, India, Indonesia, South Korea, South Africa, Poland, Turkey, Mexico, Brazil and Argentina. These are the same dynamic markets that we have identified for growth, and we are investing tens of millions of dollars to expand into these markets with the hope of participating in their development.

Dover's experiences highlight how effectively the FSC program has encouraged the growth of U.S. exports. Back on January 1, 1985, prior to the time when companies were first permitted to form a FSC, Dover owned 13 foreign corporations, and seven of those were principally sellers of U.S.-made products. As of January 1, 1995, we have over 100 foreign corporations, and over 90 of them principally sell U.S.-made products.

I can assure you that, although our Company substantially benefits from the FSC program, such benefits pale in comparison to our expansion costs. Our Chief Executive Officer has charged our business operators with searching for growth opportunities and has instituted incentives to encourage development of export markets. Simply stated, the more opportunities Dover has to export our products and the more we expand our FSC program, we all benefit.

The FSC program has become the key factor facilitating our Company's ability to timely identify opportunities for export sales throughout our Company's various businesses. The FSC tax requirements have mandated that each of our 53 separate businesses institute computer monitoring systems to track export sales and margins, on a quarterly basis. Dover's FSC reporting system is now used to provide the background data we need to respond to the ever-increasing investment community inquiries concerning a publicly traded company's level of exports. The FSC program has obviously facilitated a successful team effort to increase our Company's ability to produce U.S. exports.

For example, the key to expanding exports of very expensive machines, such as our semi-conductor insertion equipment, is to combine a world class product with the ability to service that equipment locally with supply parts immediately available in the foreign market. Our goal with regard to repairs of our semiconductor machines is to get the customer's machine back on line within 24 hours, anywhere in the world. With a FSC, such service is possible with U.S.-made products. The FSC incentive provides us the extra edge we need to compete against huge companies in their government-supported home markets. The program helps equalize the treatment of American exporters with that received by foreign competitors exporting from countries providing indirect tax refunds and exemptions.

Title Passage Rule is Not Sufficient

Testimony was presented at the hearing indicating that the title passage rule might be more beneficial than forming a FSC. *See, e.g.*, Testimony of Joseph H. Guttentag, International Tax Counsel, Department of Treasury (July 21, 1995) 12. While this might be true for some companies, the title passage rule, in practice, provides a better incentive only if the company is in an excess foreign tax credit position. Those companies that are more concerned with title passage than with forming a FSC typically have shifted their manufacturing offshore. In contrast, companies like Dover have most of their manufacturing facilities in the U.S. A FSC provides Dover with the incentive to manufacture in the U.S. and sell abroad.

Mr. McIntyre's Testimony Is Incorrect

I examined Professor McIntyre's testimony in opposition to the FSC program. In particular, I noted that Professor McIntyre contends that floating currency exchange rates offset any benefit of a FSC.

While I cannot speak as an international economist, but instead as a businessman and tax director, I can tell you that our experience does not reflect Mr. McIntyre's concerns. He provides little rationale for his flat statement that "any stimulation in exports . . . will be offset, through adjustments in the exchange rate for the U.S. dollar, by a stimulation of imports." *See* Statement of Michael J. McIntyre before the Senate Finance Committee (July 21, 1995) fn 4. It is our belief that the FSC program helps smooth over the erratic costs of an export sales program within the context of floating exchange rates. If the value of the dollar is low, our exports are naturally benefitted; if the dollar is high, the costs becomes prohibitive without a program like FSC. Moreover, we have seen no evidence of a detrimental "adjustment in the exchange rate" as a result of the FSC benefits.

In conclusion, we believe the FSC program is the most successful tax incentive program ever utilized by our Company. Our success with the FSC program in large part may be due to our corporate structure that consists of a large collection of mostly smaller U.S. businesses. Each of these companies is the kind of business that not only can benefit from using a FSC but also, traditionally, is the kind that provides the largest number of jobs for our country. The FSC program rewards U.S. taxpayers, particularly smaller businesses, for successfully penetrating foreign markets -- a goal our country must meet to maintain market share in a growing, more competitive global economy.

FDTA

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August 2, 1995

Editorial Section
United States Senate
Committee on Finance
Washington, DC 20510

Statement on Foreign Sales Corporations In Relation to Finance Committee Hearings on Foreign Tax Issues held on July 14, 1995

The FSC/DISC Tax Association(FDTA), is a not-for-profit 501C(3) corporation formed in 1984, the year the legislation establishing Foreign Sales Corporations was passed. The FDTA's mission is to educate U.S. exporters and multinationals in the area of export tax incentives and international tax compliance and planning. We hold seminars and conferences throughout the U.S. and publish a series of periodic newsletters to educate and train our members, subscribers and attendees in the area of export and international taxation.

In addition to our educational mission, the FDTA acts as a public clearinghouse for the FSC industry by publishing an annual directory and hosting an annual conference and regional seminars which bring together companies with FSCs and interest charge DISCs, professional accounting and legal advisers, and offshore FSC management companies.

Our Association maintains an ongoing membership and regular seminar and conference attendees list from the FSC and DISC industry. This list totals approximately 4,000 companies - or by far the majority of the industry.

Since the passage of the FSC legislation, which also brought into being the interest charge DISC, approximately 5,000 companies have set up a FSC and approximately 1,000 companies are utilizing an interest charge DISC. The interest charge DISC is used by exporters in closely held companies to defer taxes on up to $10,000,000 of export sales. Deferred taxes are subject to an interest charge DISC based on the Treasury's one year T-bill rate. The FSC, on the other hand, provides a tax exemption of approximately 15% on the profits from export sales.

(The original DISC program was created in 1972 to give incentives to exporters. It did not require an interest charge on the deferred taxes and did not contain a maximum limitation on sales which could receive the benefits of the tax incentive. It was discontinued when our GATT trading partners objected to the incentive, calling it an unfair export subsidy that contravened GATT rules.)

Of the approximately 6,000 companies with a FSC or DISC, more than half have annual export sales of under $10,000,000. In other words, they are the small and medium size companies that the U.S. looks to for substantial job increases.

To take advantage of a FSC or DISC and cover the start up and running costs of these special purpose entities, a company needs to export approximately $1,000,000. Based on the Commerce Department estimates, there are approximately 15,000 U.S. firms with exports in excess of $1,000,000. Consequently, the current usage of FSCs and DISCs represents less than half the total possible U.S. exporters with sales in excess of $1,000,000. However, firms with more than $2,000,000 of export sales total approximately 10,000 and account for more than 80% of U.S. exports. It is our estimate that a majority of the eligible companies with export sales of more than $2,000,000, that are neither S-Corps nor multinationals with excess foreign tax credits, have FSCs.

U.S. exporters are found in all fifty U.S. states and account for a large, growing and well paid workforce. Exports are becoming a more and more important part of the U.S. economy. They help create and retain jobs in the U.S., make companies more competitive in world markets, and play a critical role in redressing the deficit in our balance of trade.

The main reasons we have ascertained that companies use the FSC or DISC and want to see it retained are as follows:

1. The tax savings from the FSC keeps U.S.companies competitive on the world markets. The loss of the 15% FSC tax savings benefit could knock many companies out of exporting, resulting in a loss of jobs.

2. The FSC export incentive focuses management's attention and energy on U.S. exports. It is an important consideration when companies are deciding whether to hire additional workers in the U.S. and expand manufacturing in the U.S., rather than expand abroad with plants and people.

3. For many small and medium size companies, exporting represents an additional cost and time commitment. The FSC benefit is the only financial incentive the U.S. offers to motivate companies to export.

4. Many U.S. companies complain that their foreign competitors enjoy far more favorable tax and financial support from their governments to encourage exports than companies receive in the U.S. The FSC benefit is an important, albeit minimal, way to level the playing field.

5. Companies that had established a DISC, an attractive export incentive prior to 1984, were told they had to close it down and form a FSC. After all the efforts these companies have made to set up FSCs and learn how to use them according to the IRS regulations, which are very complex, it would be a very negative and unfair step to remove this singular tax incentive. By "changing the rules in the middle of the game," the government would be adding to public cynicism that is already too high.

Steps to Encourage More Use of the FSC and More U.S. Exports

Companies that do not use the FSC fall into a number of areas:

1. The most important group are closely held companies that have organized themselves as S-corporations. These companies cannot own more than 80% of a FSC subsidiary and cannot obtain the 100% dividend received deduction which generates the FSC benefit. If current regulations were changed to provide them with greater latitude, we estimate that approximately 2,500 new companies would form FSCs and then increase their export sales to generate more profits.

2. Many computer software companies export using master recordings which are reproduced abroad, generating royalty income. At present, they are not entitled to receive FSC benefits. Companies in the movie and music industry do receive FSC benefits for the same type of activity. We strongly support Sen. Orrin Hatch's efforts to introduce legislation to correct this inequitable treatment.

3. Companies in AMT or excess foreign tax credit position are often better off not using a FSC. We support legislation to elimate AMT tax or to reduce or eliminate the ACE adjustment on dividends coming from an FSC. The benefits from 863(b) should be lowered to make them equal to the resourcing rule under 927(e)(1), that is, to reduce the sourcing rule on foreign title passage to only 25% foreign source income rather than 50%. Companies would then be motivated to use their FSCs, which permit 25% foreign source income, plus the 15% FSC benefit. The savings generated by reducing 863(b) benefits will more than cover the cost of maintaining the FSC.

4. Companies providing services - as opposed to manufactured products- do not receive FSC benefits when they export. The FSC benefits should be expanded to cover certain professional, financial, advertising, transportation or consulting service

type products to motivate companies to conduct these activities from the U.S., using U.S. based employees.

5. At present, companies that export military property receive only 50% of the normal FSC benefit. With the cutback in U.S. defense spending, many companies need to export to maintain employment levels in the U.S. By restoring the full 100% FSC benefit for military property, the U.S. would encourage companies to put more effort into exporting and thereby increase employment in the U.S. We support efforts to restore the full 100% FSC benefit for military property.

With total U.S. merchandise exports in 1994 of approximately $500 billion, companies with FSCs or DISCs represent export sales in excess of $250 billion. If one billion dollars in exports creates 20,000 jobs (Commerce Department estimate), companies with FSCs or DISCs represent 5,000,000 jobs. Those are important figures for the committee members to keep in mind.

In reinforcing and expanding the FSC incentive, the Committee has a unique opportunity to make a positive impact on American business, creating jobs, and improving our balance of payments. We encourage you to make the most of this opportunity.

The FDTA thanks you for the opportunity to present the views of our Association.

Robert H. Ross
Executive Director
FDTA

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July 31, 1995

Senator Daniel Patrick Moynihan
Washington, DC 20510

Dear Senator Moynihan:

I am writing as a result of the hearing on foreign tax issues held by the Senate Finance Committee on July 21st. At that hearing, testimony was received on a variety of issues relating to deferral of foreign source income, including matters concerning Foreign Sales Corporations (FSCs) and Domestic International Sales Corporations (DISCs).

We have extensive experience in the use of FSCs and DISCs by taxpayers and, thus, would like to submit the following brief comments concerning their value in carrying out the stated purposes of the legislation, principally as it aids in the promotion of increased U.S. exports. Our comments are limited to the use of FSCs because DISCs are of value primarily to small start-up companies.

We think it is very important that Congress understand that large and small exporters respond in very different ways to the FSC law.

As to the response of large exporters, we have found that export-related behavior is largely unaffected by the availability of a FSC benefit. I can say unequivocally that we have never seen a material alteration in the business conduct of a large exporter in response to the FSC or DISC provisions in more than 20 years of dealing with them. Indeed, our admittedly unscientific observation has been that only about half of large companies permit their profit centers from reflecting the benefit for management accounting purposes. Typically, the other half run their FSCs from within in-house tax departments and the company's operating units and subsidiaries engaged in exporting may or may not even be aware their company operates a FSC unless reflected in the effective tax rate section of the annual report to shareholders. In this latter case, where there is no FSC-linked financial incentive with those in the company responsible for making export sales, and where the responsible personnel may not even know of the FSC's existence, it seems difficult to maintain that the legislation is having its desired effect.

With small and medium sized businesses, the response is very different. We have seen a number of cases where companies were "fence sitting" as to whether to begin exporting until they became aware of the FSC provisions and, thereafter, decided to proceed with their plans. Similarly, we have seen companies already engaged in exporting become more aggressive in their export promotion when shown how they could use the provisions more effectively than they were. These experiences lead us to conclude that the FSC provisions should be made somewhat more "user friendly" to small companies and that an enhancement of the benefit for these companies would be an efficient way for the country to increase exports.

At your request, we would be pleased to provide further comments or information on this very important export incentive.

Cordially,

Davis W. Nelson

Davis W. Nelson

STATEMENT FOR THE RECORD
SUBMITTED BY
ALAN W. GRANWELL
ON BEHALF OF
THE INTERNATIONAL TAX POLICY FORUM

COMMITTEE ON FINANCE
UNITED STATES SENATE

HEARINGS ON
SELECTED FOREIGN TAX ISSUES

AUGUST 4, 1995

I. Introduction

These comments are respectfully submitted by Alan W. Granwell, Director of International Tax Services with the Washington National Tax Services office of Price Waterhouse LLP, on behalf of the International Tax Policy Forum. The Forum, founded in 1992, consists of 23 major U.S. based multinational companies, with a diverse industry representation. The primary purpose of the Forum is to promote research and education on U.S. taxation of income from cross-border investment. To this end, the Forum sponsors research and conferences on international tax issues and meets periodically with academic and government experts to promote a dialogue on these important issues. A list of the members of the Forum is attached to this statement.

These comments are intended to provide helpful information and analysis with respect to the Committee on Finance hearing on selected foreign tax issues, held July 21, 1995. It should be noted that several members of the Forum support specific legislative proposals to modify the current law rules.

II. Importance of international competition

Three decades ago, U.S. corporations accounted for over half of all multinational investment in the world, the United States produced about 40 percent of world output, and the United States was the world's largest lender of capital. Based upon recent statistics, the U.S. economy now produces less than 30 percent of world output and the United States has become one of the world's largest debtors. Three decades ago, 18 of the 20 largest corporations in the world were U.S. corporations; in 1994, only 7 U.S. corporations ranked in the top 20.

U.S. businesses increasingly have recognized the need to compete in both domestic and foreign markets. In case after case, the employment base and potential growth of operations within the United States is highly dependent upon a company's ability to sell goods and services overseas. In order for U.S. corporations to be competitive in the global marketplace, they must be able to provide U.S. goods and services efficiently and economically. U.S. companies are constantly challenged to exceed international competitors in terms of quality, innovation, and price. These challenges necessitate quick and effective corporate response to changing and emerging international markets.

Under current law, the United States taxes its citizens, residents, and domestic corporations on a worldwide basis, and, subject to certain limitations, provides for the elimination of double taxation through the foreign tax credit. The taxation of foreign source income by the United States can be a significant cost of doing business to U.S. corporations in the international marketplace. For this reason, it is clear that the policy decisions made by Congress with respect to the taxation of a U.S. business's foreign operations have an immediate and significant impact on a U.S. company's ability to respond to the needs and opportunities presented by international markets. Accordingly, the taxation of foreign source income has become an issue of vital importance to most U.S. multinational corporations.

It is respectfully submitted that Congress has a significant responsibility to craft tax policy that allows for the fair taxation of U.S. multinational corporations, without hampering the ability of these companies to be able to compete aggressively internationally, or penalizing these companies through burdensome and unnecessary compliance costs. In past decades, when the U.S. economy was dominant, there may not have been as much concern with how the tax system affected the competitiveness of U.S. companies in world markets. Today, however, the Nation cannot afford to ignore global competition in formulating tax policy.

III. Deferral

Under present law, the United States generally does not tax U.S. shareholders on foreign source income earned by a foreign corporation until such income is distributed as a dividend, although a number of regimes have been enacted that limit deferral and tax U.S. shareholders currently on certain types of undistributed foreign income, as if such income in fact were distributed.

The concept of deferral permits U.S. taxpayers operating through foreign corporations to compete internationally through reinvesting their foreign earnings without subjecting such earnings to current U.S. income taxation.

Similar to the United States, a number of countries limit the eligibility of their taxpayers to defer income earned by affiliated foreign corporations in order to protect the tax base of the resident country. Of the several countries that have implemented a system of deferral, the United States is among the most aggressive in eliminating the benefits of deferral, particularly with respect to active trade or business income.

In the case of U.S.-controlled foreign corporations, the Internal Revenue Code denies the benefits of deferral for passive income and for various types of active business income including financial services income, refining income, international shipping income, and certain other income. Moreover, under recently enacted provisions, deferral is substantially limited in the case of U.S.-controlled foreign corporations with significant amounts of passive assets.

All told, at least six different sets of provisions serve as exceptions to the general rule permitting deferral of U.S. tax on foreign source income earned through a foreign corporation. These include (i) the controlled foreign corporation rules, (ii) the foreign personal holding company rules, (iii) the passive foreign investment company rules, (iv) the foreign investment companies rules, (v) the personal holding company rules, and (vi) the accumulated earnings tax rules.

The Code also contains other provisions that, in effect, could be considered provisions limiting deferral. One of these is the non-controlled section 902 corporation foreign tax credit limitation provision (the "10/50 basket") that, in effect, could be viewed as eliminating any benefits of deferral upon a distribution mandated by a foreign co-venturer because of the necessity of placing such income in a separate foreign tax credit limitation basket.

These limitations on deferral reflect a wide range of policy concerns. In a number of instances, these restrictions were aimed at limiting deferral to situations involving particular types of income that legislators believed could be manipulated for purposes of tax avoidance. However, other tax policy arguments have been cited in favor of limitations on deferral. In particular, the doctrine of "capital export neutrality" has been offered as a reason to end deferral. Under that doctrine, the U.S. tax on foreign earnings should be the same as the U.S. tax on domestic earnings, so that U.S. tax is a neutral factor in deciding whether to invest at home or abroad. Advocates of capital export neutrality believe that capital should flow to investments offering the highest pre-tax rate of return, whether domestic or foreign. This approach could be viewed as reflective of the U.S. approach when our country was a net exporter.

In contrast, supporters of deferral cite the doctrine of "capital import neutrality" in favor of fewer restrictions on deferral. Under that doctrine, taxes should be a neutral factor between U.S. and foreign companies operating in the same markets. Accordingly, a U.S. taxpayer in a foreign country should not be subject to more burdensome taxation on income than a local company engaging in the same activities. This approach could be viewed as more reflective of what the U.S. approach currently should be as it permits U.S. multinational corporations to compete more effectively internationally.

Congress has the authority and responsibility to delineate those cases in which deferral will be permitted, and those where current inclusion of the foreign source income of a foreign corporation owned by U.S. persons will be required. In general, commentators have indicated that factors such as the concentration of U.S. control in a foreign corporation and the presence of passive or easily movable types of income appear to be the key indicia of when the United States will limit deferral, but the policy rationale underlying the provisions relating to limitations on deferral is not entirely clear. It should be noted that the concerns related to easily movable types of income should not be applicable in the case of foreign operations of *bona fide* banking and financial services operations conducted by U.S.-controlled foreign corporations, as well as analogous business operations of other U.S. multinational corporations.

It is essential that Congress remain cognizant of the practical impact of rules limiting deferral upon the international competitiveness of U.S. multinational corporations. Any justification for a proposed legislative change should be considered by reference to the impact of such change on U.S. corporations operating abroad, their ability to provide domestic jobs, and their important contribution to our trade position.

IV. Economic Inefficiencies and Complexities of the Current System

The current regimes limiting deferral in reality reflect a series of discrete provisions enacted over the last half-century. There are multiple sets of rules limiting deferral, each of which reflects a singular response to an alleged shortcoming in the deferral rules existing at the time of enactment, or to the need to raise revenue. Over the years, the aggregate result of overlaying disparate limitations to the deferral regime is a "crazy-quilt" system that requires current taxation of certain types of income by reference to different factors and criteria, or, in the alternative, imposes an interest charge on certain actual or deemed dispositions.

The various regimes have different rules of priority. In numerous cases, the systems are redundant, so that certain classes of income initially can be subject to several deferral limitation regimes, each with its own tax consequences and compliance requirements.

The overall effect of this patchwork of rules is to give an arbitrary quality to the taxation provisions governing deferral, since no underlying tax policy justification can be made to rationalize the cacophony of conflicting rules. For example, U.S. taxpayers must understand the potential consequences under the deferral limiting provisions of the Internal Revenue Code when they engage in otherwise simple and straightforward business activities, such as acquiring and owning a majority stock interest in a foreign corporation.

Additionally, in conjunction with restrictions on the use of foreign tax credits, such as the limitation that a foreign tax credit cannot be taken if the taxpayer is in a loss position, and the two-year carryback and five-year carryforward limitation for unused credits, the rules limiting deferral can result in permanent double taxation of foreign source income of U.S. taxpayers

The regime relating to controlled foreign corporations has been in the law for over 30 years, and was crafted when the U.S. economy was dominant in the world economy. These rules deal with foreign operating companies that are majority-owned by U.S. businesses As part of the Tax Reform Act of 1986, a new regime targeted at ending deferral for certain passive investments, known as the passive foreign investment company rules, was enacted This regime was conceived, in both the House and Senate bills, as a way to eliminate deferral for U.S. individual investors in widely-held offshore foreign investment funds who could avoid the application of the controlled foreign corporation regime and other deferral limiting regimes. It was not aimed at controlled foreign corporations. The final legislation, however, inexplicably did not exclude controlled foreign corporations from the ambit of the passive foreign investment company rules. These two systems, enacted at different times and intended to promote different policies, to a significant extent are contradictory as well as redundant, causing severe economic inefficiencies and complexity as a result.

Congress recently has enacted yet another provision limiting deferral. Section 956A of the Internal Revenue Code, enacted as part of the Omnibus Reconciliation Act of 1993, originally was intended to protect the U.S. tax base by requiring current taxation of foreign income when significant excess passive investments are held overseas; instead, its practical effect in a competitive world marketplace has been to lock funds into long-term overseas investments. Additionally, the rule is in large part redundant with the above-described rules dealing with controlled foreign corporations and passive foreign investment companies.

Accordingly, the perceived unfairness and arbitrary consequences resulting from application of the current rules limiting deferral impose unwarranted economic inefficiencies and complexities.

V. Conclusion

The present complex system of rules limiting deferral is the collective result of individual provisions enacted over the past half century that promote competing policy objectives and respond to disparate concerns. Many of those policy decisions were made in past decades when the U.S. economy was dominant. Recent policy decisions appear to lack adequate consideration of the realities of the global marketplace, especially as it applies to U.S. multinational companies. The resulting regime relating to deferral produces substantial economic inefficiency and administrative burdens, and does not appear to promote any uniform policy objective. The complexity and increased tax burden engendered by the rules, the efforts to understand their application, and the significant compliance costs necessitated by these rules, make it more difficult for U.S. multinational corporations to compete effectively in world markets.

At such time as Congress deems it appropriate to revisit the current-law deferral provisions, it is hoped that Congress will measure any proposed changes to these provisions by their prospective impact on the ability of U.S. multinationals to compete in the global marketplace and the ability to comply with such laws in a reasonable manner

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STATEMENT OF

INTERNATIONAL SHIPHOLDING CORPORATION,

OMI CORP., AND

OVERSEAS SHIPHOLDING GROUP, INC.

SUBMITTED TO

THE FINANCE COMMITTEE

UNITED STATES SENATE

AUGUST 3, 1995

I. Introduction and Summary

This statement is submitted by a coalition of three U.S. shipping companies with substantial U.S.-flag and foreign-flag fleets: International Shipholding Corporation ("ISC"), OMI Corp. ("OMI"), and Overseas Shipholding Group, Inc. ("OSG").

ISC, a Delaware corporation listed on the New York Stock Exchange with headquarters in New Orleans, Louisiana, is engaged through its subsidiaries in ocean and inland waterborne freight transportation throughout the world. ISC's fleet consists of LASH (Lighter Aboard Ship) vessels, car carrier, roll-on/roll-off vessels and similar liner-type vessels.

OMI Corp., a Delaware corporation listed on the New York Stock Exchange and headquartered in New York, is engaged in the ocean transportation of liquid and dry bulk cargoes in both domestic and worldwide markets. OMI charters its vessels to commercial shippers and to U.S. and foreign governmental agencies for the carriage of crude oil, petroleum products, chemicals, liquefied natural gas, grain, and other dry bulk commodities.

OSG, a Delaware corporation also listed on the New York Stock Exchange and headquartered in New York, is engaged in the ocean transportation of liquid and dry bulk cargoes in both domestic and worldwide markets. OSG is the largest independent owner of unsubsidized U.S.-flag bulk tonnage, including over 10% of the unsubsidized U.S.-flag fleet. The company also has a substantial presence in the foreign trades. OSG charters its ships to commercial shippers and to U.S. and foreign governmental agencies for the carriage of bulk commodities, principally petroleum and related products, grain, coal, and iron ore.

In 1975, Congress adopted a new tax rule that severely penalized U.S. shipowners and undermined their ability to compete in international markets. Specifically, the inclusion of foreign base company shipping income in the "Subpart F" provisions of the Internal Revenue Code (the "Code") subjects shipping income earned by foreign subsidiaries of U.S. corporations to current U.S. taxation. This represented a departure from the general U.S. tax rules applicable to international subsidiaries of U.S. corporations. Given the capital intensive and highly competitive nature of the international bulk shipping trades, current taxation places materially greater tax burdens on U.S. shipowners than are imposed on our principal competitors.

This tax change has had a measurable effect on the vitality of the U.S.-owned international shipping fleet, which has declined substantially. Moreover, the pace of that decline is likely to accelerate over time. For instance, just since 1986, the U.S.-owned foreign flag bulk fleet has declined from 36 million deadweight tons ("dwt") to 26 million dwt, while the world bulk fleet has grown from 462 million dwt to 502 million dwt as of the end of 1991 (the most current data). The U.S.-owned foreign-flag portion of the world bulk fleet now is only 5%, one third smaller than in 1986.

OSG, OMI, and ISC respectfully urge Congress to restore the prior law taxation for shipping companies that operate both U.S. and foreign-flag fleets. Exclusion from Subpart F would place these enterprises on the same tax footing as other U.S. multinational corporations engaged in active, capital-intensive businesses around the globe as well as our primary foreign competitors.

II. The Competitive Environment and Taxation of Shipping

A. Shipping Operations of OSG, OMI and ISC.

OSG, OMI, and ISC operate in both worldwide and domestic markets. We believe that ownership of a diversified fleet, with vessels of different flags, types and sizes, provides operating flexibility and permits maximum usefulness of vessels. For a variety of business reasons, each of our vessels is owned by a separate corporate subsidiary, many of which are organized in foreign countries.

OSG's U.S.-flag bulk fleet consists of 16 vessels aggregating approximately one million deadweight tons. ISC's U.S. flag fleet consists of 16 vessels as well. OMI's U.S.-flag fleet consists of 15 vessels aggregating approximately 930,000 dwt. All three companies operate substantial fleets in the foreign trades as well.

By law, U.S. coastwise and noncontiguous shipping is primarily reserved for U.S.-flag vessels built here without subsidies and operated without them. The preference trades, primarily grain shipments to foreign governments, employ both subsidized and unsubsidized vessels. OSG's U.S.-flag vessels, for example, are employed in the Alaskan oil trade and other domestic petroleum trades, by the U.S. government, in the transportation of motor vehicles and for transporting dry bulk cargo, primarily under P.L. 480. The domestic trade is very competitive, and is principally affected by the levels of domestic crude oil production and oil imports, the volume of oil refining, and the government's requirements for military and grain shipments.

Competition in the foreign bulk shipping markets also is extremely keen. Demand generally is dependent upon international economic conditions, as well as on world oil production and consumption, steel production and grain shipments. Charter rates are determined by market forces and are highly sensitive to changes in supply or demand. Any change in costs, including taxes, can have a direct and adverse impact if it is borne by some but not all carriers.

The economic viability of the international flag fleet has special importance to shipowners operating in both domestic and international trades. For them, income from the international flag fleet provides support for the U.S.-flag fleet when domestic markets are under pressure.

B. Taxation of U.S.-Controlled Shipping Income.

Under tax principles of long-standing application, the United States generally does not tax the income earned abroad by separately incorporated controlled foreign subsidiaries of U.S. corporations until such income is repatriated (e.g., as a dividend by the foreign subsidiaries to the U.S. parent corporation). The "Subpart F" provisions of the Code are an exception to this general tax principle and only apply current taxation to narrowly defined types of income. Under the Subpart F exception, which was first enacted in 1962, the principal U.S. shareholders of a U.S. controlled foreign corporation ("CFC") are taxed on the "Subpart F income" of the CFC in the year such foreign income is earned. Subpart F treats such income as if it had been paid by the CFC as a current dividend to those U.S. shareholders whether or not such income is then (or ever) in fact repatriated. If Subpart F income is repatriated by the CFC in a subsequent year, it is classified as "previously taxed" and is not subject to what would otherwise be a second U.S. tax.

From 1962 until the enactment of the Tax Reduction Act of 1975, foreign shipping income was not classified as Subpart F income. Therefore, in accordance with the generally applicable U.S. tax principle of deferral, the income attributable to the foreign operations of the effectively U.S. controlled foreign flag (EUSC) fleet continued to be subject to U.S. tax only when and to the extent it was actually or constructively repatriated to the United States.[1] In the Tax Reduction Act of 1975, Congress redesignated the foreign shipping income of a CFC as Subpart F income, but provided that such foreign shipping income would not be subject to the basic Subpart F current taxation rule if and to the extent such income was reinvested by the CFC in its foreign shipping operations. When the 1975 legislation was enacted, the "reinvestment rule" was acknowledged to be necessary given the capital-intensive nature of the foreign shipping business and the importance to the nation of a viable U.S.-owned maritime fleet.

Consequently, notwithstanding the redesignation of foreign shipping income as Subpart F income in 1975, for all practical purposes the general U.S. tax principle of deferral continued to apply to the foreign income of the CFC which was attributable to EUSC fleet operations where such income was reinvested in those foreign shipping operations.

[1] "Effectively U.S.-controlled" foreign-flag vessels are typically owned by foreign subsidiaries of U.S. corporations and are generally flagged under the laws of "open registry" countries that permit the United States to exercise control over the vessels in time of war or other national emergency.

The repeal of the reinvestment rule (and the resulting elimination of tax deferral) in the Tax Reform Act of 1986 consummated a fundamental tax law change initiated in 1975 that reversed more than half a century of U.S. tax policy. As explained below, these changes have had and will continue to have a severe adverse effect on the long-term viability of the EUSC fleet. Moreover, repeal does not conform to the tax policies of other key countries; it was not needed to protect the U.S.-flag merchant marine fleet from deterioration; it is not in the national interest; and it is not sound tax policy.

III. Severe Adverse Effects of the 1975 and 1986 Act

The international shipping business is capital intensive and highly competitive. The capital intensive nature of the business requires an almost continual reinvestment of a high percentage of income to remain economically viable. The acceleration of the timing of U.S. taxation imposes a substantially higher cost of capital on the EUSC fleet (i.e., reinvestments must be financed for the first time with after-tax dollars). This is particularly significant because most "home countries" of the international flag vessels with which the EUSC fleet competes do not impose current taxes on the unrepatriated income of international shipping subsidiaries.

The following countries do not impose a comparable current tax on unrepatriated foreign shipping income: Greece, Hong Kong, the Netherlands, the Philippines, Taiwan, Italy, Korea, Denmark, and France. Under the tax laws of the United Kingdom, tax deferral is permitted with respect to 50 percent of unrepatriated foreign shipping income. While other countries (including Japan and Germany) have adopted tax regimes similar to Subpart F, their use of particular organizational structures, availability of tax and nontax concessions, or other arrangements significantly reduce the impact of such taxes.[2] Significantly, approximately four years ago Canada liberalized the taxation of foreign shipping earnings of foreign corporations. This change was intended to attract to Canada the owners of Hong Kong-based shipping companies, and also to encourage those owners of foreign shipping operations that had relocated to other countries (and other shipping companies) to establish bases in Canada (see Journal of Commerce, February 22, 1991).

U.S. investors in the EUSC fleet effectively now pay a "premium" on investments in that fleet because those investments must be made with after-tax dollars, while a substantial portion of their foreign controlled competitors still invest with pretax dollars. Over time, these premiums on investments in the EUSC fleet would require EUSC vessels to command higher charter rates than their competition in order to maintain overall rates of return that are comparable to those earned by their foreign controlled competitors. To the extent such comparatively higher charter income cannot be obtained--and it will be virtually impossible to do so on a continual basis--the overall economic posture of the EUSC fleet will continue to be eroded. As a

[2] The information with respect to tax regimes of other countries is based in part on a November 1990 study conducted by Ernst & Young for OSG.

consequence, owners of the EUSC fleet are being forced to adopt measures that will further erode the U.S. maritime industry.

The responses to the current taxation of foreign company shipping income include using joint ventures with foreign persons or other techniques to avoid the majority U.S. ownership that will trigger the application of the Subpart F exception, or relocating to another country, such as Canada. As these or other similar options are pursued, there is an increased likelihood that a well-maintained EUSC fleet, both in terms of numbers of vessels and their state of repair, will be unavailable for requisition by the United States when the need arises. Indeed, these results have already begun to materialize. Few new tankers have been registered in the EUSC fleet since 1986, and majority ownership of some EUSC vessels has been transferred to foreign interests so that the vessel owning foreign corporation will not be classified as a "controlled foreign corporation" for purposes of the Subpart F exception (see Fairplay, Page 10, February 8, 1990).

IV. National Security Issues

The competitive viability of the EUSC fleet is a matter of national concern. The EUSC fleet has been deemed by the defense authorities to be a national security asset in times of war or other national emergency.

The National Sealift Policy, signed by the President on October 5, 1989, as National Security Directive 28, states in part:

> Sealift is essential both to executing this country's forward defense strategy and to maintaining a wartime economy . . . . The United States' national sealift objective is to ensure that sufficient military and civil maritime resources will be available to meet defense deployment, and essential economic requirements in support of our national security strategy.

The experience with Desert Shield and Desert Storm vividly demonstrates the continued importance of our sealift capability even as the Cold War has ended. Restoration of the prior law for dual-flag operators will help ensure the viability of the EUSC fleet and advance the country's sealift policy.

V. Restoration of the Exclusion of Foreign Base Company Shipping Income from Subpart F

In light of the severe adverse consequences to the EUSC fleet of the 1975 and 1986 tax law changes (and the importance of the EUSC fleet to the nation), Congress should restore the prior law for companies operating a qualified U.S.-flag fleet.

Eliminating foreign base company shipping income from Subpart F would not constitute a special tax break or insulate companies like ISC, OMI, and OSG from the rigors of international competition. The deferral of U.S. tax on unrepatriated earnings is the general norm of U.S. tax policy. The current inclusion rule of Subpart F is the exception to the historic principle of deferral. The income from the EUSC fleet, with its substantial required investment in tangible assets, differs from other types of income covered by the Subpart F exception. Restoration of the prior law would be consistent with the general scheme of U.S. taxation applicable to the active business operations of many other U.S. controlled foreign corporations.

Moreover, returning to pre-'75 law is necessary to promote cross-border tax equality between the U.S. owners of the EUSC fleet and many of the foreign owners of the foreign vessels with which the EUSC fleet competes. In short, from a tax policy perspective, restoration of the prior rule would simply give the affected U.S. owners of foreign shipping corporations parallel treatment with the U.S. owners of many other types of controlled foreign corporations and with major foreign-based shipping competitors.

For the reasons set forth in this statement, Congress should reinstate the exclusion for shipping income earned abroad by U.S. operators of dual-flag fleets. Healthy EUSC operations can provide a source of financial strength to weather difficult market conditions by the U.S. merchant marine industry; and the health of both is critically important to the national interest.

STATEMENT OF WILLIAM P. McCLURE
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Submitted In Connection With
The July 21, 1995 Hearing on Foreign Tax Issues
Before the United States Senate
Committee on Finance

The Senate Finance Committee is considering many important changes to the current laws governing foreign tax issues. I make the following three suggestions for possible inclusion in the next tax bill to be considered by the Committee:

1. CFC Exception From PFIC Rules -- U.S. shareholders of controlled foreign corporations ("CFCs") should be exempted from the Passive Foreign Investment Company ("PFIC") rules since section 956A, which was enacted as part of the Revenue Reconciliation Act of 1993, taxes currently the income of CFCs to the extent that the CFCs' accumulated earnings are invested in excess passive assets rather than business assets. Under the PFIC rules, a corporation which is a PFIC has all of its income taxed whether it is passive or active. Section 956A is aimed at the proper target -- only earnings invested in excess passive assets.

2. Section 902 Extended to Six Tiers -- H.R. 11, the Revenue Act of 1992 (which was vetoed by President Bush), included a provision which extended the section 902 foreign tax credit to fourth, fifth and sixth-tier CFCs. This provision should be adopted once again by the Congress.

3. Look-Through for 10-50 Companies -- The Tax Reform Act of 1986 created several separate limitations for the purpose of computing the foreign tax credit. These limitations substantially reduce the averaging of high-taxed income with low-taxed income. One limitation requires that dividends received by a U.S. corporation from each foreign corporation, which is not a CFC and in which the U.S. corporation has at least a 10-percent interest, be included as a separate "basket". Such a provision is very punitive and is in very much need of change. I suggest that a U.S. parent be able to apply a look-through rule for dividends received from these corporations. Thus, dividends attributable to each type of income of the foreign corporation for which there is a separate basket

for computing the foreign tax credit should be included in that particular basket. For example, dividends attributable to the foreign corporation's active income should be included in the active (general limitation) basket and dividends attributable to the foreign corporation's passive income in the passive basket. This would be true also for the dividends attributable to the foreign corporation's other types of income for which there are separate limitations under existing law.

Each of these suggestions is discussed further below. In addition, I include a discussion of why the Committee should not favorably consider any proposal that further limits or repeals the deferral of U.S. taxation of income of CFCs.

DISCUSSION

I. CFC Exception From PFIC Rules

The Revenue Reconciliation Act of 1993 amended the Internal Revenue Code by inserting section 956A which taxes currently the income of a CFC to the extent that the CFC's accumulated earnings are invested in excess passive assets rather than active business assets. Excess passive assets are defined as the excess of the average amount of passive assets held by the CFC at the close of each quarter of its tax year over 25 percent of the average amount of the total assets held by the CFC at the close of each quarter. Passive assets are defined as those assets which produce passive income under the rules relating to a PFIC or which are held for the production of such passive income.

It is respectfully suggested that since section 956A has been enacted, there is no reason whatsoever for subjecting CFCs to the provisions relating to PFICs. Under the PFIC rules a foreign corporation is a PFIC if: (1) 75 percent or more of its gross income is passive income; or (2) 50 percent or more of its assets produce or are held for the production of passive income. If a corporation is a PFIC, then all of its income is subject to current taxation, or its U.S. shareholder is subjected to an interest charge upon a disposition of the PFIC or a receipt of an excess distribution from the PFIC.

As previously stated, section 956A taxes CFC earnings that are invested in excess passive assets. Section 956A is aimed at the proper target -- earnings invested in excess passive assets. The PFIC provisions are too draconian in that they tax all of the income of a PFIC and not merely the income invested in excess passive assets.

In the context of CFCs, the U.S. shareholders will have sufficient influence that they will be able to obtain the information from the foreign corporation that is required to apply the more finely-tuned rules of section 956A rather than the PFIC provisions. This ability makes it feasible to subject U.S. shareholders of CFCs only to section 956A and not to the PFIC regime. Providing an exception to the PFIC regime in the case of CFCs also would promote tax simplification and compliance, by eliminating the need to address complex issues that currently arise from the interaction of two separate but overlapping sets of rules for dealing with the same policy objective -- the prevention of deferral with respect to offshore passive assets and income.

It is respectfully submitted that for the foregoing reasons Congress should provide that a U.S. shareholder of a CFC shall not be subject to the PFIC regime.

II. Section 902 Extended to Six Tiers

Under section 902 a U.S. corporation which owns at least 10 percent of the voting stock of a foreign corporation is treated for foreign tax credit purposes as though it pays a portion of the foreign taxes paid by that foreign corporation when a dividend is distributed to the U.S. corporation. A U.S. corporation is also deemed to pay the taxes paid by a second or third tier foreign corporation.

When taxes are paid by corporations below the third tier, a foreign tax credit is not allowed. In order to be entitled to the foreign tax credit in these situations, taxpayers often go through costly and burdensome restructurings.

Recognizing that this situation should be remedied, H.R. 11, the Revenue Act of 1992, included a provision which extended the application of the indirect foreign tax credit to fourth, fifth, or sixth tier CFCs. Unfortunately, H.R. 11 was vetoed by President Bush for reasons that have nothing to do with this indirect foreign tax credit provision.

The reasons for extending the indirect credit to fourth, fifth and sixth tier subsidiaries are the same today as they were in 1992, and it is respectfully requested that such a provision be included in any forthcoming legislation dealing with the U.S. taxation of foreign income.

III. Look-Through for 10-50 Companies

Prior to the Tax Reform Act of 1986, the foreign ~~tax credit was generally computed on an overall basis which~~ permitted the averaging of high-taxed income with low-taxed income. The 1986 Act established several separate limitations for computing foreign tax credits of U.S. corporations which substantially reduced such averaging. Separate limitations were applied to general business income, passive income, shipping income, financial services income, and dividends from certain noncontrolled corporations (as hereinafter described), among others.

The last mentioned limitation requires that dividends received by a U.S. corporation from each "noncontrolled section 902 corporation" be subject to a separate limitation. Such a corporation is a foreign corporation which is not a CFC and in which a U.S. corporation has at least a 10-percent interest. Since a separate limitation applies to each noncontrolled section 902 corporation, if a U.S. corporation has interests in 20 different noncontrolled section 902 corporations, it has to keep track of 20 different separate limitations.

Taxpayers with interests in noncontrolled section 902 corporations are normally in joint undertakings with foreigners. These ventures in corporate form have been increasingly important over the past few years, particularly in penetrating foreign countries which require control of businesses by local nationals. Also important is that such undertakings often allow U.S. taxpayers to take advantage of foreign technology and manufacturing expertise.

As a result of the separate limitations for noncontrolled section 902 corporations, the income of such a corporation not only cannot be averaged with income of other noncontrolled section 902 corporations but also cannot be averaged with income subject to other separate limitations. Thus, the foreign tax credits of U.S. taxpayers owning interests in such corporations are substantially reduced, placing those taxpayers at a great disadvantage with their foreign competitors. Further, U.S. taxpayers owning such interests in foreign corporations are placed at a competitive disadvantage with U.S. taxpayers owning similar minority interests in partnerships controlled by foreigners since the income received from such partnership interests can be averaged by the U.S. partner.

With respect to dividends received by a U.S. taxpayer owning at least a 10-percent interest in a CFC, the 1986 Act applies a "look-through" rule. This rule allows such a taxpayer to apply the separate limitations to the income from which the dividends were paid. Thus, under this look-through rule, the U.S. corporation is able to treat the dividend from the CFC as general limitation income to the extent the dividend is attributable to the foreign corporation's general limitation income. There should be a look-through rule for dividends from noncontrolled section 902 corporations for the same reason there is a look-through rule under present law for dividends from CFCs. This reason is set forth in the Conference Report for the Tax Reform Act of 1986 (H.R. Rep. No. 99-841), which states on p. II-573 that --

> . . . a primary purpose of look-through treatment [for dividends from a CFC] is to make the foreign tax credit limitation treatment of <u>income earned through foreign branches and income earned through foreign subsidiaries more alike by, in effect, treating income earned by a foreign subsidiary as if it were earned directly by its U.S. parent.</u> (Emphasis added.)

It is my understanding that the look-through rule was not adopted for noncontrolled section 902 corporations because of the concern that U.S. taxpayers would not be able to obtain the information to make the necessary U.S. tax computations. However, U.S. taxpayers must obtain information to take a section 902 credit and the burden would be only slightly more to apply the suggested look-through rule.

It is respectfully submitted that a taxpayer be allowed to apply a look-through rule to dividends received from a foreign corporation if the taxpayer takes a section 902 credit for foreign taxes paid by the foreign corporation.

IV. <u>No Additional Limitations or Repeal of Deferral</u>

It has long been a fundamental principle of the U.S. tax laws that a corporation is a separate taxable entity from its shareholders. As a corollary to this principle, a shareholder is not taxed currently on the income earned by a corporation. Instead, the taxation of the shareholder is deferred until the corporation distributes its earnings as a dividend, or until the shareholder disposes of the stock of the corporation.

In the context of foreign corporations, Congress has enacted various limitations on deferral, including the above-discussed rules for CFCs and PFICs. These rules are targeted to situations in which there is considered to be a potential for abuse, such as the excessive accumulation of passive assets in a foreign corporation. Absent such a situation, however, the earnings of foreign corporations are governed by the general rule of deferral, under which a U.S. shareholder is not taxed on the earnings until they are distributed or until the U.S. shareholder disposes of the stock of the foreign corporation.

As indicated above, the existing limitations on deferral are already over-broad (for example, by subjecting CFCs to the PFIC rules when they are already subject to the section 956A rules). Further limitations or the repeal of deferral for CFCs would be a change in the wrong direction. For example, if the United States were to further limit or repeal deferral, then U.S.-based companies would be unable to compete through foreign subsidiaries on an equal tax footing with foreign competitors in foreign markets. I know of no country in the world that has repealed deferral or limited it to the extent of the U.S. tax laws, and many countries provide a tax exemption even for repatriations of income that is earned through a foreign subsidiary (sometimes referred to as a "participation" exemption).

Moreover, the further limitation or repeal of deferral would be likely to lose rather than to gain revenue. By eroding the competitive position of U.S.-based companies in foreign markets, the limitation or repeal of deferral would enable non-U.S.-based companies to take a larger share of those markets, thereby reducing the income of U.S.-based companies. This reduction in income would likely have a negative effect on U.S. tax revenue that more than offsets any additional tax revenue which accrues from the direct effect of the acceleration of taxation of foreign subsidiaries' income.

For the foregoing reasons, it is respectfully submitted that any proposals to further limit or repeal deferral should not be adopted.

STATEMENT

CONCERNING EXCLUSION OF "BANKS" FROM THE PFIC RULES

SUBMITTED TO

THE COMMITTEE ON FINANCE

UNITED STATES SENATE

AUGUST 3, 1995

I.

Introduction and Summary

This statement is submitted for inclusion in the record of the hearings conducted by the Committee on Finance on July 21, 1995 with respect to various international tax legislative issues, including proposals to modify the provisions of the Internal Revenue Code applicable to passive foreign investment companies (PFICs). For the reasons set forth in this statement, Congress should clarify that the PFIC provisions were not intended to apply to bona fide banks which are regulated as such by appropriate foreign banking authorities.

II.

Explanation of Proposal

The PFIC rules (sections 1291-1297 of the Code) were enacted in 1986 in order to fill perceived gaps in the then existing limitations on the ability of U.S. taxpayers to use foreign corporations to defer U.S. taxes on passive foreign source income. For this purpose, a PFIC is defined as any foreign corporation if either 75 percent or more of its gross income is passive income or 50 percent or more of its assets produce or are held for the production of passive income.

Congress did not intend for banks to be classified as PFICs even though much of their income consists of interest or other receipts that ordinarily would be treated as "passive" income. To accomplish this objective, Congress created a statutory exemption (section 1296(b)(2)(A)) from the definition of passive income for ". . . any income derived from the active conduct of a banking business by an institution licensed to do business as a bank in the United States (or, to the extent provided in the regulations, by any other corporation)". The legislative history of the Tax Reform Act of 1986 indicates that Congress intended this exemption to encompass "bona fide banks" engaged in the "active" conduct of the banking business.

Proposed regulations have recently been issued to implement the banking exemption, but (as explained below) they appear to exclude some foreign institutions that are regulated as "banks" either by the Federal Reserve (e.g., foreign bank affiliates of U.S. bank holding companies) or by the banking authorities of their home countries. This latter effect may be of increasing importance if the foreign banks continue to seek equity capital in the U.S. by selling stock (or ADRs) to U.S. citizens and institutions.

Specifically, the proposed regulations adopt a deposit test, a lending test and a licensing test, as well as a definition of "banking income". Unfortunately, various portions of these tests and the "banking income" definition are based upon the concept of a "bank" that no longer comports with reality. For example, for purposes of the "banking income" definition and the proposed lending test, commercial paper and corporate debt instruments that are treated as securities for financial statement purposes do not qualify even though they are both well accepted alternatives to direct traditional loans of the type evidenced by loan agreements. Indeed, under the proposed regulations, it may be virtually impossible for a foreign bank, which is regulated as "bank" and regularly accepts deposits and makes direct loans, to escape PFIC classification unless such direct loans constitute a dominant portion of its portfolio even though in numerous cases, holding such a high percentage of assets in the form of direct loans could well be imprudent.

Congress should revisit this issue both to end nearly a decade of uncertainty and to assure that "bona fide banks" are in fact excluded from PFIC status. There are various legislative solutions that would be both administratively feasible and not open to abuse. For example, Congress could simply amend section 1296(b)(2)(A) to exclude from the definition of "passive" income any income that is derived by a corporation that would be described in section 581 if it were a domestic corporation (i.e., a substantial part of the corporation's business consists of receiving deposits and making loans and it is subject by law to supervision and examination by the banking authorities of the country in which its principal office is located). Alternatively, Congress could simply clarify that it intends for the Internal Revenue Service to retain and exercise the right to rule in individual cases where a bank, based on all relevant facts and circumstances, is a "bona fide bank" even if it fails to meet one or more of the standards of the proposed legislation. Finally, Congress could revise the definition of "passive" income to exclude deposit-based income (i.e., income earned from the investment of deposits).

STATEMENT

CONCERNING FOREIGN PERSONAL HOLDING COMPANIES (H.R. 3419)

SUBMITTED TO

THE COMMITTEE ON FINANCE

UNITED STATES SENATE

AUGUST 3, 1995

I.

Introduction and Summary

This statement is submitted for inclusion in the record of the hearings conducted by the Committee on Finance on July 21, 1995 with respect to various international tax legislative issues, including issues addressed part in the proposed simplification legislation (adopted by the House of Representatives in 1994 as H.R. 3419). H.R. 3419 would have repealed the foreign personal holding company provisions of the Internal Revenue Code and modified the passive foreign investment company (PFIC) and subpart F provisions to make them the exclusive anti-deferral provisions of the Code. For the reasons set forth in this statement, if the foreign personal holding company provisions ultimately are retained, they should be modified this year to apply the PFIC look-through rules (section 1296(c)) in determining whether a foreign corporation is a foreign personal holding company.

II.

Explanation of Proposal

The foreign personal holding company rules were enacted in 1937 to eliminate the opportunity for deferral of U.S. taxes with respect to foreign corporations that have substantial amounts of "passive" income and are controlled directly or indirectly by a small number of U.S. persons. The PFIC provisions were enacted in 1986 to close perceived gaps in the then existing anti-deferral regime, including the opportunity for deferral for investments in passive foreign corporations that are more than 50 percent owned by persons not subject to U.S. tax.

The PFIC and foreign personal holding company rules have much in common. They are both aimed at investment companies, they both take on "all or nothing" approach and neither is intended to apply to corporate parents of operating groups. The foreign personal holding company provisions were aimed at the "incorporated pocketbook" (H. Rep. No. 1546, 75th Cong., 1st Sess., p.20) and "[r]eal operating companies" were not intended to be included as p. 37, Aug. 5, 1937). Similarly, Congress did "not intend foreign corporations owning the stock of subsidiaries engaged in active businesses to be classified as PFICs". Pub. L. 99-514, 1986 U.S. Code of Admin. News 4728.

For purposes of the PFIC rules, this policy of excluding corporate groups engaged in active businesses is implemented by the subsidiary look-through rule of section 1296(c), which allows foreign corporation owning at least 25 percent of the stock of another foreign corporation to characterize the dividends, etc. it receives from such a subsidiary by reference to the character of the subsidiary's income. The absence of a comparable rule under the foreign personal holding company provisions produces results that are difficult to justify in terms of tax policy; namely, dividends received by a foreign parent from its operating subsidiaries will be treated as **operating income** of the foreign parent under the PFIC rules, but as **passive income** of the foreign parent under the foreign personal holding company rules if the operating subsidiary's country of incorporation is different from that of the parent.

The PFIC look-through principles should be substituted for the present related company dividend and interest provision contained in section 552(c) of the Code. The current provision is patterned after a comparable provision in subpart F, but subpart F is aimed at a different problem: selective tax avoidance by operating multinational corporations. As enacted in 1962 and strengthened thereafter, the subpart F rules are intended to eliminate the benefits of deferral for certain types of income (whether or not "passive" in the strict sense) that is shifted to tax havens through controlled foreign corporations. Given this purpose, subpart F is both specific and selective, with special rules for active leasing, branches, relative rates of tax, etc. This is marked contrast to the "all or nothing" approach of the PFIC and foreign personal holding company rules. In such "all or nothing" cases, the object should be to determine the overall economic nature of the group as either an investment enterprise or an operating enterprise.

H.R. 3419 rectifies this disparate treatment by folding the foreign personal holding company provisions into the PFIC rules. If Congress decides to retain the foreign personal holding company rules, those rules should be amended this year to incorporate the look-through principles of section 1296(c). This result would be consistent with the growing trend in the tax laws to focus on economic realities rather than legal structure. See sections 864(e), 904(d) and 7701(f) of the Code.

The PFIC look-through rules accomplish this objective. Applying those same rules to foreign personal holding companies, as opposed to rules patterned on subpart F, would accomplish the same objective in a strikingly similar context. If the overall economic character of a corporate group is "investment", the PFIC and foreign personal holding company rules should apply. If that overall economic character is "operating", and the "passive" income is really dividends and interest from operating subsidiaries, nether the PFIC nor the foreign personal holding company rules should apply. The authors of H.R. 3419 properly reached this result and it should be embodied in the foreign personal holding company rules if those rules are retained as a separate anti-deferral regime in the Code.

STATEMENT

CONCERNING EXCLUSION OF "BANKS" FROM THE PFIC RULES

SUBMITTED TO

THE COMMITTEE ON FINANCE

UNITED STATES SENATE

AUGUST 3, 1995

I.

Introduction and Summary

This statement is submitted for inclusion in the record of the hearings conducted by the Committee on Finance on July 21, 1995 with respect to various international tax legislative issues, including proposals to modify the provisions of the Internal Revenue Code applicable to passive foreign investment companies (PFICs). For the reasons set forth in this statement, Congress should clarify that the PFIC provisions were not intended to apply to bona fide banks which are regulated as such by appropriate foreign banking authorities.

II.

Explanation of Proposal

The PFIC rules (sections 1291-1297 of the Code) were enacted in 1986 in order to fill perceived gaps in the then existing limitations on the ability of U.S. taxpayers to use foreign corporations to defer U.S. taxes on passive foreign source income. For this purpose, a PFIC is defined as any foreign corporation if either 75 percent or more of its gross income is passive income or 50 percent or more of its assets produce or are held for the production of passive income.

Congress did not intend for banks to be classified as PFICs even though much of their income consists of interest or other receipts that ordinarily would be treated as "passive" income. To accomplish this objective, Congress created a statutory exemption (section 1296(b)(2)(A)) from the definition of passive income for ". . . any income derived from the active conduct of a banking business by an institution licensed to do business as a bank in the United States (or, to the extent provided in the regulations, by any other corporation)". The legislative history of the Tax Reform Act of 1986 indicates that Congress intended this exemption to encompass "bona fide banks" engaged in the "active" conduct of the banking business.

Proposed regulations have recently been issued to implement the banking exemption, but (as explained below) they appear to exclude some foreign institutions that are regulated as "banks" either by the Federal Reserve (e.g., foreign bank affiliates of U.S. bank holding companies) or by the banking authorities of their home countries. This latter effect may be of increasing importance if the foreign banks continue to seek equity capital in the U.S. by selling stock (or ADRs) to U.S. citizens and institutions.

Specifically, the proposed regulations adopt a deposit test, a lending test and a licensing test, as well as a definition of "banking income". Unfortunately, various portions of these tests and the "banking income" definition are based upon the concept of a "bank" that no longer comports with reality. For example, for purposes of the "banking income" definition and the proposed lending test, commercial paper and corporate debt instruments that are treated as securities for financial statement purposes do not qualify even though they are both well accepted alternatives to direct traditional loans of the type evidenced by loan agreements. Indeed, under the proposed regulations, it may be virtually impossible for a foreign bank, which is regulated as "bank" and regularly accepts deposits and makes direct loans, to escape PFIC classification unless such direct loans constitute a dominant portion of its portfolio even though in numerous cases, holding such a high percentage of assets in the form of direct loans could well be imprudent.

Congress should revisit this issue both to end nearly a decade of uncertainty and to assure that "bona fide banks" are in fact excluded from PFIC status. There are various legislative solutions that would be both administratively feasible and not open to abuse. For example, Congress could simply amend section 1296(b)(2)(A) to exclude from the definition of "passive" income any income that is derived by a corporation that would be described in section 581 if it were a domestic corporation (i.e., a substantial part of the corporation's business consists of receiving deposits and making loans and it is subject by law to supervision and examination by the banking authorities of the country in which its principal office is located). Alternatively, Congress could simply clarify that it intends for the Internal Revenue Service to retain and exercise the right to rule in individual cases where a bank, based on all relevant facts and circumstances, is a "bona fide bank" even if it fails to meet one or more of the standards of the proposed legislation. Finally, Congress could revise the definition of "passive" income to exclude deposit-based income (i.e., income earned from the investment of deposits).

STATEMENT

CONCERNING SECTION 956A AND APPLICATION OF PFIC RULES

TO CONTROLLED FOREIGN CORPORATIONS

SUBMITTED TO

THE COMMITTEE ON FINANCE

UNITED STATES SENATE

AUGUST 3, 1995

I.

Introduction and Summary

This statement is submitted for inclusion in the record of the hearings conducted by the Committee on Finance on July 21, 1995 with respect to various international tax issues, including the subpart F and passive foreign investment company (PFIC) provisions of the Internal Revenue Code. For the reasons summarized in this statement, Congress should repeal section 956A of the Code and exempt U.S. shareholders of controlled foreign corporations (CFCs) from the PFIC provisions, with the result that CFCs and their U.S. shareholders will be subject to but one anti-deferral regime (subpart F). If the PFIC rules continue to be applicable to CFCs (and whether or not section 956A is repealed), Congress should (as proposed by Senators Packwood and Moynihan in 1991) repeal the so-called "passive assets" test of section 1296(a)(2) to the extent that test is applicable to determining whether a CFC is a PFIC.

II.

General Explanation of the Problem

Current Law. Under current law, income earned by a foreign corporation with U.S. shareholders generally is not subject to U.S. tax unless and until it is repatriated (either actually or constructively) to the U.S. shareholders as a dividend. There are numerous statutory exceptions to this general principle of deferral, including the subpart F (sections 951-964) and PFIC (sections 1291-1297) provisions of the Code.

The subpart F provisions apply only to controlled foreign corporations (CFCs). Under subpart F, certain of the U.S. shareholders (as defined) of a CFC are subject to a current U.S. tax on their proportionate shares of that portion of the CFC's income that is classified as "subpart F income". This **mandatory** current inclusion rule applies whether or not the subpart F income of the CFC is then (or ever) repatriated to the U.S. shareholders of the CFC.

In 1993, Congress enacted section 956A of the Code to expand the definition of subpart F income to include income earned by CFCs with excess passive assets. Under section 965A, a U.S. shareholder of a CFC must include in its current income a portion of the CFC's earnings and profits if the CFC's passive assets exceed 25 percent of its total assets. The ostensible purpose of section 956A was to discourage the accumulation by CFCs of substantial passive assets "offshore", as opposed to repatriating the income used to acquire such assets. Testimony presented to the Committee suggests that section 956A is likely to encourage CFCs to invest promptly in foreign operating assets and thus make repatriation less likely.

In at least two respects, the PFIC rules are broader in scope than the subpart F rules. **First**, they apply to all foreign corporations that have U.S. shareholders (and not simply to CFCs). Under section 1296(a) of the Code, a foreign corporation generally will be classified as a PFIC if either 75 percent or more of its gross income is derived from passive sources (the "passive income" test) or if 50 percent or more of its assets produce passive income or are held in the production of such income (the "passive assets" test). **Second**, if a foreign corporation is classified as a PFIC, the benefits of deferral are eliminated completely and not (as under subpart F) just selectively with respect to its tainted income. Specifically, its U.S. shareholders are generally subject to an **elective** current inclusion rule under which they would pay a current U.S. tax on all of the PFIC's income (both passive and nonpassive). If such an election is not made, deferral is permitted, but the economic benefits of such deferral are eliminated by recapture of the deferred U.S. tax, with interest, if and when either the PFIC subsequently makes an excess distribution (as defined in section 1291(b)(1) of the Code) to its U.S. shareholders or a U.S. shareholder disposes of stock in the PFIC.

H.R. 3419. CFCs and their shareholders are thus subject to two anti-deferral regimes, both of which reach CFCs that have substantial passive income (subject to the high tax kickout in the case of subpart F) or substantial passive assets. However, as noted, the effects of triggering the subpart F rules are quite different. Subpart F eliminates deferral with respect only to the "tainted" income while the PFIC rules (with their higher threshold) eliminate the benefit of deferral for all the CFC's income. The proposed simplification legislation (adopted by the House of Representatives in 1994 as H.R. 3419) would exacerbate the adverse effects of this dual regime for CFCs. H.R. 3419 would restructure the PFIC and (to a lesser extent) the subpart F rules and make them the exclusive anti-deferral mechanisms in the Code. Among other things, the "passive income" test of section 1296(a)(1) of the Code would be expanded to include any foreign corporation if 60 percent or more of its gross income is derived from passive sources; the "passive assets" test would be retained and (most significantly) the current inclusion rule now applicable to the U.S. shareholders of a PFIC on an **elective** basis would be converted into a **mandatory** current inclusion rule for all PFIC's U.S. shareholders if the PFIC is U.S.-controlled (applying principles similar to those used in determining whether a foreign corporation is a CFC under subpart F).

H.R. 3419 would in some cases have the same practical effect as repealing certain of the subpart F exceptions now applicable to CFCs. Specifically, in the case of a foreign corporation that is a CFC, and is thus subject to the provisions of subpart F, the proposed PFIC **mandatory** inclusion rule would have a practical effect of overriding (and to this extent repealing) the high tax kickout and the other exceptions to the classification of income as "subpart F income". This is not limited to the passive income of the CFC that, but for the application of one or more statutory exceptions, would be classified as subpart F income. For example, if a CFC is (by reason of its working capital or other factors) treated as PFIC solely under the "passive assets" test, its shareholders could be subject to the proposed PFIC **mandatory** current inclusion rule, even if its income is principally active (rather than passive).

III.

<u>Explanation of Proposals</u>

From the foregoing, it is readily apparent that CFCs are subjected unnecessarily to two anti-deferral regimes: subpart F and the PFIC rules. The policy justification for the application of both regimes to CFCs has been difficult to discern since 1986 (when the PFIC rules were first enacted) and has been virtually impossible to discern since the enactment of section 956A in 1993.

Imposing the H.R. 3419 concepts without change would produce even more harsh results. Many CFCs are an integral part of the active business operations of a larger economic enterprise. As such, their income may often be reinvested in the enterprise's international operations. There therefore is likely to be neither an excess distribution with respect to, nor a disposition of, the stock of the foreign corporation. Consequently, classification of such a corporation as PFIC under the "passive assets" test of current law is typically of little immediate consequence because of the **elective** nature of the PFIC current inclusion rule. In contrast, the adoption of the proposed current PFC **mandatory** current inclusion rule would (standing alone) have the practical effect of repealing deferral with respect to these CFCs.

For the reasons set forth above, Congress should exempt CFCs from the PFIC rules and repeal section 956A. If CFCs remain subject to the PFIC rules, Congress should revise the PFIC rules (and whether or not section 956A is repealed on the principles of H.R. 3419 are adopted), to repeal the "passive assets" test so that PFIC status for CFCs generally would be determined by reference to the proportion of the PFIC's income which is "passive" in nature.[1] Repeal of the PFIC "passive assets" test as applied to CFCs would be good tax policy and in 1991 Senators Packwood and Moynihan made just such a proposal. As noted in connection with comments filed with the Committee in connection with that 1991 proposal, the reach of PFIC rules to both

[1] Two other amendments would be appropriate. <u>First</u>, if the "passive assets" test is repealed, the "once a PFIC/PFC always a PFC" rule of proposed sections 1294(g)(1) and 1297(d) (4) would need to be modified to prevent a corporation that was treated as a PFIC for any year prior to 1996 only under the "passive assets" test from being automatically classified as a PFC even if it did not so qualify under the expanded passive income test of proposed section 1296(a)(1) <u>Second</u>, the "passive income" test should be based on gross receipts rather than on gross income (as is now the case) so that a foreign corporation with operations that normally produce substantial nonpassive income will not be classified as a PFC if it experiences losses from operations and a resulting artificial elevation in its passive income percentage.

active and passive income can be justified in a regime based on a general principle of deferral only where some substantial portion of the foreign corporation's income is passive in nature. Moreover, the asset mix of a foreign corporation is not in all cases a reliable indicator of its income mix. Thus, the "passive assets" test is a questionable definitional component of the PFIC regime. Indeed, the Treasury Department has in the past questioned the scope of the "passive assets" test.

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August 4, 1995

VIA HAND DELIVERY

The Honorable Bob Packwood
Chairman, Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Extension of Indirect Foreign Tax Credits to Sixth Tier Controlled Foreign Corporations

Dear Mr. Chairman:

This statement is submitted for the record of your July 21 hearing on foreign tax issues. I am writing in my capacity as Vice President, Taxes, of Sara Lee Corporation, a Chicago-based U.S. multinational with subsidiaries around the world.

Background

Current U.S. tax law presents U.S.-owned multinational companies with numerous time-consuming, inefficient and ill-considered administrative burdens. In particular, under sections 902(b) and 960, a U.S. taxpayer is not entitled to foreign tax credits on either Subpart F income attributable to or dividends received from its foreign subsidiaries below the third tier.1/ As a consequence, such income is taxed at least twice at the corporate level (once abroad and once in the U.S.) and, of course, a third time at the shareholder level. There is no known policy reason for the third-tier restriction.

In an effort to remedy this problem, most of the major tax legislation proposed in the last few years has included provisions which would allow U.S. taxpayers to use the generally applicable foreign tax rules for income attributable to fourth-,

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1/ For these purposes, the controlled foreign corporation ("CFC") in which the U.S. Person directly holds its interest is considered the first tier corporation. Its subsidiary would be considered the second tier corporation and so on.

fifth-, and sixth-tier CFCs. A provision which would resolve this issue was included in both H.R. 11 (section 4414) and H.R. 4210 (section 4414), passed by Congress in 1992 (but subsequently vetoed on other grounds), and in the Tax Simplification and Technical Corrections bill (section 413 of H.R. 3419), passed by the House in 1994.

The Current Third-Tier Limitation Harms U.S. Companies and Has No Apparent Justification

Congress has repeatedly recognized the current third-tier limitation is "arbitrary", "may have resulted in taxpayers undergoing burdensome and sometimes costly corporate restructurings", and "contributed to decisions by U.S. companies against acquiring foreign subsidiaries". See, for example, the attached excerpt from a 1993 House report.

As these statements suggest, it is difficult and sometimes impossible to structure holdings to conform to the third-tier requirement. Foreign structures can be complex and multi-layered for business, regulatory, or local tax or accounting reasons, or simply because of the general complexities of operating as part of a large company in a multinational environment. A U.S. corporation may, for example, acquire a European group of companies that has subsidiaries in 10 or more layers. In such cases, there are many impediments, including significant foreign tax costs, in attempting to restructure these operations so that no companies are below the third tier. In addition, regulatory constraints and foreign investment restrictions often impede the required restructurings.

The third-tier limitation makes U.S.-owned companies organized and operating in foreign markets less competitive. By not permitting the foreign tax credit on imputed and paid dividends of companies below the third tier, a double corporate tax is imposed on the repatriated earnings of such companies. This double tax effectively raises costs for U.S. owned multinationals. Similarly, acquisitions of foreign multi-tiered corporate groups are less advantageous to U.S. purchasers than they are to foreign acquirers. Moreover, since the payment of taxable dividends can often be controlled by the U.S. parent, the present rule encourages corporations below the third-tier to reinvest their earnings abroad at no U.S. tax cost rather than repatriate them for use in the U.S. Under either outcome, U.S. economic interests are sacrificed without any apparent rationale.

Finally, the previously approved proposal will simplify matters for taxpayers without complicating administration for the IRS. CFCs at any tier are subject to Subpart F under present law. As a result, U.S. shareholders must currently be able to obtain the required information to file information returns and determine Subpart F income. Similarly, such taxpayers have, or can obtain, the necessary information to compute the deemed paid foreign tax credit by a CFC at any tier.

Conclusion

For these reasons, the previously approved proposal to extend the deemed paid foreign tax credit under sections 902 and 960 to dividends from, or Subpart F income of, CFCs below the third tier should be adopted.

Respectfully,

Donald L. Meier
Vice President - Taxes
Sara Lee Corporation

103D CONGRESS 1st Session	HOUSE OF REPRESENTATIVES	REPORT 103-353

TAX SIMPLIFICATION AND TECHNICAL CORRECTIONS ACT OF 1993

REPORT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ON

H.R. 3419

[Including cost estimate of the Congressional Budget Office]

NOVEMBER 10, 1993.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Indirect foreign tax credits

A U.S. corporation that owns at least 10 percent of the voting stock of a foreign corporation is treated as if it had paid a share of the foreign income taxes paid by the foreign corporation in the year in which the foreign corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder (sec. 902(a)). A U.S. corporation may also be deemed to have paid taxes paid by a second- or third-tier foreign corporation. That is, where a first-tier foreign corporation pays a dividend to a 10-percent-or-more U.S. corporate shareholder, then for purposes of deeming the U.S. corporation to have paid foreign tax, the first-tier foreign corporation may be deemed to have paid a share of the foreign taxes paid by a second-tier foreign corporation of which the first-tier foreign corporation owns at least 10 percent of the voting stock, and from which the first-tier foreign corporation received dividends. The same principle applies to dividends from a second-tier or third-tier foreign corporation. No taxes paid by a second- or third-tier foreign corporation are deemed paid by the first- or second-tier foreign corporation, respectively, unless the product of the percentage ownership of voting stock at each level from the U.S. corporation down equals at least 5 percent (sec. 902(b)). Under present law, foreign taxes paid below the third tier of foreign corporations are not eligible for the indirect foreign tax credit.

An indirect foreign tax credit generally is also available to a U.S. corporate shareholder meeting the requisite ownership threshold with respect to inclusions of subpart F income from controlled foreign corporations (sec. 960(a)).[36] Moreover, an indirect foreign tax credit may also be available to U.S. corporate shareholders with respect to inclusions of income from passive foreign investment companies.

REASONS FOR CHANGE

The committee believes that complexities are caused by uncertainties and gaps in the present statutory schemes for taxing gains on dispositions of stock in controlled foreign corporations as dividend income or subpart F income. These uncertainties and gaps may prompt taxpayers to refrain from behavior that would otherwise be the result of rational business decisions, for fear of exces-

[36] Unlike the indirect foreign tax credit for actual dividend distributions, the indirect credit for subpart F income inclusions can be available to individual shareholders in certain circumstances if an election is made (sec. 962).

sive tax--for example, double corporate-level taxation of income. In many cases, concerns about excessive taxation can be allayed, but only at the cost of avoiding the simpler and more rational economic behavior in favor of tax-motivated planning.

The committee understands that, as a general matter, other aspects of the tax system may interfere with rational economic decision making by prompting taxpayers to engage in tax-motivated planning in order to eliminate taxation in cases where income is in fact earned. Some such characteristics of the tax system have in the past been altered by Congress in order to reduce excessive interference by the tax system in labor, investment, and consumption decisions of taxpayers.[36] The committee believes that in the context of tax simplification, it generally is appropriate to reduce complexities caused by aspects of the rules governing controlled foreign corporations that provide for nonuniform tax results from dividends, on the one hand, and stock disposition proceeds to the extent earnings and profits underlie those proceeds, on the other.

In light of the bill's provisions extending section 1248 treatment to dispositions of stock in lower-tier companies, the committee believes it is appropriate to repeal the limitation on look-through treatment (for foreign tax credit separate limitation purposes) of dividends from controlled foreign corporations to U.S. shareholders out of earnings from periods in which the payor was a controlled foreign corporation but the dividend recipient was not a U.S. shareholder of that corporation. By extending section 1248 treatment to dispositions of stock in lower-tier controlled foreign corporations, the committee believes that earnings and profits (and related foreign tax credits) of such lower-tier companies cannot readily be transferred from the control of one U.S taxpayer to another. Moreover, the committee believes that repeal of this limitation on look-through treatment will avoid significant complexity that would otherwise be engendered by practical application of the limitation.

The committee also understands that certain arbitrary limitations placed on the operation of the indirect foreign tax credit may have resulted in taxpayers undergoing burdensome and sometimes costly corporate restructurings. In other cases, there is concern that these limitations may have contributed to decisions by U.S companies against acquiring foreign subsidiaries. The committee deems it appropriate to ease certain of these restrictions in cases where the administration of the foreign tax credit rules by taxpayers and the IRS will not be significantly impaired.

**STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
SUBMITTED FOR THE RECORD
OF THE HEARING ON
FOREIGN TAX ISSUES
JULY 21, 1995**

The Securities Industry Association (SIA) is pleased to present testimony on foreign tax matters before the Committee on Finance.* SIA member firms are active in all phases of corporate and public finance, serving individual and institutional investors, corporations, and government entities.

As a result of the globalization of the world's financial markets, the long-term viability of the U.S. securities industry depends on the ability of U.S. securities firms to compete with foreign financial institutions in capital markets throughout the world. It is critical, therefore, that U.S. laws and regulations do not unnecessarily impede the foreign operations of U.S. securities firms by imposing restrictions that foreign firms do not face. Like overly restrictive regulations, tax laws that are unduly onerous or complex, or that reflect an outdated understanding of the securities industry, place U.S. securities firms at a competitive disadvantage relative to foreign financial institutions. Thus, we believe that Congress must review the tax rules that apply to the foreign operations of U.S. securities firms and other financial institutions, with a view to eliminating barriers to international competition.

To this end, our testimony addresses the effects of current U.S. tax law on the international competitiveness of the U.S. securities industry. We discuss below a number of proposals for reform of the provisions of the Internal Revenue Code of 1986, as amended (the "Code"), that govern the taxation of the foreign operations and foreign source income of U.S. securities firms. These proposals would remove a number of significant barriers that U.S. securities firms now face in their efforts to compete with foreign securities firms on a worldwide basis.

INTRODUCTION

The world's financial markets have become highly integrated and interdependent over the past several decades, due primarily to technological innovations and the elimination of regulatory barriers (for example in the European Union). In keeping with this globalization of the capital markets, U.S. securities firms have established business operations in all of the world's major financial centers, and these foreign operations now represent a substantial portion of their worldwide revenues. This situation contrasts sharply with the historical focus of the

* The Securities Industry Association is the securities industry's trade association representing the business interests of about 750 securities firms in North America, which collectively account for approximately 90% of securities industry revenue in the United States.

U.S. securities industry -- competition with other U.S. financial institutions to serve U.S. customers in the U.S. capital market.

The globalization of the capital markets has also prompted foreign financial institutions to expand into markets outside their home countries, including both third-country financial centers and the U.S. capital market. As a result, U.S. securities firms now face substantial competition from foreign firms in both U.S. and foreign markets. Thus far, the U.S. securities industry has risen successfully to the challenge of international competition. The long-term viability of the U.S. securities industry will depend, however, upon the ability of U.S. securities firms to maintain and strengthen their competitive position in the global market.

The international operations of U.S. securities firms play a critical role in attracting much needed foreign capital to U.S. government securities, corporate bonds, corporate equities and direct investment in U.S. companies. As worldwide demands for capital increase, directing foreign capital to U.S. companies and the U.S. Treasury will become even more important. It is essential, therefore, that U.S. laws and regulations do not unnecessarily impede the foreign operations of U.S. securities firms by imposing restrictions that non-U.S. financial institutions do not face.

The Code provisions that presently apply to the foreign operations of U.S. securities firms reflect an outdated understanding of the U.S. securities industry. These provisions, many of which were enacted decades ago, fail to recognize that U.S. securities firms now conduct major business operations (usually in subsidiary form) in financial centers such as London, Tokyo and Frankfurt. These foreign operations are essential to the ability of U.S. securities firms to compete effectively with non-U.S. competitors. They are not, as the Code often assumes, designed to take advantage of tax planning opportunities. Indeed, the United Kingdom, Japan and Germany, as well as most other countries with developed capital markets, impose corporate income tax at rates similar to or higher than the U.S. rates. As a result, many U.S. securities firms are subject to significant foreign tax on their foreign income.

The applicable Code provisions also fail to take into account two fundamental differences between the foreign operations of U.S. securities firms and those of other non-financial U.S. businesses. First, the conduct of a foreign securities business is generally subject to significant foreign regulation. In general, a foreign securities subsidiary must obtain local regulatory approval to conduct business in a foreign jurisdiction. Each securities regulator enforces its own particular requirements, and U.S. securities firms expend considerable resources ensuring that they comply with foreign securities regulations. As is the case with U.S. securities regulation, the principal purpose of foreign regulation is to protect the customers of a foreign securities subsidiary by ensuring that the subsidiary can fulfill its obligations to customers. Thus, foreign regulatory regimes generally impose minimum capitalization requirements and may severely limit the ability of a foreign securities subsidiary to shift funds to related entities, whether through dividends or other mechanisms. One of the Code's principal concerns in the international context -- the ability of a U.S. parent corporation to arrange the capitalization and operations of its foreign subsidiaries so as to minimize U.S. tax -- is therefore much less relevant in respect of U.S. securities firms.

Second, the international provisions of the Code fail to take adequate account of the fact that a securities firm necessarily earns, as active business income, certain types of income that the Code generally views as passive investment income, e.g., interest and dividends. As a result, the active foreign income of a U.S. securities firm is often subject to burdensome rules enacted, not with the securities industry in mind, but to limit deferral or avoidance of U.S. taxation on foreign source income from portfolio investments. These rules include, in particular, Subpart F of the Code, which requires certain U.S. shareholders of a controlled foreign corporation to include currently certain types of passive income earned by the controlled foreign corporation.* The application of these Code provisions to active securities income hinders U.S. securities firms in their efforts to compete with foreign firms. Moreover, as discussed below, to the extent that these rules preclude U.S. securities firms from lowering their foreign tax liability, they impose additional costs on the U.S. fisc in the form of higher foreign tax credits.

Although the policy concerns that led to these restrictions do not apply to the foreign operations of U.S. securities firms, the Code's anti-deferral and foreign tax credit rules do not always distinguish between interest, dividends and similar income earned by a U.S. securities firm in its active business operations and income of the same types that is earned by a non-financial taxpayer. This problem has been exacerbated with the development of new financial products and services, because the traditional sources of income for the securities industry -- commission income and gains from sales of inventory securities, which are excluded from Subpart F under current law -- represent a less significant percentage of the revenues of U.S. securities firms, while an increasing percentage is represented by other types of income that are not excluded from Subpart F.**

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* See Report of the House Committee on Ways and Means on the Revenue Act of 1962, H. Rep. No. 1447, 87th Cong., 2d Sess., reprinted at 1962-3 C.B. 466 ("Your committee while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same foreign countries, nevertheless sees no need to maintain deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income."); Report of the Senate Finance Committee on the Revenue Act of 1962, S. Rep. No. 1881, 87th Cong., 2d Sess., reprinted at 1962-3 C.B. 789.

** As recently as 1986, Congress assumed "that bona fide underwriters of securities would be excluded from classification as [passive foreign investment corporations] both under the asset test (because the majority of their assets, particularly securities held for sale to the public, are assets that do not give rise to subpart F [foreign personal holding company] income by virtue of the dealer exception in sec. 954(c)) and under the income test (because a substantial amount of their income is commission income, which is not subpart F [foreign personal holding company] income)." Staff of the Joint Committee on Taxation, General Explanation of the Tax

In addition, many U.S. securities firms are denied much of the benefit of credits for foreign taxes by virtue of the allocation of domestic interest expense to their foreign subsidiaries, even where these foreign subsidiaries have incurred indebtedness of their own and the resulting interest expense has already reduced the subsidiaries' foreign source income. The foreign tax credit rules also limit the ability of U.S. securities firms to average foreign taxes paid on different types of active securities income, thereby exposing foreign earnings to double taxation on an overall basis. In contrast, many non-U.S. financial services firms have full, or relatively full, use of credits for taxes paid to foreign countries.

Some progress has been made recently in reforming these rules. In 1993, Congress enacted Code section 1296(b)(3), which excludes from passive income, for purposes of the passive foreign investment company rules, any income earned in the active conduct of a securities business by a controlled foreign corporation that is either (i) registered under the Securities Exchange Act of 1934 or (ii) an active securities dealer, broker or qualified securities affiliate, as provided in Treasury regulations. Proposed regulations recently issued under that section have comprehensively described the activities that constitute an active securities business and provide rules for distinguishing between securities firms and other taxpayers that might earn similar types of income.

These rules should form the basis for a more comprehensive reform of the anti-deferral and foreign tax credit rules, as they apply to U.S. securities firms. To this end, we discuss below certain impediments faced by U.S. securities firms under the Code's international provisions and propose solutions to these problems. These items fall into several broad categories: the treatment of active securities income earned by controlled foreign corporations under Subpart F of the Code; restrictions imposed by Subpart F of the Code on ordinary business transactions between U.S.

(..continued)
Reform Act of 1986, at p. 1025. In 1993, Congress recognized that these assumptions were inaccurate. Explanation of Senate Finance Committee Revenue Provisions of the Omnibus Revenue Reconciliation Bill of 1993 (S.1134), at p. 144 ("The committee is informed, however, that foreign securities dealers do not always earn sufficient gross income in the form of underwriting commissions to avoid qualification as [passive foreign investment corporations] under the gross income test. For example, securities dealers may earn substantial amounts of interest and dividend income from securities held as inventory for sale to customers. Securities dealers may also earn substantial amounts of interest income from transactions incidental to the business of dealing in securities, such as margin loans and reverse repurchase transactions. The committee is further informed that inventory securities held by a foreign corporate securities dealer may not represent more than 50 percent of the corporation's assets."); Report of the House Ways and Means Committee on the Revenue Reconciliation Bill of 1993, at p. 255 (same). Congress then enacted Code section 1296(b)(3), which provides an exception for certain controlled foreign corporations engaged in an active securities business from the passive foreign investment company rules.

securities firms and controlled foreign corporations; and restrictions on the ability of U.S. securities firms to utilize credits for foreign taxes paid on active foreign source income.

A. TREATMENT OF ACTIVE INCOME UNDER SUBPART F OF THE CODE

Sections 951 through 964 of the Code ("Subpart F") require a U.S. shareholder of a controlled foreign corporation (a "CFC")* to include in income its pro rata share of certain types of income earned by the CFC in the year in which that income is earned. Exceptions are provided for CFCs that earn *de minimis* amounts of includible income and for income that is subject to high rates of foreign tax.

Under current law, much of the active securities income earned by CFCs that conduct a securities business (herein "securities CFCs") is taxed currently to their U.S. shareholders. This is because, as described above, the rules of Subpart F generally do not distinguish between the active business income of a securities firm and investment income of similar types (*e.g.*, interest and dividends).** Moreover, the exceptions to Subpart F frequently are not available to a securities CFC. For example, if a securities CFC earns substantial amounts of interest and dividends on securities held in inventory, the *de minimis* exception is not available. In addition, although securities CFCs located in major financial centers are generally subject to foreign tax rates similar to or higher than the U.S. rates, the high tax exception frequently does not apply due to anomalies in the interaction of U.S. and foreign tax rules.

In contrast, the foreign earnings of many non-U.S. financial institutions benefit from unlimited deferral of home country taxation. Thus, the burden of current taxation, combined with restrictions on the utilization of foreign tax credits (discussed in Section C. below), seriously impedes the ability of U.S. securities firms to compete in foreign markets.

Prior to 1986, active income earned by a securities CFC generally was not taxed currently to its U.S. shareholders by virtue of a special exemption from Subpart F for income derived from the active conduct of a "banking, financing or similar business". Congress revoked this exception in 1986, however, in the belief that securities income, and other active financial services income, is "inherently manipulable" and thus easily located in tax haven jurisdictions.***

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* A controlled foreign corporation is any foreign corporation in which more than 50% of the vote or value of the outstanding shares is owned, directly or indirectly, by "U.S. shareholders" (*i.e.*, any U.S. person that holds a 10% or greater voting interest).

** At present, gains and losses realized by a securities dealer on the sale of inventory securities or arising out of certain related hedging transactions are excluded from foreign personal holding company income under Code section 954(c). Most other types of income derived from securities and other financial products are not so excluded.

*** Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, pp. 966-967.

In fact, U.S. securities firms often have little or no choice as to the location of a securities CFC. Instead, location is generally governed by the type of business that the CFC conducts, the location of the relevant markets and customer base, and applicable foreign regulatory requirements. The globalization of the financial markets has not generally presented U.S. securities firms with opportunities to book income in low-tax jurisdictions. To the contrary, under the tax and securities laws of most countries, income from financial services generally must be booked in the jurisdiction where the relevant securities are traded or the relevant services are performed. In this respect, financial services income is not significantly different from other types of active income (such as manufacturing income) earned by U.S. multinationals for which deferral is not eliminated under Subpart F.

We discuss below several proposals for amendment of the Subpart F rules, as they apply to active income earned by securities CFCs. These proposals would go far towards removing the tax barriers that U.S. securities firms now face in their efforts to compete abroad.

1. Exclude Active Financing Income from Subpart F

One of the proposals under consideration by this Committee would exclude from the definitions of "foreign personal holding company income" and "foreign base company services income"* set forth in Code section 954, any income that is derived from sources within the country where a CFC is created or organized and that is derived in the active conduct of a "banking, financing or similar business", if the CFC is predominantly engaged in such active conduct.**

This exclusion would constitute a significant measure towards rectifying the anti-competitive treatment of active securities income under Subpart F. It is the most comprehensive proposal in this regard, and for that reason the simplest. For example, an exclusion for active financing income would obviate the need for special rules (discussed below) excluding interest, dividends and other securities income earned in connection with a securities business from foreign personal holding company income. It would also reduce the need to amend the rules governing the high-tax exception from Subpart F (also discussed below).

If this exclusion is enacted, however, it would be helpful to clarify that the term "banking, financing or

* Under Subpart F of the Code, a 10% U.S. shareholder of a CFC must include in income currently its pro rata share of various categories of "foreign base company income" earned by the CFC. Foreign base company income includes foreign personal holding company income, defined to include various types of investment income, such as dividends, interest and gains, and foreign base company services income, defined as income received for services performed by a CFC for a related person outside the CFC's country of organization. As noted above, de minimis and high tax exceptions may apply.

** This provision is listed as Foreign Provision #19 in the Committee Press Release and is also Section 5 of H.R. 1690, The International Tax Simplification and Reform Act of 1995, introduced on May 24, 1995 by Representatives Houghton and Levin.

similar business" includes the various activities typically conducted by securities CFCs. In this regard, we recommend that a "banking, financing or similar business" be defined to include the active conduct of a "securities business" as that term is used in Code section 1296(b)(3)(A) (relating to the exception for securities dealers from the passive foreign investment company rules). As noted above, the Treasury regulations that were recently proposed under Code section 1296(b)(3)(A) contain a comprehensive list of the "securities activities" that comprise an active securities business.

In addition, the exclusion should apply broadly to income derived from sources both within and outside the CFC's country of organization. If the exclusion were limited to income earned within the CFC's country of organization, much of the active securities income earned by securities CFCs would still be treated as foreign personal holding company income or foreign base company services income. For example, under the Code, dividend and interest income is generally sourced by reference to the residence of the payor.* Thus, income from inventories of securities issued by corporations organized in a different country than the CFC (e.g., income from inventories of Eurobonds and Yankee bonds held by a CFC organized in the U.K.) is not income sourced in the CFC's country of organization.

Moreover, as a result of the internationalization of the financial markets and to enhance managerial or structural efficiency, many securities CFCs provide financial services on a regional basis and thus earn substantial amounts of active securities income outside their countries of organization.** For example, securities firms that are licensed or organized in one country within the European Union (EU) will soon be able to conduct a securities business in any other EU country without obtaining specific authorization from each country. Similarly, many U.S. securities firms have organized a CFC in one country in the Far East (for example, Hong Kong) in order to conduct business in another country or throughout the region. This often occurs, for example, where one country offers a hospitable regulatory regime. Alternatively, some countries do not permit U.S. securities firms to operate through subsidiaries organized in that country; for example, Japan requires that U.S. securities firms conduct business in Japan through a Japanese branch of either a U.S. corporation or a subsidiary organized in a third country. Any exclusion for active financing income should be broad enough to reflect these regulatory and market realities.***

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* Code sections 861(a)(1) and (2), 862(a)(1) and (2).

** Services income is generally sourced in the location where the services are performed. Code sections 861(a)(3), 862(a)(3).

*** We note also that, in the case of foreign base company services income, restricting the exclusion to income earned within the CFC's country of organization would effectively negate the exclusion entirely. Income derived from services performed within the CFC's country of organization is not treated as foreign base company services income under current law. Thus, if the exclusion were so restricted, it would cover only income that would not be foreign base company services income in any event.

2. Exclude Active Interest and Dividends from Foreign Personal Holding Company Income

If a comprehensive exclusion of active financing income from Subpart F is not enacted, Congress should, at a minimum, provide an exclusion from foreign personal holding company income for interest, dividends and other income earned on securities that are held by a securities CFC in connection with the active conduct of a securities business. Under present law, foreign personal holding company income, which must be included currently by the U.S. shareholders of a CFC, does not include gains realized on the sale of inventory property (e.g., inventory securities). Interest, dividends and other income earned on securities held in connection with a securities business is, however, treated as foreign personal holding company income.

The treatment of interest and dividends as foreign personal holding company income is intended to eliminate incentives for U.S. taxpayers to earn investment income through foreign corporations, thereby deferring U.S. tax. In the case of a typical investor, the holding of investment securities is an activity that could otherwise be located in whichever jurisdictions were most convenient in order to minimize the tax imposed. A securities CFC, however, which typically earns substantial amounts of dividends and interest income from securities held in connection with its active business, cannot manipulate the location of this income. For a variety of reasons, a securities CFC must purchase and sell securities through regulated subsidiaries in the jurisdictions where the customers are located and the securities are most actively traded: for example, regulators may require that a customer securities business be conducted in a regulated local entity; moreover, the least costly financing, the most convenient clearing mechanism, and the greatest customer demand are generally found in a security's home jurisdiction.

There is no thus policy reason to require current inclusion of interest, dividends and other income earned on securities held in connection with an active securities business. In the absence of a more general exclusion for "active financing income", this income should be excluded from the definition of foreign personal holding company income.

3. Amend Test for Determining Whether Income Is Subject to a High Rate of Foreign Tax

The current inclusion rules of Subpart F of the Code are intended to prevent U.S. taxpayers from deferring U.S. tax on certain types of income by moving the income offshore. If, however, the income of a CFC is subject to foreign tax at a rate that is substantially equal to the U.S. rate, it is evident that the U.S. shareholders of the CFC have not used the CFC to avoid paying tax. Therefore, Subpart F provides that "foreign base company income" is not includible in income by a U.S. shareholder if the income is subject to a high rate of foreign tax (the "high-tax exception").

The Tax Reform Act of 1986 modified the high-tax exception to make the test broader and more mechanical than under prior law. As modified, the high-tax exception provides that, if foreign base company income is subject to an effective rate of foreign income tax that is greater than 90% of the maximum U.S. corporate income tax rate, the income is not subject to current inclusion.

Although the high-tax test appears quite simple, the test is often difficult to satisfy even when a CFC is located in a high-tax jurisdiction, such as the United Kingdom or Germany. The principal reason is that the test compares the effective rate (i.e., the average rate of tax applied to income) of foreign income tax to the highest marginal rate (i.e., the rate of tax applied to the last dollar of income) of U.S. corporate income tax. A second reason is that, in determining the effective rate of foreign tax, the income of a CFC must be computed under U.S. tax principles, rather than the tax laws of the foreign country. Thus, because U.S. tax law does not permit the inclusion of a foreign affiliate in a consolidated group, an effective foreign tax rate must be computed for each CFC on a corporation-by-corporation basis. If the foreign law allows "group relief" (as in the United Kingdom), or otherwise permits a CFC to offset the losses of another corporation within its "group" against its income, the effective rate of foreign tax is reduced from a U.S. perspective.

A similar mismatch may occur where the timing of income inclusion under foreign law differs in various respects from U.S. law, e.g., where foreign law allows a CFC to value its inventory on a different basis than under U.S. tax law.* Thus, under the current rules, a U.S. shareholder of a CFC located in a "high-tax" jurisdiction is often inappropriately required to include in income currently the foreign base company income earned by a CFC, even though such income will be subject to a high rate of foreign tax in a later year. This result is inconsistent with the legislative purpose of the high-tax exception.

In order to conform the application of the high-tax exception to its purpose, the Code should exclude from foreign base company income any income of a CFC that is subject to tax in a foreign country with a maximum marginal corporate tax rate equal to 90% of the maximum marginal U.S. corporate tax rate (assuming that the CFC does not enjoy a special tax "holiday" or other special reduction in the tax rate). As a safeguard, the Internal Revenue Service could be given authority to specify that income earned in certain countries does not qualify for the high-tax exception, because those countries had enacted the highest marginal tax rate specifically to permit U.S. shareholders to avoid taxation under Subpart F.

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* Under Treas. Reg. § 1.954-1T(d)(3)(i), the amount of foreign tax paid or accrued with respect to an item of income earned by a CFC is the amount of foreign income tax that would be deemed paid under Code section 960 (regarding the indirect foreign tax credit) with respect to that item if the item were included in the income of a U.S. shareholder under Subpart F. The amount of tax deemed paid by the CFC under Code section 960 is determined based on a "pool" of foreign taxes paid by the CFC over a period of years. Thus, the amount of foreign tax treated as paid or accrued by a CFC for purposes of the high-tax exception is determined under an averaging approach. This approach mitigates, but does not eliminate, the mismatching that arises from differences in foreign and U.S. law.

Alternatively, a U.S. shareholder could be permitted to calculate the effective rate of foreign tax based on the taxable income of the CFC as determined under the tax laws of the foreign country (including group relief or other consolidation principles), to the extent that these laws are generally analogous to U.S. principles or result in mere differences in the timing of income. To address the "group relief" problem in particular, U.S. shareholders could be permitted to calculate the effective rate of foreign tax paid by all CFCs within a single country on an aggregate, rather than corporation-by-corporation, basis.

4. Permit Portfolio Interest Earned on Inventory Securities to Qualify for High-Tax Exception

Under current law, a foreign person is not subject to U.S. federal income tax (including withholding tax) on "portfolio" interest (i.e., U.S.-source interest paid on obligations issued after July 18, 1984 to a foreign person other than a "10% shareholder" of the issuer, a bank on an extension of credit, or a CFC "related" to the issuer).

Under Subpart F of the Code, interest income earned by a CFC is generally foreign personal holding company income that must be included currently in the income of any 10% U.S. shareholder of the CFC. This rule reflects Congress' concern that the ability to achieve deferral of U.S. tax might otherwise encourage U.S. taxpayers to hold investment assets offshore and Congress' view that current taxation of investment income earned offshore would present no competitive disadvantage for U.S. multinationals.*

Where foreign personal holding company income is subject to a high rate of foreign tax, it is not required to be included currently by a U.S. shareholder because there is no tax deferral motive (the "high-tax exception", discussed above). Under current law, however, portfolio interest received by a CFC is not eligible for the high-tax exception. Thus, for example, if a securities CFC located in the United Kingdom receives interest on U.S. Treasury securities (or debt securities of a U.S. corporation) that it holds in inventory, and the CFC pays tax on the interest at the U.K. corporate rate of 35%, the interest will be

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* See Report of the House Committee on Ways and Means on the Revenue Act of 1962, H. Rep. No. 1447, 87th Cong., 2d Sess., reprinted at 1962-3 C.B. 462 ("Nevertheless, the testimony before your committee did convince it that many have taken advantage of the multiplicity of foreign tax systems to avoid taxation by the United States on what could ordinarily be expected to be U.S. source income....Your committee has also concluded that U.S. tax should be imposed currently, on the American shareholders, on income which is held abroad and not used in the taxpayer's trade or business...) and 466 ("Your committee while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same foreign countries, nevertheless sees no need to maintain deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying postponement of the tax until the income is repatriated."). See also Report of the Senate Finance Committee on the Revenue Act of 1962, S. Rep. No. 1881, 87th Cong., 2d Sess., reprinted at 1962-3 C.B. 789.

includible under Subpart F, even though the high rate of U.K. tax would otherwise permit the interest income to qualify for the high-tax exception.

Although the purpose of the foregoing provision is not stated in its legislative history, it is presumably intended to prevent a U.S. taxpayer from routing interest income that is not subject to U.S. withholding tax through a CFC in order to avoid current U.S. taxation. In the case of portfolio interest securities that are held by a securities CFC in connection an active securities business, there is clearly no tax avoidance motive. Securities CFCs have substantial non-tax business reasons to hold portfolio interest obligations; for example, the market for Eurodollar obligations is centered in London, and market makers in Eurodollar securities generally carry their inventories in companies located in the United Kingdom.

Thus, the exclusion of portfolio interest from the high-tax exception is unnecessary and punitive in the case of securities held in connection with an active securities business. Moreover, this exclusion impairs the competitiveness of U.S. securities firms to the extent that third-country subsidiaries of non-U.S. firms can defer home country taxation of interest earned on U.S. securities. Accordingly, portfolio interest earned by a securities CFC on securities held in connection with the active conduct of a securities business should be eligible for the "high-tax" exception from Subpart F.

B. TREATMENT OF ORDINARY BUSINESS TRANSACTIONS BETWEEN SECURITIES CFCS AND U.S. PERSONS UNDER SUBPART F

Under sections 951 and 956 of the Code, a U.S. shareholder of a CFC is generally required to include in income currently its pro rata share of the CFC's increase in earnings invested in "United States property". The term "United States property" is broadly defined in Code section 956 to include an obligation of a U.S. person (other than obligations of certain unrelated U.S. corporations). Earnings of CFCs that are invested in "United States property" are taxed currently, unless an exception applies, "on the grounds that [the investment] is substantially the equivalent of a dividend" to a U.S. shareholder.*

Because the term "United States property" is broadly defined, it appears to include certain obligations that arise in ordinary course business transactions between securities CFCs and their U.S. parent corporations, or with unrelated U.S. entities that are not organized as corporations. (For simplicity, we refer to all such persons herein as "U.S. persons".) While these transactions may involve a short-term transfer of funds from a securities CFC to a U.S. person, or a short-term exchange of funds between a securities CFC and a U.S. person, they generally do not permit the U.S. person to utilize the accumulated earnings of securities CFCs on an extended basis. Thus, treating these transactions as giving rise to investments in United States property would not further the purposes of Code section 956. In addition, it would needlessly impede legitimate business transactions, force securities CFCs to transact their businesses in inefficient ways, and reduce the ability of U.S. securities firms to compete with their foreign counterparts. Moreover, the legislative history of

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* S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), reprinted at 1962-3 C.B. 794.

the Revenue Act of 1962, which introduced Code section 956, indicates that Congress intended to exclude ordinary business transactions from the scope of that section.**

While we have no specific knowledge in this regard, we would anticipate that expressly exempting these ordinary course transactions from Subpart F would be revenue-neutral, given that U.S. securities firms currently seek to structure these transactions so as to avoid Subpart F inclusions. We recommend, therefore, that Code section 956 be amended to clearly exclude the following transactions from its scope.

1. <u>Securities Repurchase and Securities Loan Transactions</u>

In a securities repurchase transaction (a "repo"), a U.S. person (i) sells securities to a securities CFC for cash and (ii) agrees to repurchase the securities from the securities CFC, at a specified time or on demand, for the purchase price plus an additional amount that is in the nature of interest. This transaction is treated under existing case law as a short-term borrowing of cash by the U.S. person from the securities CFC under which the U.S. person posts securities as collateral.* The U.S. person has an obligation to return the amount of cash treated as loaned by the CFC. The repo transaction may also be reversed (a "reverse repo"), so that the U.S. person is treated as making a secured loan to the securities CFC. In this case, the U.S. person has a contractual obligation to return the collateral (<u>i.e.</u>, the securities) to the CFC.

In a securities loan, a U.S. person either borrows securities from, or lends securities to, a securities CFC. The party that borrows the securities posts collateral (generally in the form of cash or marketable securities) with the lender. When the loan expires, the borrower returns the securities to the lender (plus a fee), and the lender returns the collateral (plus an additional return that is in the nature of interest on the collateral) to the borrower.** Thus, where a U.S. person borrows securities

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** <u>See</u> H. Rep. No. 1447, 87th Cong., 2d Sess. (1962), reprinted at 1962-3 C.B. 468-69 (describing the existing exceptions to the definition of "United States property" as covering transactions "where the property located in the United States is ordinary and necessary to the active conduct of the foreign corporation's business" and "normal commercial transactions without any intention to permit the funds to remain in the United States indefinitely"); S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), reprinted at 1962-3 C.B. at 787, 793-94 (similar).

* <u>See</u>, <u>e.g.</u>, <u>American National Bank of Austin v. United States</u>, 421 F.2d 442, 452 (5th Cir.), <u>cert</u>. <u>den</u>. 400 U.S. 819 (1970); Rev. Rul. 77-59, 1977-1 C.B. 196; Rev. Rul. 74-27, 1974-1 C.B. 24.

** When the collateral posted is cash, securities loans are almost identical to repurchase transactions. The principal difference is that where the securities loan is described in Code section 1058, the securities loan is treated for tax purposes literally in accordance with its terms as a tax-free transfer of securities in exchange for the counterparty's obligation to return substantially identical securities (rather than as a borrowing of money). When other securities, rather from a securities CFC, the U.S. person incurs a contractual obligation to return the loaned securities; where a U.S. person lends securities to a securities CFC, the U.S. person incurs an obligation to return collateral.

A U.S. person's contractual duty to return cash or securities to a securities CFC should not be regarded as an "obligation" that constitutes "United States property" for purposes of Code section 956, where this obligation arises in connection with a repo or securities loan transaction entered into in the ordinary course of business. First, these transactions do not give the U.S. person the use of any earnings of the CFC, on a temporary basis or otherwise, because the U.S. person generally must transfer an equal amount of either cash or marketable securities to the CFC in connection with these transactions. Furthermore, where the securities CFC and the U.S. person are acting as intermediaries between unrelated customers, the U.S. person does not have possession or use of any cash or securities received from the CFC during the term of the transaction.*

Therefore, Code section 956 should be amended to clarify that the obligation of a U.S. person to return cash or securities to a securities CFC in connection with a repo or securities loan transaction that is entered into in the active conduct of a securities business will not be treated as an investment in United States property for purposes of Code section 956.

2. Margin Posted in Futures Transactions

Securities CFCs frequently enter into futures transactions on U.S. futures exchanges on behalf of their customers. The only way that a securities CFC can execute a futures transaction on a U.S. futures exchange, however, is through a U.S. futures commission merchant (an "FCM"). The CFC therefore is usually required, under the rules of a U.S. futures exchange, to post two types of "margin" with the FCM. The first, "initial margin," generally equals less than 5% of the value of the futures position. Initial margin is in the nature of a performance bond, and the amount generally does not vary over the life of the futures transaction. The FCM is obligated to return the initial margin to the CFC when the futures position is closed out.

The second type of margin, "variation margin," is an additional amount that a securities CFC must pay to an FCM as an exchange-traded futures position "moves away" from the CFC. An exchange-traded futures position is marked to market each day, and any excess variation margin is returned to the CFC when the position moves back toward the CFC.

If the obligation of a U.S. person that is an FCM to return initial or variation margin to a securities CFC is treated as an investment in United States property for purposes of Code section 956, securities CFCs would effectively be precluded from availing themselves of their

(..continued)
than cash, are posted as collateral, a securities loan does not resemble either a repurchase transaction or a cash borrowing, but is merely a temporary exchange of marketable securities.

* Collateral posted by a foreign customer with the securities CFC is re-posted by the securities CFC with the U.S. person; the U.S. person then, in turn, posts this collateral with a U.S. customer.

own related-party FCMs, and any FCMs (whether related or unrelated) that were U.S. partnerships, trusts or other non-corporate entities. Such a result would force the U.S. financial community to transact business in inefficient ways and face burdens not borne by foreign competition, all without furthering the purposes of Code section 956.

Moreover, a securities CFC entering into a futures transaction on a U.S. futures exchange is frequently acting as an intermediary for one of its customers, in which case the CFC acts merely as an agent in collecting and remitting the margin. In effect, the FCM is receiving cash from an unrelated foreign person, rather than from the CFC. Moreover, much of the margin posted by a securities CFC cannot be retained by an FCM. Instead, the FCM is required to post much of this margin with the U.S. futures exchange. The FCM thus generally derives no real economic benefit from its brief possession of the margin.*

In view of the foregoing, Code section 956 should be amended to clarify that the obligation of a U.S. person to return margin that is posted by a securities CFC, in order to comply with the rules of a U.S. futures exchange, in connection with a transaction entered into in the active conduct of a securities business, is not treated as an investment in United States property.

3. Margin Posted in Over-the-Counter Derivatives and Swap Transactions

If a securities CFC enters into an over-the-counter derivatives transaction (*e.g.*, it writes an over-the-counter option) with a U.S. person that is subject to regulatory net capital requirements (such as a U.S. broker-dealer), the U.S. person may need to collect margin from the CFC in order to avoid the regulatory net capital "haircut" that would be required if performance by the CFC were not secured. The U.S. person would thus incur a contractual obligation to return the margin to the CFC during the term of, or on termination of, the derivatives transaction. Similarly, a securities CFC that enters into a swap or other notional principal contract with a U.S. person may be required, by the terms of the contract, to post margin with the counterparty in order to secure its performance; the U.S. person would be required to return this margin during, or on termination of, the term of the contract.

Again, the status of the obligation of the U.S. person (to return margin to the CFC) in these situations is not clear, but its treatment as "United States property" for purposes of Code section 956 would be inappropriate. These obligations arise solely in order to secure performance by a securities CFC in an ordinary business transaction. Even where the U.S. person is related to the securities CFC, the posting of margin clearly is not designed to achieve the effect of a dividend. Section 956 should therefore be amended to clarify that the obligation of a U.S. person to

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* In the case of variation margin, the duty of a U.S. person to return the margin to a securities CFC cannot constitute a debt obligation under U.S. federal tax principles, because the U.S. person has no obligation to pay a fixed sum on a certain date in the future. In this regard, we note that Treas. Reg. § 1.956-2T(d)(2) defines the term "obligation" to include "any bond, note, debenture, certificate, bill receivable, account receivable, open account, or other indebtedness".

return margin posted by a securities CFC in an over-the-counter derivatives transaction, or pursuant to the terms of a swap or other notional principal contract, is not an investment in United States property where the transaction is entered into in the active conduct of a securities business.

4. Making a Market in Debt Securities

When a U.S. person that is related to a securities CFC issues debt securities overseas, the securities CFC (if it is a securities dealer) may underwrite and make a market in those securities. In addition, a securities CFC may underwrite and/or make a market in debt securities of unrelated U.S. persons that are not corporations. At any given time, therefore, a securities CFC may have varying amounts of such securities in inventory. To the extent that these debt securities are held for sale to customers, they should not be treated as investments in United States property.

The Internal Revenue Service has recognized that debt securities of a related person purchased by a securities dealer in its market-making capacity should not be treated in the same manner as debt securities purchased by a non-dealer for purposes of Code section 108(e)(4) (under which a debtor recognizes cancellation of indebtedness income if a related party purchases its debt securities at a discount). Treas. Reg. § 1.108-2(e)(2). Likewise, debt securities held as inventory by a securities CFC should not be treated in the same manner as other debt obligations for purposes of Code section 956. Inventory securities are clearly held for ordinary business reasons. Moreover, debt securities issued by a related U.S. person that are held temporarily for sale to customers cannot be considered to serve as the equivalent of a dividend from the securities CFC to a U.S. shareholder.

5. Loans to Unrelated Partnerships

Code section 956 presently excludes from the definition of "United States property" any debt obligation of a U.S. corporation that is neither a 10-percent U.S. shareholder of the CFC nor a domestic corporation 25 percent or more of the voting stock of which is owned directly or indirectly by U.S. shareholders of the CFC. This exclusion reflects the reality that a loan by a CFC to an unrelated domestic corporation cannot be considered a repatriation of funds for the use of a U.S. shareholder.

The fact that this exclusion is limited to debt obligations of unrelated U.S. corporations has restricted the ability of securities CFCs to take full advantage of opportunities to lend to unrelated U.S. investors that are organized as partnerships or other non-corporate entities. For example, U.S. investment funds, or "hedge funds", that are organized as partnerships frequently seek to borrow in a foreign currency or to finance securities purchases in overseas markets. Securities CFCs are hampered in competing for this business, however, by the potential that any such loan may be regarded as a deemed dividend to their U.S. shareholders. As a result, securities CFCs are effectively forced to cede this business opportunity to foreign financial institutions.

To rectify this competitive disadvantage, Code section 956 should be amended to exclude obligations of unrelated partnerships and other non-corporate entities from the definition of United States property. There is no tax policy reason to treat unrelated non-corporate entities differently from unrelated corporate entities for this purpose. In both cases, a loan to an unrelated person cannot be considered a repatriation of funds to a U.S. shareholder of the CFC.

C. AMENDMENTS TO THE FOREIGN TAX CREDIT LIMITATION RULES

To prevent double taxation of foreign source income, the Code allows a U.S. taxpayer to claim a tax credit, within certain limits, for foreign taxes paid on income from sources outside the United States. In general, the foreign tax credit may not exceed the U.S. tax payable on the taxpayer's net foreign source taxable income. To compute the foreign tax credit limitation, the taxpayer must allocate deductions for expenses, such as interest expense, between gross income from U.S. sources and gross income from foreign sources. This allocation permits the taxpayer to compute taxable net foreign source income, and the U.S. tax attributable to that income.

The Code also includes special rules that prevent a taxpayer from using foreign income taxes paid on one type of income as a credit against the U.S. tax on other types of income (known as "cross crediting"). Thus, foreign source income must be allocated to different categories or "baskets" of income, and taxpayers may not use the foreign taxes imposed on income in one basket as a credit against the U.S. tax imposed on income in another basket.

1. Include High Withholding Tax Interest in the Financial Services Basket for Securities Firms and Clarify that Commodities Income Is Also Included in the Financial Services Basket

Most of the active foreign source income earned by a U.S. securities firm is included in the "financial services basket" for purposes of the foreign tax credit limitations. Thus, foreign taxes imposed on one item of securities income generally may be used as a credit against the U.S. tax imposed on another item. Certain types of income derived by a U.S. securities firm are not, however, included in the financial services basket. As a result, a U.S. securities firm may be unable to utilize credits for foreign taxes paid on that income.

There is no policy reason to prevent "cross-crediting" with respect to the active business of a securities firm. Cross-crediting is permitted with respect to the active business income of most non-financial services businesses, by virtue of the fact that all of their business income is included within the "general" or residual limitation category. For a securities firm, the financial services basket is the equivalent of the general limitation category. Thus, the financial services basket should include all of the types of active income that may be earned by a U.S. securities firm.

a. High Withholding Tax Interest. The Code excludes "high withholding tax interest" (i.e., interest subject to foreign withholding tax at a 5% or higher rate) from the financial services basket. High withholding tax interest is subject to a separate foreign tax credit limitation so that high withholding taxes cannot be used to reduce U.S. tax on other types of foreign source income. In particular, Congress believed that the economic burden of high withholding taxes was borne not by U.S. lenders, but instead by foreign borrowers; therefore, Congress was concerned that the cross-crediting opportunities that existed under pre-1986 law provided an incentive for U.S. lenders to make otherwise uneconomical foreign loans, rather than domestic loans, in order to obtain a tax benefit. In addition, Congress was concerned that these cross-crediting opportunities might have encouraged foreign countries seeking to attract U.S. capital to increase, rather than decrease, withholding tax rates.*

A securities firm generally derives high withholding tax interest from its active business (e.g., on inventories of securities held in foreign subsidiaries for sale to foreign customers and for trading in local markets) and thus, by definition, earns such income as financial services income. A securities firm cannot choose whether or not to deal in particular debt securities on the basis of the withholding rate that applies to interest payments; in order to compete effectively in foreign markets, a U.S. securities firm must deal in the securities that its customers wish to buy and sell. Moreover, unlike a financial institution making a direct loan to a foreign borrower, a securities firm dealing in foreign-issued debt securities cannot pass the economic burden of high withholding tax rates through to the underlying issuer. Thus, high withholding rates do not have the same incentive effects for U.S. securities firms that they might otherwise have for non-securities businesses, and the policy concerns underlying the separate limitation for high withholding tax interest do not apply with respect to U.S. securities firms.

Further, the effect of the separate limitation for high withholding tax interest is that income earned from the purchase and sale of a foreign-issued debt instrument is divided into two separate limitation categories. For example, if a U.S. securities firm buys and sells Italian government bonds, any interest income earned on those bonds will fall in the high withholding tax interest basket, while any gain or loss realized on sale of the bonds will fall in the financial services basket. As a result, foreign tax credits attributable to the interest earned on the bonds cannot be used to reduce U.S. tax imposed on foreign source gain from sale of the bonds, even though the interest income and the gain are both components of the total profit realized by the securities firm on the purchase and sale of the bonds.

There is no tax policy reason to separate the income earned by a securities firm from a single business transaction into different baskets for foreign tax credit limitation purposes. More generally, there is no policy reason to subject the active business income of a U.S. securities firm to more than one foreign tax credit limitation. Therefore, the definition of financial services income should be amended to include high withholding tax interest derived by securities firms in the active conduct of a securities business.

b. Commodities Income. A second type of income earned by securities firms that may be excluded from the definition of financial services income is active income from a commodities business (e.g., dealing in commodity derivatives). Under existing law, neither the Code nor the regulations under Code section 904(d) mention commodities income in defining financial services income. The

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* Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, pp. 864-865.

commodities business is closely related to the securities business conducted by U.S. securities firms, and there is no policy reason that foreign taxes paid on the income from one business should not be creditable against U.S. tax on income from the other. Therefore, the definition of financial services income should be amended to clarify that it includes income from the active conduct of a commodities business by a group of companies which earns predominantly financial services income.

2. Allocation of U.S. Interest Expense

As described above, much of the foreign source income generated by U.S. securities firms is earned in countries with tax rates that are comparable to or higher than U.S. income tax rates. The Code imposes significant limitations, however, on the ability of U.S. securities firms to credit the full amount of foreign tax paid by foreign subsidiaries against U.S. tax liability arising from an actual or deemed repatriation of foreign income. By contrast, many non-U.S. financial institutions benefit from an "exemption" system, under which their home countries do not tax income earned outside the home country; others reside in countries that do not restrict the use of foreign tax credits to the same degree as the United States. As a result, U.S. securities firms effectively bear a higher rate of taxation on foreign source income than do non-U.S. financial institutions competing in the same markets.

A principal reason for the inability of U.S. securities firms to utilize foreign tax credits is the rules of Code section 864(e) and the regulations thereunder that govern the allocation of interest expense in determining the foreign tax credit limitation. As discussed above, the Code generally limits the foreign tax credit to the U.S. tax on net foreign source income. To compute this limitation, the taxpayer must allocate deductions for interest (and other expenses) between gross income from U.S. sources and gross income from foreign sources; this allocation permits the taxpayer to compute net taxable income from foreign sources.

The existing rules governing the allocation of interest expense reflect the general principle that money is fungible. Thus, these rules treat an affiliated group of U.S. corporations as a single entity and require that the aggregate interest expense of such a group be allocated to U.S. and foreign source income based on the relative values of the U.S. and foreign assets of the group. In other words, these provisions assume that funds borrowed by any member of a U.S. affiliated group may support the U.S. and foreign assets of the group as a whole, and that the identity of the actual borrower or the purported use of the funds is not relevant in determining the relationship between interest expense and the gross income of the group.

The interest allocation rules are problematic for all U.S. multinational corporations, because they require the allocation of interest expense to foreign source income (whether derived by a branch or a subsidiary), even where the proceeds of U.S. borrowings are invested in the United States (and not, for example, re-loaned or contributed to a foreign subsidiary). The foreign country in which the income is earned, however, does not treat any part of the interest expense incurred by a U.S. corporation as deductible in determining the foreign tax due on that income. As a result, a U.S. taxpayer's foreign tax liability will be measured by reference to a higher amount of net foreign source income than the taxpayer's U.S. tax liability on the same net foreign income. In other words, for U.S. tax purposes, net U.S. source income is effectively increased, and net foreign source income is effectively reduced. The effect of this reduction in foreign source income is to reduce the taxpayer's foreign tax credit limitation, and thus its ability to use foreign tax credits.

The effects of the interest allocation rules are exacerbated by the fact that the interest expense of a U.S. affiliated group must be allocated by reference to all of the assets held by members of the group, including the stock of foreign subsidiaries. In effect, the interest expense allocation rules treat the U.S. group as incurring debt in part to invest in the stock of foreign subsidiaries, rather than to support assets that generate U.S. source income. In this sense, the interest allocation rules effectively assume that U.S. securities firms fund their foreign operations by borrowing in the United States and making capital contributions to foreign subsidiaries, without taking into account the level of direct borrowing by those subsidiaries. In other words, a U.S. multinational corporation must apportion some of its domestic interest expense to stock in foreign subsidiaries, notwithstanding that foreign source dividends received (or deemed received) from such subsidiaries have already been reduced by the expenses of those subsidiaries, including interest expense. While this rule affects all U.S. multinational corporations, it is particularly onerous for U.S. securities firms which must maintain high amounts of leverage.

In the case of a U.S. securities firm, regulatory oversight and market realities preclude the use of debt incurred by one member of a worldwide group to support the operations of another member with the same flexibility that may be available to members of a non-financial group. Both the U.S. Securities and Exchange Commission and U.S. rating agencies discourage U.S. securities firms from establishing unregulated holding companies to borrow funds for making equity investments in regulated subsidiaries (whether U.S. or foreign). This practice, referred to as "double leverage", is considered to expose the U.S. firm to the risk that funds needed to pay down its debt will be trapped in a subsidiary, due to regulatory restrictions on distributions that would reduce the regulatory capital of the subsidiary.

A securities dealer typically finances its day-to-day operations at a much higher level of leverage than a non-financial business (e.g., a 20:1 or 30:1 debt-equity ratio, rather than a 1:1 or 2:1 ratio). Thus, the negative impact of the allocation of domestic interest expense against foreign source income is greatly exacerbated in the case of U.S. securities firms. Moreover, much of this leverage is attributable to the securities dealer's business need to carry and finance an enormous volume of inventory. For example, it is not unusual for a U.S. government securities dealer to borrow up to 99% of the value of the government securities in which it makes a market. The cheapest and most efficient sources for inventory financing are secured borrowings in local markets, collateralized by the inventory securities that trade in the local market. In the case of a foreign subsidiary, funding in a local currency also provides a hedge against the value of local-currency securities. Nevertheless, despite the clear use of these borrowings to finance inventories of securities, the interest allocation rules treat the borrowings of U.S. broker-dealers as incurred in part to make equity investments in foreign subsidiaries, and completely disregard the fact that those foreign subsidiaries have incurred their own indebtedness to finance their own securities operations. There is thus a fundamental contradiction between the premise of funding flexibility underlying the interest expense allocation rules and the actual constraints on the funding of the members of a U.S. securities firm's worldwide group.

In summary, the interest allocation rules impose a much higher cost on U.S. securities firms than on other U.S. taxpayers, because the foreign tax credit limitation of the former is more severely reduced. These rules are also anti-competitive, in that foreign securities firms do not face similar exposure to double taxation of foreign source income. The interest allocation provisions should at the least be modified to take into account the high leverage typical of the securities industry and the non-fungibility of the interest expense incurred by a securities group. SIA recognizes that solutions to these issues that work fairly across a wide range of business organizations are not easy to develop, and we would be pleased to work with the Committee and its staff on reform of the current rules.

We thank you Mr. Chairman for holding these hearings today and for the opportunity to share our views with you and the other members of the Committee. We hope that today's discussion and testimony will lead to international tax law reform. The present structure of international tax law predates the globilization of financial markets and places U.S. securities firms at a competitive disadvantage in the international market place. The Committee should act promptly to reform and modernize the international tax laws. We would be pleased to respond to any questions or requests for additional information related to our testimony.

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