STATEMENT OF
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For the hearing on
AN EXAMINATION OF U.S. TAX POLICY AND ITS EFFECT ON DOMESTIC AND INTERNATONAL COMPETITIVENESS OF U.S.-BASED OPERATIONS

Before the
SENATE COMMITTEE ON FINANCE

On
JULY 15, 2003

Mr. Chairman and members of the Committee, I am Charles Hahn, Director of Taxes for The Dow Chemical Company. My company, as a member of the Coalition for Fair International Taxation (C-FIT), believes the international competitiveness of U.S. companies operating in the global marketplace should be the focus of any legislative response to the World Trade Organization (WTO) ruling that invalidated the "Foreign Sales Corporation (FSC) Replacement and Extraterritorial Income Exclusion (ETI) Act."1

Dow is a diversified, integrated science and technology company that develops and manufactures innovative chemical, plastic and agricultural products and services to many essential consumer markets worldwide. We serve customers in more than 170 countries in a wide range of markets, including food, transportation, health and medicine, personal and home care, and building and construction, among others. Dow's annual sales equal approximately $28 billion, with 40.8 percent in the U.S. and 59.2 percent international. We have 191 manufacturing sites in 38 countries; 62 of those sites are in the U.S. representing 57 percent of the long-lived assets of the company.

Chemical markets are necessarily worldwide and fiercely competitive. Dow is the largest U.S. chemical company, but only the third largest in the world. Of the ten largest chemical companies, only three are from the U.S.

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1 The January 14, 2002, WTO Appellate Body Report in *United States – Tax Treatment for "Foreign Sales Corporations" – Recourse to Article 21.5 of the DSU by the European* upheld the decision of the WTO panel that the FSC Replacement and Extraterritorial Income Exclusion Act confers prohibited export subsidies in violation of the international trade obligations of the United States.

The topics of this hearing, ETI replacement and international competitiveness, are critical to us.

Introduction

This statement focuses on the importance of enacting FSC/ETI replacement legislation to Dow and other U.S.-based multinational companies in the manufacturing industry. In order to allow companies like mine to continue playing a vital role in increasing U.S. exports and maintaining millions of American jobs, repeal of the ETI provisions must be coupled with much needed reforms of our outmoded international tax laws. In any case, the Congress should strive to maintain the competitiveness of *all* American businesses and their workers, without discriminating against U.S. companies that have substantial, active businesses abroad. To do otherwise would penalize U.S. workers whose jobs depend on their companies' ability to sell products and services throughout the globe.

Discussion

Today's hearing springs from a WTO dispute initiated by the European Community (EC), leading to a WTO ruling that both the FSC and the ETI regime that replaced it are impermissible export subsidies. The WTO has authorized the EC to impose over $4 billion in annual sanctions against American products, and the EC has threatened to impose these sanctions on January 1, 2004, if the Congress has not made "significant progress" in complying with the WTO's ruling by the fall of this year. In view of the magnitude of the potential sanctions, we understand the inevitability of the ETI regime's repeal. At the same time, we understand the Congress is expected to fashion replacement legislation that is WTO-compliant but that also addresses the competitiveness of American companies. The core element of any replacement legislation should be reform of antiquated U.S. tax rules that undermine the international competitiveness of U.S.-based multinational corporations and their workers.

I. Replacement Legislation Should Take Account of the Vital Role of U.S. Multinational Corporations

The ETI regime in current law is intended to create a level playing field for U.S. companies competing in markets outside the United States. If the goal of replacement legislation is to target former ETI users, then the Congress must take into account the impact of repeal on U.S.-based multinational companies like Dow. Dow is a major exporter with $3.76 billion of export sales in 2002. Our ETI benefit in 2002 was $38 million. For all of the U.S. chemical industry, ETI benefits range from $750 million to $1 billion annually. Collectively, U.S.-based multinational corporations, which manufacture in whole or in part in the United States but also rely on foreign operations to carry out distribution, marketing, or other export-related activities, currently provide 56 percent of all U.S. exports.

Repeal of the ETI benefits would result in a huge tax increase at a time when the chemical industry is severely depressed. Our industry has suffered its worst two years in two decades and its most prolonged downturn since the 1930's, in large part due to the overall economic downturn and high energy and feedstock prices.

Additionally, if the focus is on improvements to the U.S. economy, then the Congress must consider that U.S. multinational corporations are responsible for 23 million American jobs; 21 percent of U.S. GDP; $131 billion in annual U.S. R&D spending; and 49 percent of U.S. corporate income tax payments. Enhancing the competitiveness of this large and important sector would contribute directly to the domestic economy.

A. Foreign Operations of U.S. Multinationals Increase U.S. Exports

Foreign direct investment by Dow creates new markets for American products. This activity leads to sales in foreign markets that likely would not occur by simply exporting goods. In the chemical industry, particularly for basic chemicals, transportation costs are high and times for production long, so locating near customers or raw materials is critical. Customers want a local presence as a way to solve problems more expeditiously and to provide supplies quickly. Local plants not only serve as customers for raw materials produced in the U.S.; but, in the case of Dow, these overseas facilities also provide distribution for full product lines, even though only a small portion is produced locally.

A recent study by the Organization for Economic Cooperation and Development (OECD) found that each dollar of outward foreign direct investment led to two dollars of additional exports and a $1.70 increase in the U.S. bilateral trade surplus. The Commerce Department's "Survey of Current Business" indicates that in 2000 (the most recent year for which data are available), U.S.-based multinationals accounted for nearly two-thirds of overall U.S. merchandise exports. Foreign affiliates of U.S.-based multinationals purchased $203 billion of goods from U.S. sources, while domestic operations of U.S.-based multinationals exported $236 billion to other foreign customers. Dow is a good example. As mentioned previously, in 2002, Dow exported $3.76 billion, with 80 percent of those sales to related subsidiaries.

B. The International Operations of U.S. Multinationals Enhance Job Opportunities in the United States

As noted by the Council of Economic Advisors in 2003, "The U.S. economy is increasingly linked to the world economy through trade and investment. Domestically based multinational businesses and their foreign investment help bring the benefits of global markets back to the U.S. by providing jobs and income."[2] Indeed, U.S. multinational corporations are major employers of American workers. The most recent Department of Commerce data indicate that U.S. multinationals employed over 23 million people in the United States in 2000, out of a national workforce of 139.2 million. Many of these U.S. jobs support and depend on the overseas operations of U.S. firms, particularly jobs related to maintaining and expanding U.S. product development and research initiatives. Dow is typical of many U.S. global companies. We are headquartered in Midland, Michigan, and naturally

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2 US Council of Economic Advisors, Economic Report of the President, 2003, p 208.

many of the functions necessary for our global operations are performed at that U.S. location. For example, 87 percent of Dow's over $1 billion in 2002 global R&D spending was performed in the U.S., the majority in Midland.

Additionally, small businesses support and depend on Dow's global operations. As the Small Business Administration found in a report discussing the role of small businesses in the global economy, "smaller firms can conduct international expansion on their own, or by collaborating with a multinational firm. The intermediated form of international expansion has certain advantages. The small firm benefits from having access to the multinational firm's global market reach."3 Accordingly, reforms that increase the international competitiveness of U.S. multinationals would have a positive "spill-over" effect on those small businesses that contract with Dow.

II. The Focus Should be on Pro-competitive Reforms to Our International Tax Rules

Dow is increasingly harmed by the basic structure of the U.S. international tax regime, which was enacted over 40 years ago, when the U.S. economy dominated the world. At that time, 18 out of the top 20 global companies were headquartered here, and this country accounted for over half of all multinational investment in the world. Today, to remain competitive and fuel U.S. economic growth and jobs, Dow and other domestic companies must compete against foreign-owned firms for clients and customers that are located around the globe.

U.S. tax policy should compliment rather than frustrate U.S. trade policy. The domestic economic benefits of free and open trade are not only challenged by ongoing tariff and non-tariff barriers in many global growth markets but are also being frustrated by an outdated domestic international tax regime written decades ago in a vastly different competitive environment.

Restrictive aspects of the foreign tax credit limitation have the effect of subjecting Dow to double taxation of foreign source income and inefficient operations. Dow typically operates in countries with tax rates similar to that of the U.S. We are currently faced with the expiration of foreign tax credits caused by the erosion of our foreign tax credit limitation by domestic losses, with no offsetting recapture when domestic profits return. The problem is made worse by the high allocation of expenses to foreign source income. The overly broad scope of current law also results in the current taxation of active business income earned abroad. These and other flaws in our U.S. tax rules operate, in a sense, as an extra "tax" on Dow. Because this "tax" is not borne by foreign multinationals, the effect impedes the competitiveness of Dow and all U.S. companies that have substantial active businesses abroad.

Additionally, the current system for taxing international operations is overly complex. We spend an enormous amount of time complying with the worldwide and detailed reach of the U.S. system. This has a large compliance cost (6100 of our 7800 page 2001 tax return dealt with international issues, and this is representative of the relative effort we are required to expend). More importantly, our non-U.S. business

3 SBA Office of Advocacy, "The New American Evolution: The Role and Impact of Small Firms" (June, 1998).

operations have to understand and deal with the U.S. tax effects of their transactions, which slows them down, distracts them, and changes how they operate. (Attachment A provides a detailed list of provisions, supported by Dow and other C-FIT member companies, that should be included among the core elements of replacement legislation to maintain the international competitiveness of U.S. businesses.)

III. In any Event, Replacement Legislation Should Take Account of the Full Range of American Businesses That Utilized FSC/ETI

The ETI regime was created to help U.S.-based companies compete with foreign-based companies that operate under significantly different and more favorable home-country tax rules. Replacement legislation must continue this objective of global competitiveness for U.S. goods and services. A proposal introduced in the House of Representatives,4 however, would focus on domestic manufacturing and actually penalize U.S. companies that seek to compete overseas. We believe this is the wrong approach. Instead, replacement legislation should take into account the interests of *all* American businesses and their workers, and ensure that they are not placed at a disadvantage in relation to their foreign competitors.

Conclusion

The challenge for Dow and other U.S. companies to remain competitive on an international basis has never been greater than it is today. When U.S. firms are competitive in the global marketplace, we are better able to enhance the demand for U.S.-produced products and create U.S. jobs. In view of this reality, the WTO-mandated changes to U.S. tax law should include much needed reforms to our international tax regime. These changes will help ensure that Dow and other U.S.-based companies can continue to compete globally against foreign-based companies operating under more advantageous tax regimes. We stand ready to work with the Finance Committee to achieve this result.

4 H.R. 1769, a bill introduced on April 11, 2003 by House Ways and Means Committee members, Rep. Crane (R-IL) and Rep. Rangel (D-NY), in order to bring the United States into compliance with the WTO ruling by replacing the current-law ETI benefit with a deduction of up to 10 percent of the income attributable to domestic production. This bill would also discriminate against companies in industries other than manufacturing that currently make use of the ETI regime, including services businesses that either facilitate U.S. exports or provide services relating to those exports in foreign jurisdictions.

Attachment A

The following provisions* should be included among the core elements of legislation to maintain the international competitiveness of U.S. businesses:

Foreign base company sales and services income. Repeal rules that impose current U.S. taxation on income from active foreign business operations involving certain sales and services transactions of a controlled foreign corporation ("CFC"). If repeal of the foreign base company rules is subject to any exception, care must be taken to avoid "creating" subpart F income where no such income would arise under current law, and thus report language should make clear that the "manufacturing" exception of current law would continue to apply.

The following provisions were not included on this list, on the assumption that the Congress will enact both the provision to repeal the foreign base company rules and the provision to add look-through rules to prevent the current taxation of payments between related CFCs (discussed below): study of proper treatment of the European Union under same country exceptions; and expansion of subpart F *de minimis* rule to the lesser of five percent of gross income or $5 million.

Provide comparable relief for other income. Current law should also be amended to prevent the current taxation of active foreign oil or gas business income, including income derived in connection with the pipeline transportation of oil or gas between foreign countries (without regard to whether the CFC that owns the pipeline also owns an interest in the oil and gas that is transported, or whether the oil or gas was extracted or consumed within the foreign country).

Provide comparable relief for commodities transactions. Amend the exceptions to the definition of subpart F rules that generally provide for the treatment of net gains on commodities transactions as foreign personal holding company income ("FPHCI"), to clarify that the exceptions cover (1) commodity hedges entered into in the normal course of a CFC's trade or business, primarily to manage the risk of price changes or currency fluctuations with respect to ordinary property or property described in section 1231(b)5 that is held or to be held by the CFC; and (2) sales of stock in trade of the CFC or other property that would be included in inventory, property that is depreciable in the hands of the CFC, or supplies of a type regularly used or consumed by the CFC in the ordinary course of business.

Look-through rules to prevent the current taxation of payments between related CFCs. Present law imposes current U.S. tax under the foreign

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*The provisions are not listed in any particular order; all are of equal importance.

5 All references to "sections" are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

personal holding company rules of subpart F on any dividends, interest, rents and royalties received by a CFC from a related CFC when those two subsidiaries are located in different countries. A "same-country" exception applies when the two related CFCs are organized and operated in the same country. Subpart F should not apply regardless of the location of the related CFCs as long as the income from which the payment is derived is non-subpart F income of the paying company. Permitting look-through treatment for these payments makes sense – as long as the payments reflect active business income that normally would not be subject to current taxation unless paid back to the U.S. parent. Current law appears designed to protect the tax base of other countries or to promote overseas investments in the same jurisdiction where the paying/distributing subsidiary of the U.S. parent company is located. Neither of these policies appears compatible with a system designed to make American companies competitive with foreign-based companies.

Provide look-through rules for sales of partnership interests. For purposes of determining subpart F income that is FPHCI, a CFC that sells an interest in a partnership in which the CFC owns 25 percent or more of the capital or profits interests should be treated as selling a proportionate share of the partnership's assets attributable to such interest.

10-year foreign tax credit ("FTC") carryforward. Extend the carryforward period for excess foreign income taxes and excess oil and gas extraction taxes from five years to ten years, effective for existing carryforwards.

Worldwide interest allocation. Modify the interest allocation rules applicable for purposes of calculating a U.S. taxpayer's FTC limitation, by providing for worldwide allocations, to prevent the over-allocation of interest expense. Consideration should be given to making this rule elective, and to addressing inequities arising under the specific allocation methodologies prescribed by current Treasury regulations.

Re-characterization of overall domestic loss. Conform the treatment of an overall domestic loss to that of an overall foreign loss by re-characterizing subsequent U.S.-source income as foreign.

Consolidation of FTC baskets. Repeal the FTC "baskets," including the special section 907 limitation, and replace them with a three-basket system for passive income and "other passive category income," financial services income, and "general basket" income.

Alternative minimum tax ("AMT") limit on FTCs. Repeal the 90 percent limit on the utilization of the AMT FTC.

Look-through rules for dividends from noncontrolled section 902 (10/50) companies. A 10/50 company is a foreign joint venture in which the U.S. ownership is more than 10 percent but not more than 50 percent. Through 2002, earnings and foreign taxes relating to these companies are segregated into a separate FTC basket that applies for each such joint venture, thus precluding use of these credits in either a company's general FTC basket (the financial services basket in the case of banks) or to average among 10/50 companies. While changes to the law made in 1997 repeal the 10/50 rules for foreign earnings after 2002, the Congress failed to provide adequate relief for significant transition issues.

These transition issues were not solved by the rules articulated in Notice 2003-5, recently released by the Treasury Department to address the transition to the new 10/50 regime. Specifically, credits derived from dividends paid after 2002 out of pre-2003 earnings and profits will be confined to a single 10/50 basket. Further, 10/50 credits carried forward from pre-2003 years will be confined to a single 10/50 basket. Effectively, in both instances, any such excess credits will expire unused because, under the existing rules, no new income will be generated of the sort needed to absorb these credits. This result appears to have been unintended when the 1997 rules were drafted, and the proposal would correct this flaw in the 1997 legislation. The proposal, as outlined in the Joint Committee on Taxation's staff simplification study published in 2001, would permit full "look-through" treatment for both credits being carried forward as well as new credits produced from pre-2003 earnings, thus permitting taxpayers to determine the allocation of credits based on the nature of the underlying earnings rather than the form of business from which the income was earned.

FTCs claimed indirectly through partnerships. For purposes of determining indirect FTCs, stock owned, directly, or indirectly, by or for a partnership should be treated as owned proportionately by its partners when applying the constructive ownership rules for determining whether applicable ownership thresholds are satisfied.

Include transition rules if FSC/ETI is repealed. Many U.S. financial institutions finance multi-year leases of various U.S. manufactured goods, including aircraft, under the FSC/ETI rules. The Congress is considering repeal of these provisions in response to a World Trade Organization ("WTO") ruling that both the ETI regime and FSC transition rules contained in the ETI statute violate existing WTO agreements. Failure to preserve transition benefits for FSC/ETI leases would create a competitive disadvantage for U.S. financial institutions and have a serious negative impact on U.S. companies that have structured lease agreements in reliance on existing law. Appropriate transition rules should be provided to preserve the total FSC and ETI benefit contemplated by the parties for transactions closed prior to enactment of any FSC and ETI repeal legislation.

Other provisions:

"Working Capital" Exception to Subpart F. Fluctuations in a CFC's working capital held in the active conduct of a trade or business should not result in FPHCI that is currently taxed under subpart F.

Application of look-through rules to interest, rents or royalties for purposes of the FTC. Extend the look-through treatment applicable to dividends from 10/50 companies to any interest, rent, or royalty received or accrued from a 10/50 company.

Ordering rules for FTC carryovers. FTCs used in a taxable year would be treated as used first from carryforwards to such year. To provide further relief, consideration should be given to extending the carryback period to three years.

Active financial services income. The rules that permit U.S.-based financial services companies to defer U.S. tax on the active financial services income of a CFC (the active financing exception to the anti-deferral rules of subpart F) were extended in 2002 for five years. These rules, which are permanent fixtures of the Internal Revenue Code for most other non-financial U.S.-based multinationals and are the norm for foreign-based competitors, should be made permanent.

Election not to use average exchange rate for foreign tax paid in a nonfunctional currency. Permit an election to determine the amount of foreign taxes paid at the exchange rate in effect on the date of payment rather than the average exchange rate for the taxable year, if the liability for such taxes is denominated in any currency other than the taxpayer's functional currency (with regulatory authority to make the election available with respect to a qualified business unit).

Application of uniform capitalization rules to foreign persons. The uniform capitalization rules should apply to foreign taxpayers only for purposes of taxing income effectively connected with the conduct of a U.S. trade or business, if the taxpayer capitalizes costs of produced property or property acquired for resale in accordance with the method used in its financial statements.

Clarification of the financial services basket. The scope of the financial services basket should be clarified to include all income from all activities that relate to the active conduct of a banking, insurance, financing, or similar business. Current law can create anomalies in which financial services income is not necessarily treated as financial services basket income. For example, under Treasury regulation section 1.904-6(a)(1)(iv), differences between the U.S. tax base and that of foreign countries can create non-financial services basket income for financial services companies. This "base difference" rule should be clarified so that income and related FTCs relating to base differences are treated as financial services basket income for financial services companies.