Statement of Stephen E. Shay

Committee on Finance, United States Senate

Hearing: An Examination of U.S. Tax Policy and Its Effect on the International Competitiveness of U.S.-Owned Foreign Corporations

July 15, 2003

Mr. Chairman and Members of the Committee:

My name is Stephen Shay. I am a partner in the law firm Ropes & Gray in Boston. I specialize in U.S. international income taxation and was formerly an International Tax Counsel for the Department of the Treasury in the Reagan Administration. I was invited last Friday by the Committee to be a witness to discuss the effects of U.S. tax policy on the international competitiveness of U.S.-owned foreign corporations.[1]

With the Chairman's permission, I would like to submit my testimony for the record and summarize my principal observations in oral remarks. Because I learned of my invitation to be a witness three days ago, I will necessarily keep my remarks limited to a few aspects of this topic.

**Overview**

My first observations relate to the objectives of U.S. tax policy – of which international tax policy is only a part. The primary focus of U.S. income tax policy should be to improve the lives and living standards of American citizens and residents.[2] The question raised by the topic of this hearing is in what circumstances, if any, improving the "tax-competitiveness" of U.S.-owned foreign corporations (meaning reduced U.S. tax on their U.S. shareholders) improves the standards of living of American citizens and residents more than alternative uses of those tax dollars.

My second set of observations address the question whether U.S.-owned multinational corporations are "tax-disadvantaged" in relation to foreign-owned corporations conducting business operations outside the United States. Although aspects of the U.S. tax rules excessively burden international commerce, to the detriment of a particular U.S. company or even industry, I have not seen compelling evidence that the U.S. tax rules taken as a whole are more onerous than the rules of other countries, even

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[1] I have attached a copy of my biography to this testimony. The views I am expressing are my personal views and do not represent the views of either my clients or my law firm.

[2] See Michael J. Graetz, *The David Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax Law Rev. 261, 284 (2001).

including countries that employ a traditional exemption system. Indeed, there is legitimate debate as to whether adoption of a exemption system by the United States would actually raise rather than lose revenue.

I encourage the Committee to consider international tax changes in the context of the overall U.S. tax system. I suggest that the tax savings from the repeal of ETI not be earmarked for international corporate taxation reforms, but instead be devoted to changes that are likely to improve the living standards of all Americans. If a proposal to modify an international tax rule is superior to all other proposals under that standard, then I would support it. I am not yet persuaded that the current international tax reform proposals meet that mark.

**United States International Competitiveness**

The objectives of the United States international income tax rules are to provide for the interaction between the United States Federal income tax system and the income tax systems (or absence of income tax systems) of other countries in a manner that achieves overall objectives of the United States. The international tax rules are a subset of the overall U.S. income tax system, the principal objective of which should be to collect revenue in the amount needed to fund the needs determined by the political branches of government to improve over some reasonable period the standard of living of U.S. citizens and residents.

The tax policy decisions before this Committee should be evaluated against a simple standard of U.S. competitiveness: will it improve over some reasonable period the standard of living of individual U.S. citizens and residents? The fact that a policy increases the after-tax profitability of U.S. owners of foreign business entities in relation to foreign owned business entities carrying on non-U.S. business should be relevant only to the extent it may be demonstrated that U.S. citizens and residents will realize a benefit commensurate with the cost of the policy.[3]

Although not directly the topic of this hearing, the ETI does not appear to have been tested against this or any other measurement standard. The effect of the ETI regime is to reduce the tax rate on certain export income by approximately 15%.[4] In the initial rush to find fault with the WTO decision finding the ETI to be an illegal export subsidy,[5]

[3] Tax policy proposals are traditionally tested against the following criteria: tax rules should (i) be efficient in that they should distort economic decisions and allocation of resources as little as possible (unless the rule has an explicit subsidy or deterrent objective), (ii) be consistent with U.S. fairness or welfare objectives as determined by the political branches of government, and (iii) raise the intended revenue at a reasonable cost to the taxpayer and the government. See U.S. Treasury Department, 3 Tax Reform for Fairness, Simplicity and Economic Growth 13-19 (1984).

[4] A domestic corporation subject to a 35% Federal corporate tax rate will pay a 29.75% rate on its net income subject to the ETI regime.

[5] On January 14, 2002, the WTO Appellate Body issued a report upholding a dispute resolution panel finding that the ETI is a prohibited export subsidy. Subsequent appeals have been rejected and the United States has committed to repeal the ETI. The ETI was the successor to the Foreign Sales Corporation ("FSC"), enacted by the Congress in 1984 and found by a WTO Appellate Body in February, 2000, to be a prohibited export subsidy. The FSC was the successor to the Domestic International Sales

and then to adopt some form of substitute benefit, I have not seen discussed the question: Does the ETI improve the overall living standards of American citizens and residents?

It is questionable whether the ETI (and its predecessors the FSC and DISC) does in fact improve the living standards of Americans by comparison with alternative ways that the foregone revenues (or tax benefits) could have been employed. There appears to be support for the position that the impact of the ETI on net exports (the increase in exports reduced by the corresponding increase in demand for imports) is modest at best and likely does not exceed the tax revenue lost as a result of the tax incentive.[6] In addition to the obvious questions that should be asked about any proposal that would perpetuate ETI benefits for old users (but apparently not new ones) and continue a benefit already found illegal, it should be asked whether an inefficient tax subsidy is good policy.

I turn next to the question whether U.S.-owned foreign corporations (or their U.S. parent companies) are disadvantaged in relation to foreign-owned corporations carrying on business outside the United States.

**Evaluating the U.S. Worldwide Tax System with Deferral in Relation to A Territorial Tax System**

The major approaches by which the tax system of a country (the "residence country") accounts for income earned by its residents in a foreign country ("foreign-source income") are a worldwide system and an exemption, or territorial, system. Although a number of major trading partners employ some form of territorial system, none of the international competitiveness or simplification tax proposals currently under discussion would adopt an exemption system.[7]

One question implied by a claim that the U.S. tax rules are anti-competitive is whether U.S. companies would be better off under a territorial tax system? If the United States were to adopt a territorial system comparable to the systems adopted in other countries, the United States (i) would not tax its own residents' foreign-source business

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Corporation ("DISC") enacted in 1971, and found to be an export subsidy in a panel report adopted by the GATT Council in 1981. I do not discuss here the substance of the U.S. position nor its merits as a matter of trade law. Suffice it to say, the WTO has twice rejected the U.S. efforts to further perpetuate the export benefits that commenced in 1971.

[6] A 2000 Report on the FSC by the Congressional Research Service cites a 1992 Treasury Department analysis that repealing the FSC would have reduced net exports by 140 million. If the impact of the ETI on net exports was in fact less than the tax expenditure, it would be ironic that the United States now is faced with having to arbitrate EU claims for compensatory damages that are based on U.S. tax expenditure estimates. The CRS Report also observed that under traditional economic analysis the FSC by definition reduces U.S. economic welfare (as opposed to the welfare of the firms benefited by the subsidy and their shareholders) because at least some portion of the benefit is presumed to be passed on to foreign consumers in the form of lower prices.

[7] The approach proposed by House Ways and Means Committee Chairman Thomas last year would substantially expand the scope of permitted deferral of U.S. tax on foreign business income earned through a foreign corporation and address provisions limiting the foreign tax credit (but would not restrict provisions that permit foreign taxes to offset U.S. income).

income that is subject to taxation in another country,[8] (ii) would disallow deduction of foreign business losses,[9] and (iii) would tax currently portfolio dividends and all foreign source interest and royalties.[10] In other words, only foreign-source business income would be exempt from U.S. tax and this income would bear the tax only in the foreign country where the income was produced (the "source country").[11]

Note that adoption of the form of exemption system just described would result in heavier taxation than under current U.S. rules in at least three respects: Foreign income generally is not exempt unless it is subject to some level of foreign tax, whereas the United States allows deferral from U.S. tax for income that is not taxed at all. Foreign source royalty income would be subject to full U.S. tax, whereas the United States allows U.S. tax on foreign royalty income to be offset by excess foreign tax credits on other income. Finally, foreign losses are not allowed as deductions, whereas the United States permits losses to be deducted (subject to possible recapture which in any event would result in a timing benefit). One response to these observations might be that taxpayers can be expected to adjust their behavior so as to obtain the full benefit of the exemption system, i.e., by paying less royalties and so on.

Although a territorial system provides no direct benefit for foreign operations in countries with effective tax rates equal to or higher than the U.S. rate, it does offer greater potential for a U.S. multinational to reduce high foreign taxes through tax planning techniques that shift income from a high tax to a lower-tax foreign country. If there is lower taxation of foreign income, taxpayers with foreign operations have an incentive to shift higher taxed U.S. (and foreign) income to lower taxed foreign operations.[12] Significantly, an exemption system also permits repatriation of future exempted foreign business earnings without further U.S. tax.[13]

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[8] For this purpose, foreign business income includes foreign dividends or gains from substantial shareholdings.

[9] In some cases, foreign losses are allowed, but are recaptured as domestic income when the taxpayer next realizes positive foreign net income.

[10] See Michael J. Graetz and Paul Oosterhuis, Structuring an Exemption System for Foreign Income of U.S. Corporations, 54 Nat'l Tax J. 771, 774 (2002).

[11] The traditional justification for exempting U.S. multinationals' foreign-source business income is based principally on a competitiveness argument that is usually stated as follows: foreign corporations operating businesses in low-tax foreign countries owned by residents of countries with a territorial tax system, as well as local businesses in the low-tax foreign countries, pay only the low local income tax on their in-country profits. Without exemption, U.S. multinationals are unduly disadvantaged when competing against these foreigners in low-tax foreign countries because in addition to the foreign tax, a U.S. multinational will pay a U.S. residual tax on its foreign profits, while the foreigners would pay only the low foreign tax. Therefore a U.S. multinational should be given a countervailing exemption from the U.S. residual tax.

[12] The principal objection to a territorial system is that it creates a bias in favor of investment in foreign operations. In the worst case, this bias causes a foreign investment to be preferred even though the U.S. investment has a higher before-tax rate of return and is, therefore, economically superior.

[13] None of the current international proposals (including Chairman Thomas's) would provide for tax-free repatriation of future earnings eligible for deferral. The Homeland Reinvestment Act would allow a reduced tax on currently deferred income - much in the nature of a tax amnesty.

Notwithstanding the potential advantages of an exemption system and the assertion that companies from other countries have a competitive tax advantage, U.S. companies apparently do not support a shift to an exemption system. In this context, the Committee should view assertions that foreign tax systems are better for taxpayers with skepticism.[14]

It is not my purpose to defend the current U.S. rules; they can and should be improved. It simply has not been proven that the direction of policy should be to decrease as opposed to increase the tax on foreign income. Proponents of reduced taxation of foreign income should be required to go further than making generalized competitiveness arguments, and should link the tax benefits of a proposal to increased American living standards.[15]

**Reform of the Current U.S Tax System of Worldwide Taxation with Deferral**

In practice the current U.S. system of worldwide taxation with deferral of U.S. tax on foreign corporate business income operates in much the same manner as a territorial system. If U.S. multinationals earn income through active business operations carried on by foreign corporations in low-tax source countries, the U.S. multinationals generally pay no residual U.S. tax until they either receive dividends or sell their shares. This phenomenon is referred to as "deferral." Deferral obviously decreases the present value of the U.S. residual tax. When this value reduction is combined with certain other features of the U.S. international tax regime (i.e., cross-crediting foreign taxes and certain source rules that overstate foreign-source income), well-advised U.S. multinationals can frequently reduce the U.S. residual tax on their repatriated foreign-source income to zero. Stated differently, the U.S. worldwide system, with deferral, frequently provides the same result as a territorial system (exemption from U.S. tax on foreign-source income). In a high-tax environment, the ability to credit excess foreign taxes against royalty income and export sales income makes the U.S. system more generous than an exemption system.

The original proponents of the DISC argued for the export subsidy in part on the grounds that exporters were disadvantaged relative to taxpayers that could locate their operations abroad and take advantage of deferral. In other words, an original rationale

[14] In none of the corporate inversions that attracted so much attention in the last two years did companies re-domicile their parent company in a major trading partner, such as United Kingdom, Canada, France, Germany of Japan.

[15] It may be anticipated that the proponents will argue that benefits for operations in lower tax foreign countries will generate greater purchases of U.S. goods because U.S. multinationals will buy from their U.S. affiliates and suppliers. Although this is a claim that deserves some scrutiny, at best this is an assertion that reduced taxation of the operations of U.S. multinationals in low-taxed foreign countries indirectly encourages U.S. exports and economic activity. It is unclear how much support there is for this claim, but no proposal to expand deferral would limit its scope to businesses with foreign operations that purchase goods from the United States.

for the DISC predecessor of the ETI was to equalize for exporters the advantages realized by U.S. multinationals from deferral.[16]

If the ETI is repealed, as a logical matter the Committee also should consider decreasing the tax advantages to earning low taxed foreign income through foreign corporations.[17] One would not have to repeal deferral to make substantial improvements in the current international tax rules without increasing the current incentives to locate investment outside the United States. It would be helpful to rationalize the current anti-deferral rules in a manner that would limit use of tax havens, but would impose less of a burden on normal business operations.

The current foreign tax credit mechanism could be improved by repeal of the sales source rule and other rationalization of source rules combined with improvements to the interest allocation rules and modification of the domestic loss recapture rules. If there were revenue available, the kinds of changes just described could be combined with revenue neutral reductions in tax for business income generally. This approach would assist U.S. businesses that export from the United States or compete against foreign imports as well as those that operate abroad. Alternatively, any revenue increase from these changes could pay for more favorable depreciation and amortization for investment in productive property, used to improve U.S. education or fund anti-terrorism initiatives.

Whatever the choice, I respectfully encourage the Committee to consider international tax reform proposals that will improve the well-being of all U.S. citizens and residents, including workers, farmers and small business men and women, and not just those in the multinational sector.

I would be pleased to answer any questions the Committee might have.

[16] See generally, Cohen and Hankin, "A Decade of DISC: Genesis, and Analysis," 2 Va. Tax Rev. 7 (1982).

[17] I and my co-authors, Professors Robert J. Peroni and J. Clifton Fleming, Jr., have outlined a proposal for a broad repeal of deferral. Essentially, our proposal would apply mandatory pass-through treatment to 10% or greater shareholders in foreign corporations. Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Deferral: Consider Ending It Instead of Expanding It*, 86 TAX NOTES 837 (2000).

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Mr. Shay is not appearing on behalf of any client or organization.

Mr. Shay is a tax partner with Ropes & Gray in Boston, Massachusetts. Mr. Shay has extensive experience in the international tax area, advising clients that include large and medium-sized multinational companies, financial institutions, and global investors on issues such as foreign tax credits, deferral of U.S. taxation, foreign currency gains and losses, withholding taxes and financial product issues. Mr. Shay regularly advises clients on transfer pricing issues and has successfully resolved numerous transfer pricing controversies with the IRS. Mr. Shay also advises U.S. and foreign high net worth clients with respect to cross-border income tax planning.

Mr. Shay graduated in 1972 with a B.A. from Wesleyan University in Middletown, Connecticut and in 1976 with a J.D. from the Law School and an M.B.A. from the Business School of Columbia University in New York. Before joining Ropes & Gray in 1987, Mr. Shay was International Tax Counsel for the U.S. Department of the Treasury.

Mr. Shay is a member of the American Law Institute and served as Associate Reporter for the American Law Institute's Federal Income Tax Project on Income Tax Treaties with Reporters David R. Tillinghast and Professor Hugh Ault. He also is a member of the Tax Section of the American Bar Association and formerly served as Chairman of the Tax Section's Committee on Foreign Activities of U.S. Taxpayers. Mr. Shay is a member of the International Bar Association and the International Fiscal Association.

Mr. Shay has been a Lecturer in Law at the Harvard Law School, teaching a course on *International Aspects of U.S. Income Taxation*. Mr. Shay authored *Revisiting U.S. Anti-Deferral Rules*, 74 Taxes 1042 (1996) and has co-authored *Selected International Aspects of Fundamental Tax Reform Proposals*, 51 University of Miami Law Review 1029 (1997) (with Victoria P. Summers), *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU Law Review 455 (1999) (with Robert J. Peroni and J. Clifton Fleming, Jr.), *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 Florida Tax Review 299 (2001) (with J. Clifton Fleming, Jr. and Robert J. Peroni) and "The David R. Tillinghast Lecture: 'What's Source Got to Do With It? - Source Rules and U.S. International Taxation'," 56 Tax Law Rev. 81 (2002) (with J. Clifton Fleming, Jr. and Robert J. Peroni).