TESTIMONY OF
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BEFORE THE SENATE COMMITTEE ON FINANCE
ON INTERNATIONAL TAX POLICY AND COMPETITIVENESS

Mr. Chairman, Senator Baucus, and distinguished Members of the Committee, I appreciate the opportunity to appear today at this hearing focusing on international tax policy and competitiveness issues. I applaud the Committee for holding this hearing to examine U.S. tax policy and its effect on the international competitiveness of U.S.-owned foreign operations. The importance of our international tax rules to the competitiveness of U.S. businesses and workers is well known to this Committee, as evidenced by the fact that the Committee has previously approved legislation addressing many issues in the international area. Unfortunately, this Committee's good work on those issues in previous sessions has not resulted in enacted legislation. Nevertheless, the need for changes, such as the changes previously approved by this Committee, continues. Indeed, with the growing importance of international competitiveness to the economy, the need is even more immediate.

Many areas of our tax law are in need of reform to ensure that our tax system does not impede the efficient, effective, and successful operation of U.S. companies and the American workers they employ in today's global marketplace. In keeping with the focus of today's hearing, I will address my remarks this morning to the tax policy issues specific to U.S.-based companies competing in markets around the world.

Introduction

Both the increase in foreign acquisitions of U.S. multinationals and the corporate inversion activity of the past few years evidence the potential competitive disadvantage created by our international tax rules. The concern this Committee faces today is that our tax code has not kept pace with the changes in our economy. From the vantage point of the increasingly global marketplace in which U.S. companies compete, our tax rules appear outmoded, at best, and punitive of U.S. economic interests, at worst. Most other developed countries of the world are concerned with setting a competitiveness policy that permits their workers to benefit from globalization. As former Deputy Secretary Dam observed last year, we, by contrast, appear to have based our international tax policy on the principle that we should tax our competitive advantages.

Our income tax system as a whole dates back to shortly after the turn of the last century. Much has changed since then. Of course, significant changes have been made to the tax code as well. In the international area, we added the subpart F rules back in 1962. Those rules have not advanced with advances in the economy. We also made fairly significant changes to the international tax rules in 1986. Many of the 1986 changes had dubious

economic underpinnings in 1986. They also have not advanced with advances in the economy.

The global economy looked very different in 1962 than it looks today. The same is true of the U.S. role in the global economy. Forty years ago the U.S. was dominant, accounting for over half of all multinational investment in the world. With a dominant role, we were free to make decisions about our tax system essentially on the basis of a closed economy. Moreover, our trade partners generally followed our lead in tax policy.

Things have changed. When the international rules were first developed, they affected relatively few taxpayers and relatively few transactions. Today, there is hardly a U.S.-based company that is not faced with applying the U.S. international tax rules to some aspect of its business.

Globalization – the growing interdependence of countries resulting from increasing integration of trade, finance, investment, people, information and ideas in one global marketplace – has resulted in increased cross-border trade, and the establishment of production facilities and distribution networks around the globe. Technology will continue to accelerate the growth of the worldwide marketplace for goods and services. Advances in communications, information technology, and transport have dramatically reduced the cost and time taken to move goods, capital, people, and information around the world. Firms in this global marketplace differentiate themselves by being smarter: applying more cost efficient technologies or innovating faster than their competitors. The returns are much higher than they once were as the benefits can be marketed worldwide.

The significance of globalization to the U.S. economy since the enactment of subpart F is apparent from the statistics on international trade and investment. In 1960, trade in goods to and from the U.S. represented just over six percent of Gross Domestic Product (GDP). Today, trade in goods to and from the U.S. represents over 20 percent of GDP, a three-fold increase, while trade in goods and services represents more than 25 percent of GDP today. It is worth noting that numerous studies confirm a strong link between trade and economic growth. Trade appears to raise income by spurring the accumulation of, and raising the returns to, physical and human capital.

Cross border investment, both inflows and outflows, also has grown dramatically in the last 40 years. In 1960, cross border investment represented just over one percent of GDP. In 2001, it was more than 11% of GDP, representing annual cross-border flows of more than $1.1 trillion. The aggregate cross border ownership of capital is valued at $16 trillion. In addition, U.S. multinational corporations are now responsible for more than one-quarter of U.S. output and about 15 percent of U.S. employment.

Globalization and Competitiveness and U.S. Tax Policy

At the same time companies are competing for sales, they are also competing for capital: U.S.-managed firms may have foreign investors, and foreign-managed firms may have U.S. investors. Portfolio investment accounts for approximately two-thirds of U.S. investment abroad and a similar fraction of foreign investment in the U.S.

The U.S. tax rules have important effects on international competitiveness both because of the integration of domestic activities of U.S. multinational companies with their foreign activities and because repatriated foreign earnings of foreign investments are subject to U.S. domestic tax. Increasingly, the flow of goods and services is not through purchases between exporters and importers, but through transfers between affiliates of multinational corporations. The rules governing transfer pricing, interest allocation, withholding rates, foreign tax credits, and the taxation of actual or deemed dividends affect these flows.

As a general rule, the ideal tax system should seek to minimize distortions to trade or investment relative to what would occur in a world without taxes. Every country makes sovereign decisions about its own tax system, so it is impossible for the U.S. to level all playing fields simultaneously. But we can ensure that our own rules minimize the barriers to the free flows of capital that globalization necessitates. Similarly, every country makes sovereign decisions about its labor markets, environmental regulations, and health and safety regimes. Fortunately, we have had enough wisdom over the years to avoid attempting to level these playing fields. But our attempts to level the playing field in tax policy have often erected costly barriers to the free flows of capital that maximizing our international competitiveness necessitates.

The question we must answer is what we can do to increase the competitiveness of U.S. businesses and workers. Professor Michael Graetz observed in his book, The Decline (and Fall?) of the Income Tax:

> The internationalization of the world economy has made it far more difficult for the United States, or any other country for that matter, to enact a tax system radically different from those in place elsewhere in the world. In today's worldwide economy, we can no longer look solely to our own navels to answer questions of tax policy.

Professor Graetz is right. We must write tax rules that take into account what other countries are doing. If what they are doing is inconsistent with improving their own international competitiveness, then we should not follow. But if they appear to be moving in ways that will improve their ability to compete, then we must reconsider the extent to which our rules impede the flow of capital of US businesses, necessitate inefficient business structures and operations, and leave US companies and workers in a less competitive position.

U.S. Taxation of Income Earned Abroad

Given the significance of competitiveness concerns, we should consider the ways in which our tax system (1) differs from that of our major trading partners to identify aspects that may hinder the competitiveness of U.S. companies and workers, and (2) creates barriers to efficient capital flows. About half of the OECD countries employ a worldwide tax system similar to that of the United States. The practical effect of a worldwide system is a tax on U.S. companies repatriating their earnings to the extent foreign tax credits are unavailable to offset U.S. taxes. That tax creates a hurdle to companies bringing profits back to the United States. It means U.S. investments abroad often face a higher hurdle than if a foreign competitor made the same investment. That is a hurdle foreign competitors in territorial tax systems do not face, for example, and a hurdle foreign competitors investing in the U.S. do not face. This creates an incentive for U.S. companies to keep their income abroad, which can increase the cost of investment in the United States. That is a result that disadvantages U.S. workers.

Even limiting comparisons of our system to that of countries using a worldwide tax system, U.S. multinationals can be disadvantaged when competing abroad. This is because the U.S. worldwide tax system, unlike other worldwide systems, can tax active forms of business income earned abroad before it has been repatriated, and it often imposes stricter limits on the use of foreign tax credits that prevent double taxation of income earned abroad.

Limitations on Deferral

Under the U.S. international tax rules, income earned abroad by a foreign subsidiary generally is subject to U.S. tax at the U.S. parent corporation level only when such income is distributed by the foreign subsidiary to the U.S. parent in the form of a dividend. An exception to this general rule is provided with the rules of subpart F of the Code, under which a U.S. parent is subject to current U.S. tax on certain income of its foreign subsidiaries, without regard to whether that income is actually distributed to the U.S. parent. The focus of the subpart F rules is on passive, investment-type income that is earned abroad through a foreign subsidiary. However, the reach of the subpart F rules extends well beyond passive income to encompass some forms of income from active foreign business operations. No other country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity.

Several categories of active business income are covered by the subpart F rules. Under subpart F, a U.S. parent company is subject to current U.S. tax on income earned by a foreign subsidiary from certain sales transactions. Accordingly, a U.S. company that uses a centralized foreign distribution company to handle sales of its products in foreign markets is subject to current U.S. tax on the income earned abroad by that foreign distribution subsidiary. In contrast, a local competitor with sales in that market is subject only to the tax imposed by that country. Moreover, a foreign competitor that similarly uses a centralized distribution company with sales into the same markets also generally will be subject only to the tax imposed by the local country. While this subpart F rule may operate in part as a "backstop" to the transfer pricing rules that require arms' length

prices for inter-company sales, this rule has the effect of imposing current U.S. tax on income from active marketing operations abroad. U.S. companies that centralize their foreign distribution facilities therefore face a tax penalty not imposed on their foreign competitors.

The subpart F rules also impose current U.S. taxation on income from certain services transactions performed abroad. In addition, a U.S. company with a foreign subsidiary engaged in shipping activities or in certain oil-related activities, such as transportation of oil from the source to the consumer, will be subject to current U.S. tax on the income earned abroad from such activities. In contrast, a foreign competitor engaged in the same activities generally will not be subject to current home-country tax on its income from these activities. While the purpose of these rules is to differentiate passive or mobile income from active business income, they operate to subject to current tax some classes of income arising from active business operations structured and located in a particular country for business reasons wholly unrelated to tax considerations. In other words, in seeking to capture as much passive international income as possible, subpart F captures a large share of active income as well, putting the companies that earn this active income at a distinct competitive disadvantage.

Limitations on Foreign Tax Credits

Under the worldwide system of taxation, income earned abroad potentially is subject to tax in two countries – the taxpayer's country of residence and the country where the income was earned. Relief from this potential double taxation is provided through the mechanism of a foreign tax credit under which the tax that otherwise would be imposed by the country of residence may be offset by tax imposed by the source country. The United States allows U.S. taxpayers a foreign tax credit for taxes paid on income earned outside the United States.

The foreign tax credit may be used to offset U.S. tax on foreign-source income but may not offset U.S. tax on U.S.-source income. The rules for determining and applying this limitation are detailed, complex, and can have the effect of subjecting U.S.-based companies to double taxation on their income earned abroad. The current U.S. foreign tax credit regime also requires that the rules be applied separately to separate categories or "baskets" of income. Foreign taxes paid with respect to income in a particular category may be used only to offset the U.S. tax on income from that same category. Computations of foreign and domestic source income, allocable expenses, and foreign taxes paid must be made separately for each of these separate foreign tax credit baskets, further adding to the complexity of the system.

The application of the foreign tax credit limitation to ensure that foreign taxes paid offset only the U.S. tax on foreign-source income requires a determination of net foreign-source income for U.S. tax purposes. For this purpose, foreign-source income is reduced by U.S. expenses that are allocated to such income. Under the current rules, interest expense of a U.S. affiliated group is allocated between U.S. and foreign-source income based on

the group's total U.S. and foreign assets. The stock of foreign subsidiaries is taken into account for this purpose as a foreign asset (without regard to the debt and interest expense of the foreign subsidiary). These rules thus treat interest expense of a U.S. parent as relating to its foreign subsidiaries even where those subsidiaries are equally or more leveraged than the U.S. parent. This over-allocation of interest expense to foreign income inappropriately reduces the foreign tax credit limitation because it understates foreign income. The effect can be to subject U.S. companies to double taxation. Other countries do not have expense allocation rules nearly as extensive as ours.

Under the current U.S. rules, if a U.S. company has an overall foreign loss in a particular taxable year, that loss reduces the company's total income and therefore reduces its U.S. tax liability for the year. Special overall foreign loss rules apply to re-characterize foreign-source income earned in subsequent years as U.S.-source income until the entire overall foreign loss from the prior year is recaptured. This re-characterization has the effect of limiting the U.S. company's ability to claim foreign tax credits in those subsequent years. No comparable re-characterization rules apply in the case of an overall domestic loss. However, a net loss in the United States would offset income earned from foreign operations, income on which foreign taxes have been paid. The net U.S. loss thus would reduce the U.S. company's ability to claim foreign tax credits for those foreign taxes paid. This gives rise to the potential for double taxation when the U.S. company's business cycle for its U.S. operations does not match the business cycle for its foreign operations.

These rules can have the effect of denying U.S.-based companies the full ability to credit foreign taxes paid on income earned abroad against the U.S. tax liability with respect to that income and therefore can result in the imposition of the double taxation that the foreign tax credit rules are intended to eliminate.

Double Taxation of Corporate Income

While concern about the effects of the U.S. tax system on international competitiveness may focus on the tax treatment of foreign-source income, competitiveness issues arise in very much the same way in terms of the general manner in which corporate income is subject to tax in the United States.

Prior to the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the United States was one of the few industrialized countries that failed to provide some form of integration of corporate and individual income taxes. Income from an equity-financed investment in the corporate sector was taxed twice, first as profit under the corporate income tax and again under the individual income tax when received by the shareholder as a dividend or as a capital gain on the appreciation of corporate shares. In contrast, under a fully integrated tax system, the double tax would be eliminated and a single tax would be imposed on corporate profit. Most OECD countries offer some form of integration under which corporate tax payments are either partially or fully taken into consideration when assessing shareholder taxes on this income, eliminating or reducing the double tax on corporate profits.

The prior non-integration of corporate and individual tax payments on corporate income applied equally to domestically earned income or foreign-source income of a U.S. company. The double tax increased the "hurdle" rate, or the minimum rate of return required on a prospective investment. To yield a given after-tax return to an individual investor, the pre-tax return must be sufficiently high to offset both the corporate level and individual level taxes paid on this return.

Whether competing at home against foreign imports or competing abroad through exports from the United States or through foreign production, the double tax made it less likely that the U.S. company could compete successfully against a foreign competitor.

To address the high effective tax rate on corporate equity investments, JGTRRA partially integrated corporate and individual taxes by providing relief from the double tax at the individual level through reduced tax rates on corporate dividends and capital gains. The maximum tax rate on dividends paid by corporations to individuals and on individuals' capital gains is reduced to 15 percent in 2003 through 2008. For taxpayers in the 10 percent and 15 percent income tax rate brackets, the rate on dividends and capital gains is reduced to 5 percent in 2003 through 2007, and to zero in 2008.

Because JGTRRA reduced the effective tax rate on income earned in the corporate sector, many more investments can achieve a desired after-tax return (after both corporate and individual taxes are paid) than under the prior non-integrated tax system. As a result, projects that could not attract equity capital in a non-integrated tax system because they might not be sufficiently profitable are able to attract equity capital in the present partially integrated system. Nevertheless, taxes on equity investments in the corporate sector are still higher than they would be under a fully integrated system. In the context of competitiveness, this may mean that a project that would otherwise be undertaken by a U.S. company, either at home or abroad, is instead undertaken by a foreign competitor. An additional concern is that the present relief from the double tax is scheduled to expire in 2009. To help ensure the competitiveness of U.S. companies, the present relief from the double tax for dividends and capital gains should be made permanent.

Additional Issues Involving Business Taxation

Mr. Chairman, in addition to the need to reevaluate our international tax rules, there are other tax policy issues that require consideration.

The President's February budget contained a number of tax provisions in addition to those that were eventually enacted in JGTRRA that are also intended to strengthen the economy. Those proposals affect a wide range of areas, including encouraging saving, strengthening education, investing in health care, increasing housing opportunities, protecting the environment, encouraging telecommuting, and providing incentives for charitable giving. They also include specific proposals to rationalize the tax laws, such as the repeal of section 809, and to simplify the tax laws, such as a permanent expansion of section 179, and to improve tax administration. To maintain their favorable effects and provide greater certainty for economic and financial planning, the Budget proposed to extend several tax provisions that expire in 2003 and 2004, and to make permanent the tax cuts enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001.

The President's budget also proposes to make permanent the research and experimentation tax credit. Research is central to American businesses' ability to compete successfully in the global economy. It results in new processes and innovative products that open up new markets and create job opportunities. American businesses can continue to compete only if they stay at the forefront of technological innovation. The research credit encourages technological developments that are an essential component of economic growth and a high standard of living in the future. A permanent research credit would remove the uncertainty about its availability in the future and thereby enable businesses to factor the credit into their decisions to invest in research projects.

The current system of tax depreciation also merits reevaluation. The 2000 *Treasury Report to Congress on Depreciation Recovery Periods and Methods* identified a number of issues with the current system of tax depreciation. Each issue represents a potential avenue to improving the tax system, and may warrant further study. One such issue is that the current system lacks a firm conceptual rationale. For example, it does not reflect inflation-indexed economic depreciation. This means that tax depreciation allowances can deviate significantly from those required to properly measure income and from those that would provide a uniform investment incentive for all assets.

A second issue in depreciation policy is that the current system is dated. The asset class lives that serve as the primary basis for assignment of recovery periods have remained largely unchanged since 1981, and most class lives date back at least to 1962. Entirely new industries have developed in the interim, and production processes in existing industries have changed.

A third issue is that the current depreciation system suffers from an ambiguous system for determining each asset's cost recovery period. This ambiguity contributes to administrative problems, makes it difficult to integrate new assets and activities into the system rationally, and inhibits rational changes in class lives for existing categories of investment.

Finally, in addition to these broad issues, the existing system is hampered by a number of narrower controversies, including the proper determination of the recovery period for real estate, the possible recognition of losses on the retirement of building components, and the presence of cliffs and plateaus in cost recovery periods that distorts the relationship between economic life and tax life.

The corporate alternative minimum tax (AMT) is an alternative tax system to the regular tax system. When investments and other expenses are large relative to a company's taxable income, as occurs during economic downturns, alternative minimum tax may be owed. Corporate AMT payments represent a pre-payment of tax that the taxpayer will get back when and if the taxpayer returns to a sufficient level of profitability.

A significant problem with the AMT that is especially relevant today is that the AMT reduces the stabilizing property of the corporate income tax, raising tax liabilities just

when the taxpayer is most troubled economically. In general, tax payments should help stabilize the economy by falling as the economy's performance declines, thereby reducing the impediment taxes place on consumption, investment, and production. The AMT tends to impose an increased tax burden during an economic downturn, which prolongs periods of economic weakness by reducing business activity. During an economic downturn, companies that seek to maintain a constant level of investment and employment are more likely to pay AMT or pay larger amounts of AMT. This is because AMT adjustments and preferences will represent a larger portion of their taxable income than during periods of high profitability.

The AMT also limits the use of net operating losses (NOLs) which tend to increase during economic downturns. Under the AMT, NOLs may not reduce a taxpayer's alternative minimum taxable income (AMTI) by more than 90 percent. The Job Creation and Worker Assistance Act of 2002 temporarily waived the AMTI limitation for NOL carrybacks arising in 2001 and 2002 as well as carryforwards to those years. In view of the slow pace of the economy recovery, the President's Budget proposed to waive the AMTI limitation for NOL carrybacks originating in 2003, 2004, and 2005, as well as for NOLs carried forward into those years. This change would provide appropriate tax relief for businesses in difficult financial straits.

Another aspect of the AMT is that it limits the use of foreign tax credits. Foreign tax credits can offset no more than 90 percent of the tentative minimum tax. Excess AMT foreign tax credits can be carried forward 5 years or back 2 years. Because the foreign tax credit is intended to ensure that foreign income of US corporations is not double taxed, the AMT's limitation on the use of foreign tax credit should be reconsidered.

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It has been observed that "it is difficult to predict the future of an economy in which it takes more brains to figure out the tax on our income than it does to earn it." That is the situation we face. Our tax laws are extraordinarily complex. A recent IRS study of the burden and cost of complexity to individual taxpayers put the burden well in excess of three billion hours per year and the cost well in excess of $60 billion per year. And that is just the individual side. The rules on the business side are even worse. While large businesses can grapple with it, many small and medium-size businesses cannot. The challenge for businesses trying to comply with the law - or the IRS trying to administer and enforce it - is enormous. It is time for us to undertake a serious effort to simplify our tax rules.

The complexity is nowhere more evident than in our international tax rules. A reexamination is needed, including of the fundamental assumptions underlying the current system. We should look to the experiences of other countries and the choices they have made in designing their international tax systems. Consideration should be given to fundamental reform of the U.S. international tax rules and to significant reforms within the context of our current system.

The many layers of rules in our current system arise in large measure because of the difficulties inherent in satisfactorily defining and capturing income for tax purposes, particularly in the case of activities and investments that cross jurisdictional boundaries. However, the complexity of our tax law itself imposes a significant burden on U.S. companies. Therefore, we must not lose sight of the need to simplify our international tax rules.