Committee on Finance
15 July 2003

Hearing on

An Examination of U.S. Tax Policy and Its Effect on the International Competitiveness of U.S.-owned Foreign Operations

Statement of
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Mr. Chairman, Senator Baucus, and Members of the Committee, thank you for the opportunity to testify here today. My name is Dan Kostenbauder. I am Vice President – Transaction Taxes at Hewlett-Packard Company in Palo Alto, California. Bill Hewlett and Dave Packard founded HP in 1939. HP completed its merger transaction involving Compaq Computer Corporation on May 3, 2002. HP had worldwide revenue of over $72 billion for the fiscal year ending October 31, 2002.

HP is a leading global provider of products, technologies, solutions and services to consumers and businesses. The company's offerings span IT infrastructure, personal computing and access devices, global services and imaging and printing. HP expects to spend over $4 billion on R&D this fiscal year. This investment fuels the invention of products, solutions and new technologies, so that we can better serve customers and enter new markets. HP invents, engineers and delivers technology solutions that drive business value, create social value and improve the lives of our customers.

Summary of Comments

My comments will focus on a few key topics:

Some general information about Hewlett-Packard Company and the high-tech electronics industry that should help to provide a context for our views on the need for improvements to the U.S. tax system to improve our international competitiveness,

Proposed reforms of the U.S. tax rules that apply to international activities of U.S.-based taxpayers, and

The benefits of encouraging U.S.-based taxpayers to move offshore cash into the U.S. economy.

Background on Hewlett-Packard Company

As a leading global information technology company, HP operates in numerous countries. In the United States, HP has over 65,500 employees. Of the $4 billion that HP spends on R&D, 80% is spent in the United States – mostly to support high-paying jobs. In addition to sales of computers and printers, HP has a significant and growing services business. Last year HPServices generated 16 percent of HP's worldwide revenue and 37% of HP's worldwide profits.

HP also has significant operations overseas because business realities dictate that we do so. Our competitors are global in scope. It would be impossible for HP to succeed in the United States if we could not compete successfully outside of the United States. This is true for several key reasons.

First, many of our customers operate globally. They typically prefer to have one or a few IT technology providers. To meet the needs of these multinational customers, HP needs to have a significant presence to sell and support products outside of the United States. Quite simply, if we did not have a global presence, we would get fewer contracts with foreign-based or with U.S.-based multinational companies. Instead, those contracts might go to our foreign-based competitors – a result that no one on this Committee would think could be good for the American economy.

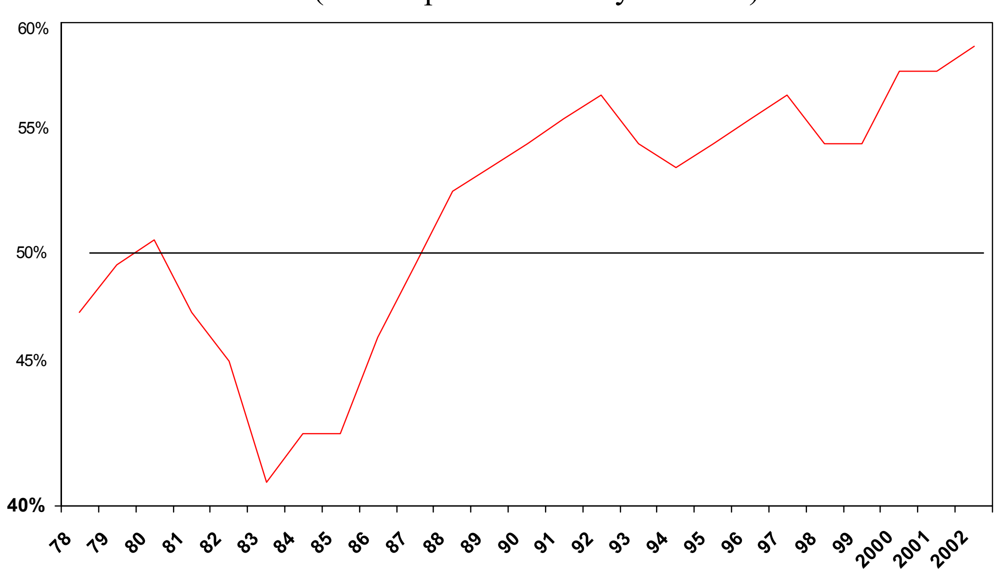
A second reason is that R&D is critical to high-tech companies. Our product life cycles are very short. In order to keep prices competitive, we need to amortize the costs of R&D over the maximum number of units sold worldwide. If we did not, our foreign competitors would eventually be able to under price our products and ultimately have the resources to do the R&D that we could no longer afford. This would leave us in the technological dust.

A third reason is that many products must be manufactured close to their markets. Usually it is not economically viable to ship products overseas that have relatively low values compared to their weight. In addition, with products like personal computers that fall in value very rapidly, supply chain considerations often dictate that they must be manufactured near their markets.

The following graph indicates the importance of HP's ability to compete in foreign markets. In our last fiscal year, about 59% of HP's trade revenues were from customers outside of the United States. (Prior to fiscal year 1999, the chart reflects the percentage of orders, rather than revenue, from outside of the Unites States.) The trend is clear.

Percentage of HP Revenue from Outside of the United States

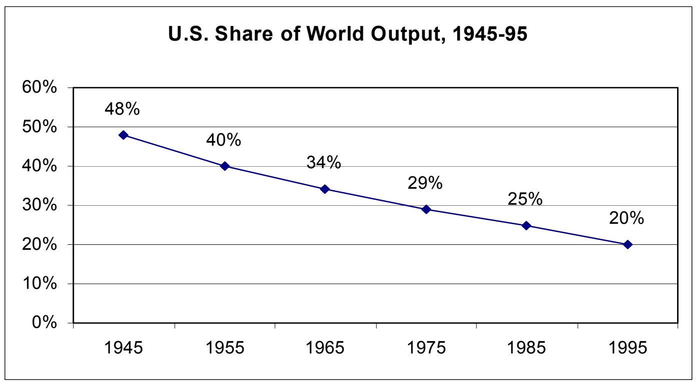
(Orders prior to fiscal year 1999)



The increased importance of foreign markets to HP is not an isolated phenomenon. The U.S. share of the world economy has declined due to faster economic growth abroad since World War II. A domestic company that limited itself to the U.S. market in 1945 would have foreclosed half the world market; today it would lose 80 percent.

The following graph illustrates this point for the whole U.S. economy.

Global economic trends



Source: Mathew J. Slaughter, *Global Investments American Returns*, 1998, p. 6.

HP has been affected in many significant ways by the high-tech recession that has lasted over three years. HP, along with many other U.S. exporters, almost certainly will lose the FSC/ETI tax benefits on exports in the near future. HP believes that one of the best ways to address the technology recession and to offset the loss of FSC/ETI would be the enactment of the international reform provisions detailed below.

The U.S. High-Tech Electronics

The technology industry has suffered a massive recession over the past three years that started with the bursting of the "NASDAQ bubble" and has accelerated with the weak business demand for technology products. We have seen overwhelming job losses in many parts of the country. This Committee heard testimony last week on the recession facing the U.S. manufacturing industry, but the technology sector has suffered a similar recession.

According to a report of the AeA (American Electronics Association) released in March of this year, the U.S. technology sector lost about 560,000 jobs in 2001 and 2002. The sector's workforce fell 10 percent to 5.15 million in December 2002 from 5.7 million in December 2001. The technology sector lost 415,000 manufacturing jobs, a 20 percent decrease to 1.62 million jobs. Total high-tech services jobs fell by 144,600, or 4 percent, to 3.52 million.

The United States Needs International Tax Reform

We believe that Congress should enact forward-looking reforms to the international tax provisions of the Internal Revenue Code that will enhance the ability of American companies to compete in global markets and emphasize the strengths of the U.S. economy. Such reforms will benefit the bottom line of our company operations, benefiting our shareholders, employees and customers, and ultimately the U.S. economy.

HP believes that the Congress is faced with an excellent opportunity to examine U.S. international tax rules and adopt a system that makes sense for our early 21st century economy. As the Committee well knows, the bulk of our international tax rules were written over 40 years ago and largely reflected a much different economy.

In 1962, the United States was the world's preeminent economic powerhouse. It did not need to consider issues of competitiveness – both for individual companies and the broader economy – as seriously as it does today.

Of the world's largest companies in 1960, 18 of 20 were U.S. corporations, and they faced less foreign competition. Today, the situation is vastly different. In 2001, only 8 of the 20 largest companies (based on sales) were U.S. corporations. U.S.-based companies face very serious competition, both at home and abroad, from foreign-based companies that frequently operate under more advantageous home-country tax rules.

Another change since 1962 is that today the United States, many believe, should worry more about its own competitiveness compared to foreign countries as an attractive place to do business and establish company headquarters. "Inversion" transactions have been of concern to the Committee in recent years. While we can all agree that these transactions should be prevented, they point to a disturbing fact: many companies view the tax ramifications of having a U.S. headquarters negatively enough that they are willing to engage in these transactions. Beyond inversions, we see a similar concern expressed with regard to cross-border acquisitions -- all too often the resulting combined business entity is foreign-headquartered, usually because of tax considerations. This matters because economic studies demonstrate that many jobs and economic opportunities follow the headquarters. Consequently, if the headquarters of a formerly U.S.-based company moves to Europe, chances are that many good, high-paying jobs and future economic activity also goes to Europe – not the United States. Furthermore, we understand that some promising U.S. start-up companies are being organized at the outset with foreign parent corporations.

The growing importance of the services sector is another major change from the early 1960s, when manufacturing dominated the U.S. economy. Today, the U.S. services sector is one of the most dynamic elements of our economy and it is where the United States enjoys a high "comparative advantage" over many foreign countries. In 2002, exports of services accounted for 30 percent of all U.S. exports. Consequently, there are real concerns about any approach to promoting U.S. exports that is limited to the manufacturing sector. HP believes that the U.S. tax laws should reflect the dominant position of our services sector and enhance its ability to compete overseas. Further, we believe the following changes would help to accomplish the goal of enhancing the international competitiveness of U.S. companies generally, and companies in the services sector specifically.

Congress Should Repeal the Foreign Base Company Rules

HP supports the reform of the U.S. international tax rules, particularly of Subpart F of the Code. HP also supports improvements to the Foreign Tax Credit rules.

The foreign base company sales income and foreign base company services income rules of Subpart F place major constraints on the ability of U.S.-based companies to operate in overseas markets – a restriction that is not shared by our foreign competitors.

Like our foreign competitors, HP centralizes its sales activities in regional hubs (for regional markets, like Europe, Asia or Latin America) within a single controlled foreign corporation ("CFC"). It is too expensive to maintain redundant operations in each of several different countries within a single geographic region. The foreign base company rules, however, impose a current U.S. tax on income earned outside the CFC's home country for transactions with a related party. [1]

The following two graphics demonstrate why companies often conduct their international activities through "base companies" or trading companies. If a company has factories and sales companies in many different countries, it would be very complex and expensive to manage all of the different transactions necessary to allow each of the factories to sell into each of the different market countries. The complexity and expense would occur because of the need to replicate the many business processes necessary to facilitate cross-border transactions. Such processes include: VAT registration and compliance, foreign currency exchange exposure management, customs declarations, export controls monitoring, invoice preparation, invoice payment, cash management, accounting, withholding tax management, and many more.

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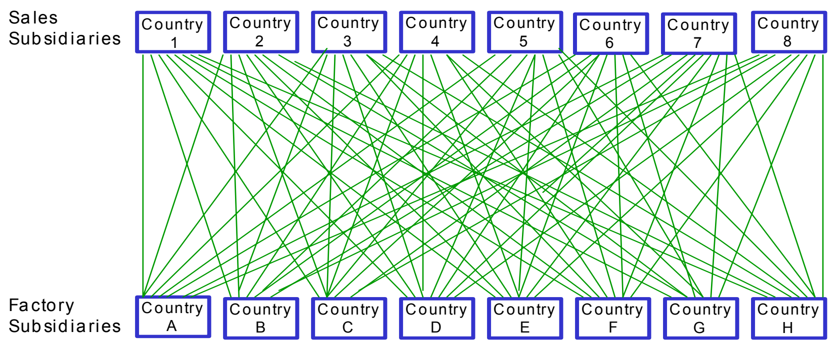
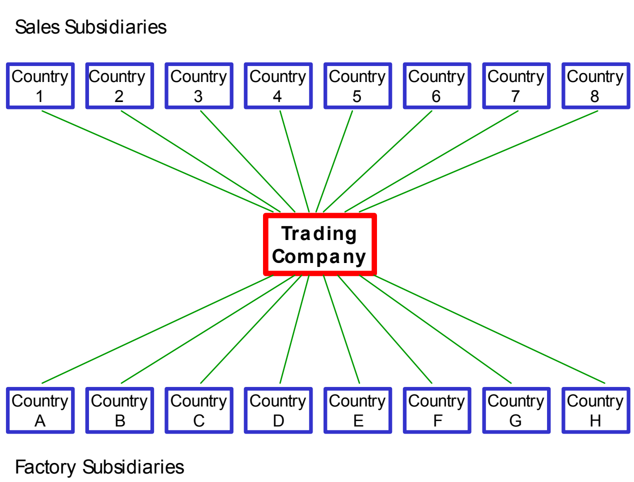
[1] FBCSI may result under when a CFC purchases personal property from anyone and sells it to a related person (or purchases personal property from a related person and sells it to anyone), if the property that is purchased is (1) manufactured outside of the CFC's home country, and (2) sold for use, consumption, disposition outside such home country. This definition of FBCSI does not apply to property that is "manufactured" by the CFC. (The technical explanation accompanying the House Report on enactment of the FBCSI provision in subpart F includes the statement that because the definition covers only transactions involving both a purchase and a sale, it does not apply to income of a CFC from the sale of a product that it manufactures. H.R. Rep. No. 1447, 87th Cong. 2d Sess. (1962); 1962-3 C.B. 405, 466.)

The capability to manage such complex transactions would need to be replicated many times over unless a trading company is used. Tremendous cost savings are achieved by placing a regional or global trading company in the middle of transactions between production centers that supply goods or services and selling entities. The simplicity of the second graphic reflects the fact that each factory can conduct its business selling to only one customer, while each selling company needs to purchase from only one supplier. Furthermore, it becomes vastly easier to add new factories or sales subsidiaries using this model. With increasing globalization, falling trade barriers (e.g., the economic integration of the EU countries and of China and Hong Kong) and improvements in technology, it is now more efficient and effective for foreign subsidiaries to conduct business on a regional or global basis than ever before.





With respect to the vast preponderance of transactions to which the Subpart F foreign base company rules apply, the transactions are between CFC's operating exclusively in foreign countries. Yet, the overly broad Subpart F rules impose current U.S. corporate income tax on such active business transactions. The U.S. approach to taxing foreign activities of U.S. taxpayers generally allows deferral of U.S. tax on active business income earned abroad. By imposing a current U.S. tax on strictly foreign transactions, the foreign base company rules place U.S. firms at a competitive disadvantage in the global marketplace.

Repeal of the foreign base company rules would permit a CFC to sell property or provide services in transactions involving related parties without generating currently taxable income. Also, the expense of complying with these complex rules would be avoided.

The original rationale in 1962 for the foreign base company rules was to prevent U.S. taxpayers from artificially shifting income into trading companies located in low-taxed jurisdictions by manipulating pricing. This concern could have arisen if one of the companies represented in the earlier graphics operated in the United States. Today, the IRS and many other country tax authorities are much more capable of enforcing the transfer pricing rules than they were when the foreign base company rules were enacted. In addition, the global enforcement of transfer pricing rules is much stronger due to better disclosure (attributable to contemporaneous documentation requirements), severe penalties, international exchange of information treaties, and Advanced Pricing Agreements between taxpayers and the Internal Revenue Service, as well as the tax authorities of other countries.

Congress Should Increase Foreign Tax Credit Carryforward Period from 5 to 10 years

Reform of the foreign tax credit ("FTC") carryover rules is needed to ensure that U.S. companies are effectively protected against double taxation. Under current law, the amount of FTC's that may be claimed in a year is subject to a limitation, so that the credit is allowed only to offset U.S. tax on foreign source income. To the extent that the amount of creditable taxes for a given taxable year exceeds the limitation, the excess may be carried back two years and forward five years.

Problems of double taxation often arise because the foreign tax treatment of items of income and expense may differ from the U.S. tax treatment. For example, the same income may arise in different taxable years for foreign and U.S. tax purposes. As a result, foreign taxes may be imposed in a year during which little or no foreign income may arise under U.S. tax principles.

The rules for FTC carryovers seek to address this problem by allowing the FTC's to be carried over from years in which foreign taxes are imposed to years in which the foreign source income arises under U.S. tax principles. Extending the period for FTC carryforwards would allow companies to offset their U.S. tax liabilities in later years when they are profitable without facing the pressure of expiring FTC carryovers. The vagaries of the economy and normal business cycles are additional factors that sometimes prevent utilization of FTC's before their expiration.

This modification would allow U.S. taxpayers that had accrued or paid foreign taxes additional time to utilize their FTC carryovers.

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

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

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

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

The United States Would Benefit by Encouraging Offshore Cash to Move Into the U.S. Economy

The Senate-passed Jobs and Economic Growth tax bill included a provision originally introduced as S. 596 by Senators Ensign, Boxer, Smith, Allen, Enzi and Bayh. It was adopted by voice vote after a 75-25 vote adopting a procedural motion on the floor to consider it. Similar bipartisan proposals have been introduced in the House.

S. 596 would, for a period of one year or less, impose a 5.25 percent toll charge on dividends or other transfers of foreign corporate earnings that exceed a company's historical average dividend flow. This toll charge would be imposed instead of the normal 35 percent tax. Any dividends taxed under the 5.25 percent toll charge would be permitted to claim only 15 percent of the foreign tax credits that otherwise would be allowed.

A recent PricewaterhouseCoopers analysis of the most recent IRS data -- for 1999 -- shows that the average U.S. tax after taking foreign tax credits into account on ordinary distributions (non-Subpart F) of foreign income was just 3.7 percent. This low effective tax rate is a consequence of U.S. tax laws that encourage companies to pay dividends from foreign companies operating in countries that subject their income to higher levels of foreign tax while discouraging payment of dividends from countries that impose lower rates of corporate income tax. Dividends from high-tax jurisdictions carry more foreign tax credits, which reduce U.S. tax liabilities on such dividends. On the other hand, low-tax foreign earnings carry few foreign tax credits, so companies have a powerful incentive to reinvest such earnings abroad rather than subject such earnings to the normal 35 percent U.S. corporate income tax rate.

In contrast to the U.S. system, many foreign countries do not tax dividends of earnings from outside their own countries. By excluding such earnings from domestic taxation, many other countries encourage the payment of such surplus foreign earnings as dividends back to those countries, where they can then be reinvested.

The structure of U.S. tax law that creates a significant incentive to leave foreign earnings offshore has in fact had a very substantial impact. Based on an examination of the financial statements of the S&P 500, a recent, independent JP Morgan study conservatively estimates that the pool of foreign earnings that has accumulated over the years and is eligible to be brought to the United States is about $500 billion. This estimate is consistent with a PricewaterhouseCoopers' detailed review of IRS tax data. Much of this accumulated foreign investment is designated for financial reporting purposes as permanently invested overseas and thus there is no expectation of any U.S. tax being paid in the future.

Enactment of the proposed temporary toll charge on dividends of foreign earnings would encourage a permanent movement of a tremendous amount of cash into the U.S. economy. The JPMorgan study estimates that about $300 billion would move from offshore to the U.S. economy. The impact of such a cash infusion would have an exceptionally powerful and positive short-term impact on the U.S. economy. If passed in the near future, the JPMorgan study anticipates:
A 1% cumulative increase in GDP growth (.5% in 2003 and .5% in 2004),
A 2-3% cumulative increase in U.S. investment during 2003 – 2004, and
A 3% reduction in corporate debt, which would strengthen corporate balance sheets and lower the interest rates on corporate bonds.

At a time when the U.S. economy, and particularly the high-tech sector, appears to be having a jobless recovery, the opportunity to generate increased U.S. investment and GDP growth should be seized upon. To demonstrate the relative significance of the incentives for growth and investment that the 5.25 percent toll charge proposal could generate, it would be useful to compare it to estimates of the economic impact of the recently-enacted Jobs and Growth Tax Relief Reconciliation Act of 2003.

Standard & Poors and Morgan Stanley Company estimated that the portion of the President's tax proposals that were enacted this year would increase GDP by about one percent in 2003. Bank of America estimated the impact at about .5 percent in 2004. Prudential Financial published a Research Report in June on the 5.25 percent toll charge proposal, stating: "We believe that a fund transfer of this magnitude would have significant macroeconomic implications, spurring growth, driving employment, stimulating domestic U.S. capital expenditures, easing the burden of under-funded pension programs, and in particular, helping hard-pressed U.S. manufacturing corporations to pay down debt and de-lever their balance sheets to better cope with deflationary pressures." The Invest in the USA proposal provides stimulus at levels similar to the just-adopted growth package, but at about 1% of the cost. This is an opportunity that we should not pass up!

A PricewaterhouseCoopers survey showed that the proposed change would result in an additional $47 billion reinvestment in the United States from just 14 companies. The funds would be used to increase domestic investment in plant, equipment, and R&D; contribute to pension plans depleted by recent declines in the stock market; reduce domestic debt loads; increase dividends that could be productively redeployed; and raise equity market valuations by increasing funds available for share repurchases.

The rate of the toll charge proposal was chosen to strike a balance between generating revenue for the U.S. and encouraging dividend payments. Based on prior revenue estimates, it is likely that modest increases in the rate of the toll charge would reduce dividend flows significantly. The 3.7 percent additional U.S. tax burden on dividends of foreign earnings to the United States (based on the PricewaterhouseCoopers study referred to above) is very close to the current corporate cost of funds to borrow. Hence, if the toll charge rate were increased above the proposed level of 5.25 percent, less investment in the United States would be stimulated. In addition, state income taxes and withholding taxes at source also increase the tax burden on dividends.

To encourage immediate economic stimulus, the reduced rate of tax would be effective for the first taxable year ending 120 days or more after the date of enactment. Thus, for example, if the bill was enacted on August 25, 2003 and the electing taxpayer is on a calendar year, the bill would apply to the taxpayer's taxable year ending December 31, 2003. To the extent that this proposal would be included in future legislation to be acted upon by this Committee, I would encourage the Committee to select effective dates that maximize the economic benefit in the near future in order to encourage the maximum amount of U.S. reinvestment as quickly as possible, while allowing companies sufficient time to plan for the movement of substantial amounts of cash in an orderly way.

Conclusion

I appreciate the opportunity the Committee has given me to share HP's views on possible changes to the U.S. income tax laws that apply to the foreign activities of U.S.-based taxpayers. The long-term international competitiveness of U.S. companies could be improved if the cost and complexity of the foreign base company sales income and services income provisions were removed from Subpart F of the Internal Revenue Code, and other international tax reforms adopted. In the short run, passage of the Invest in the U.S.A. Act of 2003 would act as a powerful stimulus to the U.S. economy. We encourage the Committee to pass legislation that includes both of these elements.