Tax Foundation Seminar Proceedings

Assessing U.S. Tax Policies Toward International Investment: An Opportunity for Change

Edited and with an Introduction by

John McGowan, Ph.D., CPA

The Tax Foundation

Tax Foundation Seminar Proceedings

Remarks by the Honorable Hank Brown

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Tax Treatment of U.S. Investment Abroad

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Tax Treatment of Foreign Investment in the U.S.

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FOREWORD

It is one of the Tax Foundation's guiding principles that the U.S. tax system should not impede the free and fair flow of goods, services, and capital. It should not penalize exports and U.S. investment abroad, nor should it adopt policies which restrict imports and foreign investment in the U.S.

Globalization of international trade and inter-dependencies across national borders are really the dominant characteristics of today's business arena. It is increasingly important, therefore, for federal taxation to be even-handed in respect to those transborder transactions.

With the unprecedented expansion of business opportunities and competition, we think it may well be time to re-think many of our tax policies towards international investment. Today, unfortunately, the U.S. has the most complex system in the world for the taxation of international operations. No other country even comes close. If we are to reap the benefits of global economic expansion, tax policies must allow international investment to flow freely across borders.

The Foundation has greatly expanded its research into the tax treatment of international investment. A recent Tax Foundation seminar examined the tax policies toward research and development because the U.S. level of expenditures on R&D has fallen far behind those of our major trading partners.

On September 25, 1990, the Tax Foundation held a seminar entitled "Assessing U.S. Tax Policies Toward International Investment: An Opportunity for Change" to examine the problems for tax policy in this area and to propose viable solutions. It also served as a forum for tax policymakers in the public sector to voice their concerns, and for private sector experts, in turn, to remind them of the economic and practical consequences of tax provisions which affect both the foreign earnings of domestic multinationals and the earnings of foreign-owned businesses operating in the U.S.

Instrumental in putting together the program were James Q. Riordan, co-chairman of the Tax Foundation, along with Bob Hannon and Glenn White, co-chairmen of the Tax Foundation's Program Committee. The Foundation's special thanks go to Dr. John McGowan, professor of accounting at St. Louis University, for editing the proceedings and contributing the introduction. The publication of these proceedings will bring these important viewpoints to a wider audience, promoting understanding of this critical issue.

Wayne Gable
President

INTRODUCTION

As the business climate becomes increasingly global and interdependent, the strength of the U.S. economy is more and more dependent on the efficient international flow of goods, services, and capital. Federal tax policy plays an important role in shaping international trade and investment decisions and economic competitiveness. Therefore, the Tax Foundation saw the need for promoting a greater understanding of federal tax policies toward international investment and provided an objective forum with a seminar entitled "Assessing U.S. Tax Policies Towards International Investment: An Opportunity for Change."

The taxation of international transactions can be divided into two major parts: Americans operating overseas (outbound transactions) and foreigners operating in the United States (inbound transactions).

The first part of this seminar is about Americans operating overseas. When American businesses decide to operate overseas, their overwhelming choice of form is the foreign subsidiary. When these subsidiaries earn income in the foreign jurisdictions, they usually pay a foreign tax. The international tax rules of the United States provide for a foreign tax credit for these taxes paid to foreign governments. However, the U.S. imposes numerous limitations on creditable foreign taxes.

The U.S. international tax rules also provide generally that a U.S. tax is not levied on foreign earnings of a U.S. subsidiary unless they are repatriated to the U.S. parent in the form of dividends. Exceptions to this general rule of deferral occur in the following cases: Subpart F income, and passive foreign investment companies (PFICs). These areas of international taxation give rise to various controversial issues. Many of these issues are discussed by the speakers in the first half of this seminar.

The two panels of this part were chaired by David M. Crowe, Partner in Caplin & Drysdale and Robert N. Mattson, Assistant Treasurer for IBM, both of whom provided articulate panel discussions. Raymond Haas, International Tax Partner for Ernst & Young; B. Anthony Billings, Professor of Accounting at Wayne State University; and Richard M. Hammer, International Tax Partner, Price Waterhouse provided an excellent overview of some of the problem areas in the international taxation rules for U.S. multinationals. Murray Schlussel, Assistant General Counsel - International Tax for Ford Motor Company, and John F. Brussel, Tax Director - International for AT&T, related how their firms have experienced difficulties complying with the U.S. tax rules of international taxation. Additionally, Peter A. Barnes, Deputy International Tax Counsel for the Treasury, provided some insight into these rules from the perspective of the Treasury Department.

The second session examined the tax treatment of foreign investment in the U.S., or inbound transactions. American individuals and corporations have long explored other parts of the world seeking financial gains and opportunities. But the movement of foreign capital here is of more recent vintage. As a consequence, the advising of foreign investors is now a larger component of American practitioners than ever before. The sheer size of the U.S. market makes it attractive to foreign investors. As a result, foreign persons - and their money - seem destined to play an ever larger role in our economy.

The very participation of foreigners on such a large scale has inevitably sparked the interest of U.S. fiscal authorities, and now through the media, politicians and the general public have become involved. The Treasury is concerned that these foreign-owned U.S. companies are avoiding U.S. taxation by using, or abusing as the case may be, the transfer pricing rules. Recent proposals have also included various information reporting rules for U.S. affiliates of foreign-owned companies. More recent bills have included the proposal to tax non-resident aliens and foreign corporations on their disposition of stock in U.S. companies.

The two panels for this session were chaired by Robert Ashby, Assistant Vice President, Taxes for Northern Telecom Inc. and John G. Wilkins, Partner for Coopers and Lybrand. Both of these panels provided a stimulating and enjoyable discussion of the taxation of foreign investment in the U.S.

An overview of inbound foreign investment issues was provided by former Attorney General Elliot Richardson, now senior resident partner in the Washington, DC office of Milbank, Tweed, Hadley & McCloy, and chairman of the Association for International Investment.

Virtually all six of the speakers on these panels agreed that the U.S. should be careful if it initiates massive changes in the way foreign-controlled U.S. corporations are taxed. Congressman Philip Crane (R-IL), House Ways and Means Committee, Peter A. Barnes, Deputy International Tax Counsel for the U.S. Treasury, Bruce R. Bartlett, Deputy Assistant Secretary for Economic Policy for the U.S. Treasury, and Harrison J. Cohen, Legislation Counsel for the Joint Committee on Taxation, provided the perspective from either the Congress or Treasury. James M. Carter, Senior Tax Counsel, ICI Americas, and Catherine T. Porter, partner in Miller & Chevalier, Chartered, spoke on foreign direct investment in the U.S. from the vantage point of having somewhat of an advocacy role for these companies. Finally, speaking as a representative of the country with the largest amount of foreign direct investment in the U.S., Richard Pratt, Economic Counsellor of the Embassy of Great Britain, stated that foreign investment in the U.S. should be viewed in a positive light.

On a personal note, I enjoyed the process of editing these presentations and attending this seminar sponsored by the Tax Foundation.

John McGowan, Ph.D., CPA
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St. Louis, Missouri

John R. McGowan is Assistant Professor of Accounting at St. Louis University, where he teaches courses in taxation and managerial accounting. He received his Ph.D. in Economics/Taxation from Southern Illinois University in 1988. Dr. McGowan is the author of numerous research publications and articles on taxation including: "How U.S. Corporations Can Reduce Their Overall Tax Burden: The Effect of Private Letter Ruling 89029," which appeared in *The CPA Journal*, July 1990; "A Comparison of Partnerships and Subchapter S Corporations After the Tax Reform Act of 1986," with D. Joy, which appeared in the *St. Louis University Law Journal*, Volume 33, Issue 4, 1989; and "Passive Foreign Investment Companies and TAMRA (Technical Amendments and Revenue Act of 1988," which appeared in *Business and Tax Planning Quarterly*, Volume 5, Number 3, 1989.

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Peter A. Barnes is Deputy International Tax Counsel for the U.S. Department of the Treasury. Mr. Barnes received a B.A. from the University of North Carolina and a J.D. from Yale University Law School. He clerked for the Honorable Gerhard A. Gesell of the U.S. District Court for the District of Columbia Circuit from 1980-1981, and was an attorney in the Washington Office of Hughes, Hubbard & Reed from 1981-1986.

Bruce R. Bartlett is currently Deputy Assistant Secretary for Economic Policy (Policy Analysis) at the U.S. Department of the Treasury. Before joining Treasury, he was a Senior Policy Analyst in the Office of Policy Development at the White House and from 1985-1987 he was a Senior Fellow at the Heritage Foundation. Mr. Bartlett holds an M.A. from Georgetown University and a B.A. from Rutgers University.

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Hank Brown is a Republican member of the United States House of Representatives from the State of Colorado. He is serving his fifth term, to which he was elected with a 73 percent majority. He serves on the House Committee on Ways and Means. Congressman Brown received his B.S. from the University of Colorado, his J.D. from the University of Colorado, his Masters of Law from George Washington University and has passed the CPA exam.

John F. Brussel directs the AT&T International Tax Department. Previously, he was the Senior International Tax Attorney at Westinghouse Electric Corporation. Before that, he was a tax attorney with Ingersoll Rand and also with the Office of Chief Counsel of the IRS. He holds a B.B.A. from the University of Wisconsin, a J.D. from Fordham University School of Law and an LL.M. from Georgetown University Law School.

James M. Carter is the Senior Tax Counsel at ICI Americas. He also serves as the Secretary of the Organization for Fair Treatment of International Investment. Mr. Carter holds an LL.B. from the University of Virginia Law School.

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Philip M. Crane (R-IL) is serving his eleventh term in the United States House of Representatives. He is the third ranking Republican on the Ways and Means Committee with jurisdiction over energy, taxes, trade, Medicare, welfare reform and Social Security. He is the Ranking Minority Member on the Trade Subcommittee and is a member of the Health Subcommittee. Congressman Crane holds a B.A. degree in psychology and history from Hillsdale College and an M.A. and Ph.D. in history from Indiana University.

David M. Crowe is a Partner at Caplin & Drysdale in Washington, D.C. Prior to joining Caplin & Drysdale, he was an attorney in the Office of the International Tax Counsel at the Treasury Department where he served as Associate International Tax Counsel from 1987-1989. He holds a B.A. from the University of Virginia, an M.Sc. from the London School of Economics, and a J.D./M.P.P.M. from Yale University.

Edward M. Graham is Senior Research Fellow at the Institute for International Economics. He has served on the faculties of Duke University, the University of North Carolina, and the Massachusetts Institute of Technology, and has also held positions at the U.S. Department of the Treasury and the Organization for Economic Cooperation and Development. He is coauthor (with Paul Krugman) of the acclaimed book Foreign Direct Investment in the United States. He holds a bachelor's degree from MIT and master's and doctoral degrees from Harvard University.

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Richard M. Hammer is International Tax Partner at Price Waterhouse and is the Tax Committee Chairman of the U.S. Council for International Business. He also chairs the Tax Committee and the Fiscal Committee of the U.S. Business and Industry Advisory Committee to the OECD. Mr. Hammer received his B.A. from Princeton University and his M.B.A. from Harvard Graduate School of Business Administration.

Robert N. Mattson is currently Assistant Treasurer of IBM Corporation at Armonk, N.Y. Previously, he held the positions of director of taxes, corporate tax counsel, and director of planning and development. He received a B.S. in Economics from the University of Pennsylvania's Wharton School of Finance, an LL.B. and LL.M. in taxation from New York University School of Law and worked toward a Ph.D. in International Economics at New York University.

Catherine T. Porter is a Partner with the law firm of Miller & Chevalier, Chartered. Previously, she was the Tax and Trade Legislative Aide to United States Senator John H. Chafee (R-RI), Assistant Counsel to the Subcommittee on Oversight of the House Committee on Ways and Means, and Tax Counsel to the House Committee on Small Business.

Richard Pratt is the Economic Counsellor at the British Embassy in Washington, D.C. Previously with HM Treasury in London, he worked in a variety of economic and administrative posts which included the coordination of the annual UK Budget presented by the Chancellor of the Exchequer and the planning and control of public expenditure. He has also worked as a Press Officer in 10 Downing Street.

Elliot L. Richardson is the Senior Resident Partner in Washington Office of Milbank, Tweed, Hadley & McCloy. Previously, he was the Secretary of Commerce, the Attorney General of the United States, Secretary of Defense, Secretary of Health, Education, and Welfare and the Under Secretary of State. Mr. Richardson holds an LL.B. from Harvard Law School and an A.B. from Harvard College.

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Keynote Address

The Honorable Hank Brown
United States Representative from Colorado
Member, Ways and Means Committee

I thought I would share a few thoughts quickly on the surprises that are likely to be part of the budget package. Certainly taxes are part of that mix.

One of the top items that appear to be included in the agenda is the Chairman of the Ways and Means Committee's suggestions with regard to taxing foreign subsidiaries. It is not a new area; many of you are experts in it and are familiar with it. But the major focus that seems to be the point of discussion is a question about the pricing policies used between a parent and a subsidiary; or more precisely, the pricing policy of taxing items that are transferred from out of the country, imported into the country, or vice versa.

The question is whether those pricing mechanisms are appropriate or whether they serve to transfer the recognition of gain out of one jurisdiction into another. It is very difficult to audit.

Secondly, it is very difficult to defend yourself on a transfer, even if it is totally legitimate. When I used to work for a living, I worked for a company called Monfort. We were in the cattle business. We had a feed lot division, the world's biggest cattle feeding operation, and several packing plants. The feed lot management was always convinced that we sold the cattle too cheap to the packing plant. The packing plant was likewise always convinced that they paid far too much for those cattle. That is a phenomenon that is not unusual, and it exists in many businesses that import and export products. So, it is not a simple matter. But it is serious when the major focus of the Ways and Means Oversight Subcommittee of Congress has been to suggest that mispricing exists and is a major source of loss of revenue.

There is a variety of things that the chairman is suggesting have a chance of being put in the bill, but I think many of them follow from the findings of the Oversight Subcommittee. And there was a suggestion by the Oversight Subcommittee chairman that indeed transfer pricing is a major villain, at least in terms of loss of revenue. The Administration does support Chairman Rostenkowski's portion of the bill that involves additional reporting requirements.

Reporting is basically meant to be an auditing tool as well as an informational tool. Additional reporting is very likely to be a part of any bill. It is not clear, however, that any revenue number will be attached to the suggestion for additional reporting requirements.

The Administration does not support the section of the bill that involves taxing the capital gains of foreigners and extending the statute of limitation for foreign-owned U.S. subsidiaries. In other words, the suggestion that you heard about the tax on capital gains and the sale of that stock and other taxes is opposed by the Administration. That does not mean, though, that if that is included in the package that they will necessarily veto the bill. I suspect that if the Administration signs off on the package from the summit, it is quite likely to include a number of things they do not like, yet they would be in a position of having to sign off on it. They may not like the whole package, at least one hopes they will not like the whole package.

The Commerce Department has testified on this as well. They, I think, have likewise supported the information reports but do express concern about the taxing of the subsidiaries' stock.

What is likely to happen? Many of you, I think, are firmly convinced that logic and thoughtful reasoning are the guiding forces in the development of tax policy. For those of you that think that, I hope you will come and observe some of our deliberations.

I must tell you that I am convinced, particularly in the foreign taxation area, those have not been the guiding hallmarks. I think it is quite likely that something dealing with foreign taxation will be included within a budget package/tax package, if indeed one is concluded. I think it is likely you will have a package, and I think it is also likely you will have something on foreign taxation included.

At a minimum, my guess is that you will see the additional reporting requirements. Also, I think there is a 50/50 chance that you could see a provision for the tax on the foreign transfer of ownership added.

But over and above that, I think this is an area where you will see additional legislative attention in an effort to come up with new provisions to deal with it. Quite frankly, part of the problem here is that it is difficult to know if the transfer pricing is correct, from both an internal and an external point of view. It is also very difficult to come up with a solution.

Issue Overview

Dr. Edward M. Graham
Senior Research Fellow
Institute for International Economics

Edward Graham, senior research fellow at the Institute for International Economics, begins his overview by noting the rapid growth of foreign direct investment in the United States since 1975. He raises the question of whether or not this is a good thing. On the one hand there is a fear of losing our economic sovereignty as a result of foreign ownership of U.S. assets. The alternative of foreigners pulling their funds out of the U.S. in these days of massive budget deficits could be much worse.

The second issue raised by Dr. Graham is the effect of foreign control in the United States economy. There are numerous ways to measure foreign ownership. Of the whole economy, foreign ownership of non-financial corporations amounts to 14.7 percent. Foreign ownership can also be measured as a percentage of manufacturing assets owned by foreign-controlled affiliates. Similarly, foreign ownership can be measured as a percentage of manufacturing sales or as a percentage of the work force employed by foreign-owned affiliates. Dr. Graham believes the most important indicator of foreign ownership in the U.S. economy is the percentage of the gross national product contributed by foreign investors. In 1987, this percentage was only 3.4 percent.

Dr. Graham points out that when compared to the three major European economies, the U.S. has the lowest degree of foreign control. France, Germany and the U.K. all have high degrees of foreign ownership in their economies. In striking contrast to these is the economy of Japan where only a miniscule fraction of the economy is controlled by foreign investors.

Next, Dr. Graham asks whether a high or low degree of foreign ownership provides the host country any advantage in international economics and business. Two conflicting schools of thought are provided to answer this question. Regardless of which school one accepts, Dr. Graham suggests the implications for U.S. policy are that the U.S. should do nothing to discourage either inward or outward investment.

Dr. Graham notes that the rate of penetration of Europe by U.S. and especially Japanese corporations is proceeding at an enormous rate. Interestingly, most European governments seem to be encouraging rather than discouraging the Japanese in this trend.

Finally, Dr. Graham suggests some broader themes for discussion in the ensuing talks. First, the Japanese market does seem to be opposed to inbound

foreign direct investment. This is not viewed in a positive light. Second, should U.S. tax policies be changed in a way that would discourage foreign direct investment in the U.S.? Dr. Graham thinks not. Third, should tax policy provide either incentives or disincentives for the extension of U.S. firms' activities overseas? Again, Graham is opposed, preferring a more neutral government policy.

Certainly the big story in terms of globalization of business during the last decade has been the increased participation in the U.S. by foreign firms. Maybe the biggest surprise is what Chart 1 on page 62 shows regarding foreign direct investment flows into the United States from 1975. A couple of things stand out, one of which is that from 1980 to 1984, these flows actually subsided, but from 1984 through just last year the rate of foreign direct investment in the United States expanded at a dizzying pace. This has, of course, resulted in all sorts of consternation in the U.S. Congress and elsewhere, which can be summarized in one question: Are we losing our economic sovereignty? The 1990 figures suggest that there is just a chance that the issue is going to change. In the past year the issue has been, "Who is selling the heritage of the United States?" The implication is that foreign direct investment is creating some sort of economic crisis within the United States. Wait until congressmen find out what will happen if foreigners pull their funds out of the United States in the wake of the current budget deficit. Such a pullout could be a really big story coming up. The future story could be, not the increase in foreign direct investment, but the lack thereof.

How extensive is foreign control in the United States' economy? This is a tough issue to get a handle on. Let us just take a very quick look at some indicators of the extent of this control. Foreign direct investment is an equity concept. One way of judging the role of foreign direct investment in the United States, relative to the whole economy, is to examine foreign direct investment as a percentage of the total net worth of non-financial corporations. This figure is a fairly high 14.7 percent, by the latest data. That is a significant amount of foreign control in the U.S. economy (See Chart 2 on page 63).

Assets of foreign-controlled manufacturing affiliates as a percent of all assets in the manufacturing sector is 13.9 percent, while sales of foreign-controlled manufacturing affiliates is 14.7 percent. However, when you look at employment of foreign-controlled affiliates as a percentage of all U.S. employment, the figure drops to 4.0 percent, and indeed if you ask how much as a percentage of the gross national product is value-added by foreign direct investors in the United States, this figure was only about 3.4 percent in 1987. It has gone up a little bit since then.

Why the discrepancy between the high and low figures? Probably the main reason is that foreign direct investment is concentrated in certain sectors of the U.S. economy, primarily the manufacturing sector, but other sectors as well. The service sector, with the exception of banking, is largely untouched by foreign direct investment.

One of the things that has amused me is that those people who want the public to get alarmed about foreign direct investment tend to pull out the high percentages from Chart 2, while those people who want to minimize this problem tend to pull out the low figures. All the figures are perfectly accurate and legitimate. But of course, what the panoply of figures suggests is that there's plenty of scope for "lying with statistics" on this issue. What is the true extent of foreign control in the U.S. economy? Personally, I think the value-added number is probably the most accurate overall indicator.

International business is becoming global, and one very important issue is: How does the extent of foreign control in the U.S. economy compare to foreign control in other major economies. What we can see, looking only at the manufacturing sector, is that the extent of foreign control in the United States actually is considerably lower than in any of the three major European economies by several measures. France is a country where there has also been significant grassroots reaction against foreign control in the economy. Somewhat surprising to many people is that foreign control in Germany by the sales measure is significantly higher than the United States, although somewhat lower by the employment measure. I think the discrepancy is accounted for by the concentration of foreign direct investment in Germany in rather capital-intensive kinds of activities such as chemicals. The United Kingdom is a similar story. The case of Japan stands out because the extent of foreign control in the Japanese economy, at least as of 1986 (and I don't think it has changed a whole lot since then), is extraordinarily low.

One thing that is reasonable to ask is, "Does foreign control really make a difference?" So what if Japan has a lower degree of foreign control, while the other of the G-5 have relatively high degrees of control? So what if in the last couple of years foreign control in the U.S. economy has reached levels approaching those of the European countries? There are really two conflicting schools of thought on these issues. One school of thought is represented by the thinking of Harvard University Business School Professor Michael Porter, a name that has come to be widely recognized. Porter believes that the advantages of firms are deeply rooted in the culture and economies of the home countries of those firms. What Porter would argue is that many of the Japanese firms' advantages in the international business place come from factors that are intrinsic to the Japanese culture and the Japanese economy.

What is interesting is that Mr. Kenichi Ohmae, who is a partner of the U.S.-based consulting firm, McKinsey, but himself a Japanese national, has become the most prominent challenger of that position. Mr. Ohmae maintains that in today's world, the competitiveness of a firm is not determined by any one country, but rather by the network of countries in which that firm has major operations. In Mr. Ohmae's view, Japanese firms do not have any particular advantage by virtue of having been rooted in Japanese culture.

What I would like to do is throw one card on the table and to suggest to Mr. Ohmae, "No, I don't think you are entirely correct on that one." Because Japan's foreign direct investment position is so asymmetric, even if the competitive position of a firm is determined by its global network of affiliates, it would appear that Japanese firms are participating in all of France, Germany, the United Kingdom and the United States, but that relatively few U.S. and European companies are in a position to compete effectively in Japan. So there is an asymmetry that exists there in Japanese versus other firms' global networks.

What does this mean for U.S. policy? I would suggest the following: I would suggest first that whether you believe in the Porter perspective or whether you believe more in the Ohmae perspective, U.S. policy should do nothing to discourage either inward or outward investment. If indeed advantage flows from the Japanese culture, one conduit by which those advantages can come into the United States is through Japanese foreign direct investment in the United States. Those who maintain that Japan is running past the United States are not being entirely consistent when they issue calls to keep Japanese industry out of the United States. To do so just doesn't make any sense at all. Japanese industry in the United States will serve as a conduit by which some of the advantages of Japanese firms will flow into this economy. Incidentally, it should flow not just to U.S. subsidiaries of Japanese firms, but to domestically owned firms as well.

But neither should we want to do anything to discourage U.S. outward investment. Indeed, U.S. multinationals operations overseas still can be a source of strength to the U.S. economy, although perhaps more so under Ohmae's scenario than Porter's. Benefits from participating in overseas economies can be transferred into the United States by U.S.-based multinationals.

What is absolutely clear, however, is that there is a major argument to be made for a further opening of the Japanese market to participation by foreign firms; this is true no matter which set of reasoning — Porter's or Ohmae's — you accept.

I shall further note two things. The first is if flows of foreign direct investment are down in the United states, what is happening elsewhere? Are they down elsewhere? The answer is no, they are not, particularly not in Europe. In Europe the rate of penetration of the local economy by Japanese corporations is proceeding at rapid rates and incidentally is generating right now some of the same tensions that foreign direct investment has generated in the United States. Nonetheless, the policy of most European governments is to encourage the Japanese investment rather than to discourage it, with some minor exceptions.

If the Japanese are running wild in Europe, so are U.S. firms, at least by one important measure. Growth of formation of fixed capital in Europe has significantly outpaced the growth of national product, the reverse of what has been true in the United States during this same period. But real capital expenditure by European affiliates of U.S. firms has grown still faster. Indeed if you were to look at any one set of actors in the European economy that is responding to Europe's 1992 initiative, that set of actors would be the local affiliates of U.S. firms, even more than Japanese firms.

My job is simply to raise a few issues. To summarize, let me suggest all of the following: 1) The Japanese market does, in fact, seem to be closed to foreign direct investment. Is that good or bad? I suggest that it is bad.

Secondly, U.S. policies, especially tax policies, should not be set to discourage foreign direct investment in the United States. In particular, in response to alleged tax abuses by foreign firms, we should avoid fixes that run the risk of discouraging foreign direct investment at a time when it is already falling.

Finally, tax policy should give neither incentive nor disincentive to the extension of U.S. firms' activities overseas.

SESSION ONE

Tax Treatment of U.S. Investment Abroad – Panel 1

Panel Chairman: David M. Crowe
Partner
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Raymond Haas
International Tax Partner
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Murray Schlussel
Assistant General Counsel - International Tax
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Peter A. Barnes
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David M. Crowe

We are going to talk about two very different sorts of issues today, one of which I have called administrative issues — the other, core policy issues.

With respect to administrative issues, there are a number of statutory provisions and regulations that were never scored for revenue when enacted. Nobody really thought a whole lot about what they meant, what they implied, or that people would have to comply with them. They have turned out to be quite an irritant to corporate management; the things that Congress and Treasury could easily fix if they wanted to, wouldn't cost much money to fix, and every multinational has a laundry list of little things they would like to have fixed — administrative issues — simplification issues.

I would like to give you my favorite as an example of that first type of issue and that is the rule for translating foreign taxes paid by foreign subsidiaries of U.S. companies. Before the 1986 Tax Act there was a relatively simple rule called the Bon Ami Rule, named after an old tax case involving the cleanser, for translating foreign taxes. Basically you took the foreign taxes that the foreign subsidiary paid and the earnings of that subsidiary and you translated them into dollars at the same rate and on the day that these earnings were distributed back, you paid a dividend. You had a spot rate and the dividend rate translated both taxes and earnings.

A simple rule — it always worked and nobody complained about it.

In 1986 Congress changed it. There was a conceptual debate, which I won't go through, about how we ought to credit foreign taxes, but the bottom line is the rule was changed. Earnings were still translated at the spot rate; the dividend comes back when your foreign subsidiary pays a dividend back to the U.S. and you translate those earnings at the spot rate into dollars. Taxes are now translated at the historic rate — the rate in effect on the date the foreign taxes were paid to the foreign jurisdiction. It is a payment-by-payment rule. It has created an enormous administrative headache for many U.S. multinationals.

As I said, I won't go into the policy reasons behind the change. It is something about which reasonable people can differ, but I think it is fair to say that it has had an effect that is at the very least an irritant to many U.S. multinationals.

There is no core policy issue at stake in an administrative issue like that. This issue of what rate you translate the taxes at, along with a number of other issues, is in a package that is up on the Hill now, a simplification package, and I think perhaps we can get Peter Barnes to comment at the end on the likelihood of getting some sort of relief with respect to this first type of issue — the administrative issue.

The second type of issue we are going to talk about is basic policy issues that go to the core of U.S. international tax policy. For example, the rules for crediting foreign taxes and specifically the separate baskets. When is it appropriate for the United States to permit a credit for a tax paid with respect with tax on one item of foreign income to offset U.S. tax liability on another item of foreign income? That goes to the core of what the foreign tax credit does.

More importantly, and particularly in this budget environment, it costs money to change those core policy issues. Obviously simplification proposals and the administrative issues are going to be easier to get through Congress, easier to get Treasury to sign on to, but we shouldn't lose sight of the core issues. It is important to continue that critical debate, and Raymond Haas will begin the panel with a presentation on these core policy issues.

Raymond Haas

Raymond Haas, International Tax Partner for Ernst & Young, offers the tax practitioner's perception of the tax treatment of U.S. multinationals. Mr. Haas starts by providing a summary of a previous study he authored, entitled "The Competitive Burden: Tax Treatment of U.S. Multinationals." The study concluded that the tax laws of the Netherlands, Germany, and Japan put companies based in those countries in superior competitive positions vis-a-vis their U.S. counterparts.

According to Mr. Haas, an important factor in this competitive disadvantage is that only the U.S. system disallows tax incentives offered by developing nations to multinational investors. Another problem is the foreign tax credit mechanism, which winds up creating instead of preventing double taxation. In addition, frequent changes in U.S. tax law have made it difficult for companies to effectively plan and administer their international tax compliance.

After the original study, Mr. Haas looked at an additional seven countries in a more cursory fashion and has arrived at a similar conclusion: U.S. multinationals have been put at a competitive disadvantage as a result of the tax rules with which they must comply.

Mr. Haas provides numerous examples of these problems: the absence of a U.S. tax sparing credit, the inability of U.S. companies to cross-credit income and taxes from foreign operations, the rules for expense allocations, and loans from foreign affiliates.

About two and a half years ago we published "The Competitive Burden: Tax Treatment of U.S. Multinationals." What it did was compare how four leading capital exporting nations taxed the international operations of their domestically based companies.

Let me start off by summarizing our conclusion. It was very simply that the tax laws of the Netherlands, Germany and Japan were competitively superior for companies in those countries vis-a-vis the U.S. tax laws applicable to U.S.-based multinationals. There were two primary reasons for that conclusion.

The first one was that the U.S. tax system, but not the systems of the other three countries, overrode and took back the incentives that foreign countries, particularly developing nations, gave to developed nation companies for investing in those countries.

Secondly, the U.S. tax system unfortunately winds up not limiting double taxation by virtue of the foreign tax credit mechanism, but actually, in my opinion, creating double taxation. That is to say, with respect to U.S. companies that have foreign operations that are taxed at a 34 percent rate in a foreign country, taking a general picture of that sort of a company, it is likely there will still be some residual tax when those earnings are brought to from the United States, thereby making a worldwide tax rate of something in excess of the U.S. rate.

Was the 1986 Tax Reform Act the standalone culprit? I would answer that it was not. The laws for the last 25 or so years have been pointing in this direction, getting more and more technical. In addition to the pure policy points, one other thing that deserves mention and perhaps Murray will comment on it in his remarks on administrative issues, is that the rate of change, both legislatively and administratively is a) tough to keep up with, b) destroys your confidence if you think you know what the rules are, and c) makes planning generally very difficult. I think that as a policy matter, even though this complexity is not a substantive issue, it is itself damaging to the competitiveness of U.S. companies.

We chose the comparable countries of Japan and Germany because I think they are perceived as our primary competitors. We chose the Netherlands for two reasons: (1) it also has many leading multinationals such as Unilever, Shell, and Phillips; and (2) it has a system that is diametrically opposed to the U.S. system vis-a-vis international operations. It basically has a territorial system allowing the foreign countries to tax foreign operations and then letting alone the income that comes back to the mother country.

Was the deck stacked by just picking these three countries? We didn't think it was originally and we concluded to our satisfaction subsequently that it was not. We looked at an additional seven countries in a more cursory fashion than we did in the original study. For the U.K., Canada, Australia, Italy, Switzerland, France and Belgium, and most of the other major capital exporting nations, our conclusions stick.

The U.K. has a tax rate that is approximately the same as the United States; we are 34 percent, they are 35 percent. But they have a much different system: (1) you can mix the foreign taxes coming from different parts of the world and different sorts of operations by having what they call a mixing company. We are not allowed to have that. (2) They do, as a policy, enter into tax sparing treaties with developing nations.

With respect to Canada and France, their systems are similar to Germany's. That is to say that with respect to foreign operations conducted in the treaty countries, it is basically an exemption or territorial system, and with respect to Switzerland and Belgium, it is very similar to the Netherlands and all three countries basically have an exemption system on a worldwide basis and also do not have the antideferral rules that the United States has.

Let me just use two examples to illustrate the two primary problems I indicated earlier (See pages 71 - 73).

Singapore, a developing nation, welcomes the introduction of capital and the employment of its people by, among other things, offering a tax holiday. That is a fairly common phenomenon in many countries throughout the world. The question is, what happens to the companies from these four countries that set up the identical operation in Singapore. The basic facts are that there is a $10 million investment; there is one million dollars of earnings, and Singapore says, "No thanks, we are not going to tax you — we appreciate your bringing business here and employing our people."

If you look at Line B, it says statutory tax rate. By the way, the Japan column should read 51 percent. It used to be 56 percent. Japan has reduced their rates to 51 percent. But if you look at that row, you will see that the statutory tax rate is by far the lowest in the United States. Then you look at lines C, B and E, and you come to a radically different answer. You see that in Germany and the Netherlands, there is no tax paid in either of those two home countries, even though the dividend is paid back there.

Secondly, in the case of Japan, even though its tax rate is 51 percent, the tax paid is actually 19 percent. But why do we have these results?

Basically Germany and the Netherlands have a territorial system, in the case of Germany by treaty and in the case of Netherlands by its internal law. Just say Singapore has the right to tax income — if it doesn't, we are not going to tax it when it is brought back to the parent company.

The U.S. and Japan have worldwide systems with foreign tax credit to offset, by way of double tax, the tax paid abroad. Note that in Japan there is a $320,000 foreign tax credit. How can that be when in fact there is no tax paid to Singapore? The answer is, as a policy matter, Japan has seen fit to encourage investment by its corporations in Singapore and gives a tax credit. A so-called tax sparing credit spares Japanese tax on the tax that could have been levied by Singapore but was not because it was trying to encourage development and because Japan has a treaty with Singapore.

It is fair to ask why U.S. policy penalizes a U.S. company that actually repatriates these earnings back to the United States by levying the 34 percent tax. Presumably the remittance helps the balance of payments and helps to offset the drag in trade deficits in the overall balance. Secondly, repatriated profits would seem to add to the capital pool available to expand our productivity in the United States. That is the first example. Again, the principle here is that the U.S. overrides the incentive granted by the foreign country.

In the second example you have a U.S. multinational that has two foreign operations (See page 72): a 100 percent owned foreign subsidiary and a 49 percent investment in a foreign company. First of all, the reason they have 49 percent may not be voluntary. It may be that the foreign country precludes a higher degree of ownership. Secondly, the 49 percent owned operation and 100 percent owned foreign operations are engaged in the identical business activity. Thirdly, there is no passive income involved here — it is pure business. If you look at the top half of page 72, what you see is that the foreign subsidiary is subjected to a 53 percent tax rate and the 49 percent owned company is subjected to a 15 percent tax rate. Conveniently those average out to 34 percent. The point is that the aggregate foreign tax incurred on this foreign business activity is 34 percent — 53 percent in one case and 15 percent in the other case. They are all business activities, they are not passive, etc. The question is, if both these operations distribute all their profits back to the U.S. owner, is there any residual U.S. tax? The lower left corner of that page 72, the part called "Anticipated Tax Consequences," demonstrates that you would anticipate no additional U.S. tax. The only U.S. tax would be the $680 you would pay on the U.S. domestic $2,000 of profit.

Unfortunately, when you go over and apply the actual U.S. rules, you come out with a radically different answer. I don't want to say that the numbers illustrated on the right bear a mathematical relationship to what always happens, but it is clear that they illustrate the concepts of what always happens, for two reasons.

There is a double tax liability. In this particular case it is $360 or 18 percent, raising the effective rate to 52 percent. Again, there is no magic to the 52 percent. That is just a mathematical way of expressing the concept of double taxation. The reason for the double taxation is two-fold: (1) because the 49 percent business activity is in a separate basket, you cannot cross-credit income and taxes of these two foreign operations — a result that I see absolutely no logic in.

Secondly, harder to explain but of perhaps even greater impact, significant parts of the U.S. companies' expenses that are not directly chargeable against these foreign operations wind up being allocated and apportioned against these foreign dividends, even though both of these foreign operations are self-financing. If you look at the facts at the top of page 72, the interest rate paid abroad in these foreign subsidiaries is basically the same rate as a percentage of profit as it is in the United States. So, for these two reasons, the U.S. company winds up having a significant residual U.S. tax even though these foreign business activities are taxed at 34 percent.

The study also shows that the U.S. has a very different point of view than the other countries concerning some other significant features of the tax system. All other countries, and again this includes the other seven nations that we subsequently looked at except for Australia which is in the process of doing so, engage in tax sparing with developing nations. The United States does not.

Secondly, with respect to the low taxed earnings of foreign subsidiaries, those can be loaned back up to the domestic parent company in all these other countries without a constructive dividend.

Thirdly, the act of having the operations, the profits from foreign operations moved among other companies on an inter-company basis is typically not something that generates an end to deferral of tax on those profits.

Mr. Crowe: Peter, would you give your reaction to some of the policy issues Ray has raised?

Mr. Barnes: When David called me last week, he said he wanted me to bring balance to the panel. I wasn't sure whether that was because you were going to get so much rational comment by the other members that he wanted some irrational comment from me, but nonetheless, I do think there is another perspective that may fruitfully be shared in this group.

I hope, however, that neither I in the Treasury Department nor the members of Congress nor the staff members for Congress are so diametrically opposed to American businesses as we sometimes are pictured. I would like to think we are working together. In fact, I think we are in many respects. Indeed the basic rule in the U.S. remains that we have deferral for active business income of U.S.-owned foreign companies. That is often overlooked. We can quarrel over what is active and what qualifies for the deferral, but the fact remains that we don't immediately tax the foreign earned income. The basic rule is deferral and we have a lot of work to do to decide how we compute the amount of that income and how we compute what is active income as opposed to inactive income that might not get the deferral.

A couple of other points—there is a residual tax in the U.S., so that the effective tax is over 34 percent, only where on an item of income or category of items of income, the foreign tax has been greater than 34 percent. I understand that the baskets cause taxpayers problems, and certainly from an administrative standpoint there is a lot to be done in simplifying the basket regime. We recognize that and I think everyone who is involved in the tax policy process recognizes that. Indeed, if you read through the simplification pamphlet that came out from Ways and Means in June, which is a wonderful compendium of ideas, over and over again people say, "There is a problem administratively with the foreign tax credit basket system."

Nonetheless, double tax, I think, means more than just somehow, somewhere, you pay more than 34 percent. The way our basket system works is that you are only paying more than 34 percent if the foreign jurisdiction charged you more than 34 percent on some items of income.

There is one major issue that I think we need to keep in mind. I understand that this is an afternoon devoted to foreign investment in the U.S. and U.S. investment abroad, but in a system that requires some revenues to be raised through taxes, we have to think about the consequences of reducing the tax burden on the group that brought us together today.

The consequence is that more money is going to have to be raised from U.S. companies providing services and goods to the U.S. market or the people who remain within the U.S. and export. Their interests are important and I think we would create a very serious problem if we insist on falling to the lowest common denominator of some foreign jurisdiction so that a U.S.-owned foreign company could compete, I hate to say more effectively but, more effectively in that foreign jurisdiction. The result of such an approach would be to increase the deficit or to increase the burden on the U.S. company providing goods and services for the U.S. market. We cannot ignore the overall revenue needs.

Tax sparing is an issue that goes back 35 years. There has been a great deal said about it, but again I think this is the kind of place where you have to put yourselves in the shoes of the U.S. manufacturer who makes widgets in middle America and sells only to middle America. He sits there and says, "I pay 34 percent on my taxes; this other guy not only doesn't pay 34 percent, but he doesn't even pay 24 percent because he gets credit for a phantom tax that he, in fact, doesn't pay." There is no discipline on that system because if it is a tax not paid, it can be a tax charged at any rate.

I would be happy to talk about tax sparing. It has such a lengthy history to it, though, that I think it is simply enough to say we can beat ourselves over the head on tax sparing, but we are wasting our time. I think as a group we can move other issues forward on very productive fronts, and I would advise us to do that rather than to fret over tax sparing.

I also want to put in a plug. I think there is a sincere desire by Treasury, by the Hill, and by taxpayers to do something in terms of the administrative issues that David mentioned earlier and these foreign tax credit basket questions. I look with great anticipation to the next two years in Congress.

Simplification is not going to happen this fall. But the simplification issues that were raised during the spring and compiled by the Ways and Means Committee, and the genuine enthusiasm for a simplification effort gives me a good feeling about what will happen in 1991 and 1992. It won't be simple and anyone who holds out too high an expectation is inviting disappointment. But I think in small bites around the edges, we can get meaningful simplification. What I would encourage you to do is not walk away just discouraged by all the problems that are created for foreign-owned U.S. companies or U.S.-owned foreign companies, but instead to go back and revisit the smaller issues that we might usefully address over the next year.

Murray Schlussel

Murray Schlussel, Assistant General Counsel of International Tax for Ford Motor Company, offers examples of practitioners in U.S. firms having to expend large amounts of money and energy to comply with tax rules for U.S. multinationals.

In Mr. Schlussel's view, the most problematic area of ill-conceived tax rules and Code provisions is Subpart F. The Tax Reform Act of 1986 (TRA '86) expanded the definition of passive income and eliminated an exemption from Subpart F for transactions not availed of for the purpose of tax avoidance. Consequently, he has Subpart F income in every single one of his foreign affiliates.

The creation in 1986 of passive foreign investment companies (PFICs) imposes, for no apparent policy reasons, new levels of complexity on companies with high interest income, not at all unusual in a hyperinflationary economy. Yet another provision of the 1986 Act which has hindered U.S. multinationals' ability to efficiently comply with U.S. tax rules is the expansion of the basket rules for the foreign tax credit. Specifically, the 10 - 50% basket has caused a significant burden in terms of compliance and planning. Like Mr. Haas, Mr. Schlussel cites the interest allocation rules as being arbitrary in the way U.S. costs are allocated against foreign source income.

Mr. Schlussel sees U.S. information reporting requirements as outrageous, especially in comparison with foreign requirements. As a key person in many joint ventures, Mr. Schlussel is put in the position of demanding information from his foreign affiliates that they do not require. This handicaps all U.S.-based companies in the process of negotiating a joint venture.

Ford Motor Company prides itself on being one of the first multinationals; it is one of the biggest and one of the most global. The talk we had by Ed Graham before shows the kind of competition we are up against, not only against the Japanese and the Europeans, but now the Koreans and others. Our industry over the last decade has seen a fierce competition, a lot of consolidation, and we have been searching for appropriate joint ventures. The economics of our industry show that you have to locate yourself in your market; you must get high volume to amortize enormous development costs and high capital costs. Our competitors, U.S.-based multinationals, European or Asian based multinationals, face the same economics.

My job at Ford is to be omniscient. I have to integrate the tax advice from our local accounting firms, law firms, overseas as well as domestic, mix up the political process, and advise management of what the tax impact could be on going into Hungary as we just announced, Russia, Portugal, Korea or any place else. Taxes are only one of those factors.

Businessmen facing these business opportunities and businessmen trying to hammer out a joint venture with an Italian-based company or a Japanese company or anybody else have a lot of things to be concerned with. My input is just one of those elements. I get involved in negotiations with the governments, looking for incentives, looking for elimination of disincentives, trying to work out a deal with the other side. One of the things I am faced with is how simple and how direct most of the home country tax laws are with respect to our prospective partners, whether they are French, Italian, German or Japanese. I come with all this "baggage" thanks to our people up on Capitol Hill legislating to help me teach foreigners how taxes ought to be.

I like to think of us as trying to be a race horse without much handicap weight to carry, but I think our government looks at us as a cash cow to be milked. That is a pretty tough way to run a race.

I have been involved in more than ten deals for the last two or three years, since the 1986 Tax Act, involving some provisions of the Code (that really weren't designed to raise money but to close some tax loophole because somebody read an article somewhere), that have really become a major impediment to our making a deal in a straightforward, efficient manner. I will just highlight a couple.

All I am trying to bring across is that I am like the retail customer of all these government inputs: everybody's grand idea of a better society, how to raise money, cut the deficit, and all that. Our company, my client if you will, just wants to be in business, to try to make a living, to stay in business. We are not in business to raise taxes; we are not in business to serve the Internal Revenue Service. They are a side line. We are "good citizens" here as we are in Germany, France, and some 30 other countries. We are major components of their economies. We happen to be U.S.-based. Most of our shareholders are here.

But we are terribly handicapped in just going about our business and fighting our competitors in a fair, straightforward way because, in large part, of ill-conceived tax rules and Code provisions. For example, in the 1986 Tax Act they tightened up something called Subpart F income which was generated in the early '60s to close some tax loopholes on passive income, mostly in tax havens. I can't quarrel with the basic philosophy of it. One of the most important things though, knowing that arbitrary rules wouldn't do justice, was an exemption for transactions not availed of to avoid taxes. Well, one of the "nice" things that happened in 1986 was that we eliminated that exemption and expanded the definition of passive income. As a result, I have Subpart F income in every one of my foreign affiliates. Another brilliant thing they did in 1986 was to invent a PFIC (Passive Foreign Investment Company). It was not designed to raise major revenue and in a couple of my tax returns, I have had to treat some manufacturing affiliates with over 20,000 employees as a PFIC, passive foreign investment company, because of some of these wonderful rules, mostly because we are in hyper-inflationary economies where there is a lot of interest income.

Many of these rules were never thought out in an integrated way. Somebody had a good idea about some little problem, stuck it in the Code, and planned to figure out later what happens. I am the kind of guy it happens to and have to explain it to my bosses. A lot of times I don't understand it until after the tax return is filed, or while we're doing it. But Subpart F income has enormously increased, with no policy purpose, the challenge of structuring deals or with just continuing to operate, something you have been doing for the last 20 years. And all of a sudden you have a different result for some unexplained reason.

As for the basketing that was mentioned, the worst thing I have faced is the 10 percent to 50 percent owned foreign affiliate basket limitation on the use of foreign tax credits. I have had at least five deals where my trying to avoid having this income fall into the deep hole of a 10 percent - 50 percent basket has complicated deals and nearly killed one. In one deal I worked out a way of getting treatment of a subsidiary in the controlled foreign corporation through some fancy mechanics which cost the other side money, though eventually we had to pay for it, all for no good reason. In other deals, like in Russia, we weren't allowed to go after more than 40 percent ownership. In Mexico, the rule is that you generally can't get more than 40 percent ownership in our industry.

You try to make partnerships. Well, guess what? Russia doesn't understand partnerships; it is not in their law. Japan does, Korea does, but the Japanese and Korean social fiber looks down upon partnerships. Big prestigious companies can't be partners; it is for a mom and pop noodle store. So, we can't have partnerships. I am stuck with a number of joint ventures with Japanese and Koreans where I am in a 10 percent - 50 percent basket. Very expensive and for no policy reason — none at all that anybody has explained to me.

Another area which is arbitrary and came in the 1986 Act that kills us in straightforward structuring, especially in finance companies, is interest allocation — arbitrary methods of charging U.S. cost to foreign income. (As an aside, I take a little issue with Peter on about whether excess credits are solely a function of foreign rates being more than 34 percent. When you start taking some U.S. costs and allocating them to foreign income, you get a different result.) It is particularly egregious when you are in a finance company that borrows money and lends it out; where money is like the "cost of good sold." You buy money wholesale, you sell it retail; you try to make profit on the margin. All those deals are structured on incremental costs, yet interest allocation does it on an arbitrary, overall basis. Why don't they adopt some kind of net interest expense before they allocate. They have never explained their reluctance though we have discussed this while legislating the 1986 Act. It's not that people on the Hill aren't aware of it.

Another area, a final one, has to do with compliance. When we sit down with foreign companies and try to welcome them into the world of Ford Motor Company — let's get together and design a transmission or a car or let's do a truck together — and they get to my end of the spectrum and talk about taxes and compliance and how many accountants they need to keep all the wonderful records the IRS demands, they can't believe it. I start sending them telexes — I need this information for boycott reports or inventory or depreciation, or some of the nice rules that we have here — it is really some fun to educate them on why we need this detail. This is true no matter what percentage we own of their companies. The burden is enormous. The purpose, I don't know.

We just had a meeting two weeks ago with the IRS. They were encouraging my management to hire more people to handle the audits. I would like to have more people. Whether I want to expend their efforts on audits is another question. But they are really upset we don't have an army of people sitting around waiting to service their audits. A cute little anecdote — I tried to explain that one of the reasons why we can't serve them is we spend too much time on some silly request — and I showed them one — we had a foreign affiliate where we owned about 20 percent. In order to explain a change in a $142.00 foreign tax credit (out of hundreds of millions of dollars) they had nine questions they wanted to have answered which would have taken over 40 hours of an accountant's time to go find out. Well, they are entitled to find out all the facts, yes. But when they are complaining that we can't service them; and we spend time on $142.00, how do we get the other hundreds of millions? That kind of mentality, that kind of anti-foreign income mentality that pervades the Code, the regulations, the approach of the agents — I don't know why it is justified. I don't know what to do to get rid of it, but it is getting worse.

Another area is the Bon Ami case, remedial legislation. For instance, before that change we had to cover taxes paid in 20 affiliates; 20 calculations. Now it is over 2,000. For what purpose? I don't know. The difference in taxes is so minuscule. Some purity of legal thought; I don't know. It is just incredible. And try to get our foreign affiliates to do it for us when we have only a minor interest. Lastly, I will just mention the "fun" everybody is having with the White Paper on intercompany pricing (whenever the Regs are going to come out — just more threats).

We welcome simplification. I would hope at least during this era of budget crisis which will be with us for a couple of decades, at least we could focus on things that don't have any basic policy problem or revenue problem, that just simplify our lives to get along with competition.

Peter A. Barnes

Peter Barnes, Deputy International Tax Counsel at the Treasury, began his remarks with a reminder that he, along with the staff and members of Congress, is not diametrically opposed to American business as the picture is often painted.

He insists that the basic rule of deferral for active business income of U.S.-owned foreign companies remains intact while conceding that the definition of active income still needs much clarification.

In Mr. Barnes view, double taxation does not take place when a U.S. firm pays foreign tax at a rate in excess of 34 percent and, in turn, receives a foreign tax credit at the maximum U.S. rate of 34 percent. He also disagrees with the assertion that the Subpart F exception was eliminated by the Tax Reform Act of 1986. It is still available, now with a more workable objective test.

Mr. Barnes also states that the need to raise revenues through taxation often gets lost in these discussions. He suggests setting aside the issue of tax sparing because of the many years of fruitless discussions that have already been held on this topic.

He clearly sees tax sparing as unfair to purely domestic firms and urges the tax policy community to expand its efforts on more productive fronts.

Finally, Mr. Barnes concludes with some encouragement regarding simplification. He refers to a June 1990 publication by the House Ways and Means Committee as evidence of some genuine enthusiasm for the prospects of simplification in 1991 and 1992. PFICs and the 10-50 percent basket are the likeliest candidates.

When the 1986 Act reduced the U.S. rates to 34 percent, I think everyone recognized, including the tax payers, that this was going to exacerbate the foreign tax credit problem of excess credits.

Given the pre-1986 rules, there is no question in my mind, and I don't think there is any question in your mind, Murray, Ray, others out there, that given those rules you could have routed a lot of money, passive money, money that was sitting in bank accounts for investment but not currently being invested, in ways that would have dramatically reduced your foreign excess credits, but at the cost of preventing the U.S. residual tax on U.S. operations.

The loophole tighteners that came from the 1986 Act have created enormous problems, but I think there was a sense, an important sense, that unless something was done, the smart tax practitioners, and I include all the people in this room, would have figured out ways that would have caused an enormous revenue drain to the U.S. by reducing what should have been the U.S. tax on U.S. income. Given that, I don't think that it was irrational to make the 1986 Act changes, although our task now is to bring some order to those changes because clearly there were problems that resulted from them.

For instance, you noted that the prior Subpart F rule prevented an inclusion under Subpart F from a corporation not availed of to avoid tax. There is still an escape valve from

Subpart F. It was simply changed from the subjective test to an objective test. The subjective test had enormous problems. I am not sure that the objective test has more, in fact, I think it has less. There is a mechanical rule that says we will decree that you were not availed of to avoid tax if you follow this mechanical formula. So, it is not that we threw out the exception, we simply changed the form of the exception, and I frankly think that the current form of the exception maybe has a lot of merit to it, compared to the old rule.

PFIC is a problem. I think everyone knows that. It is included on everyone's list of simplification proposals. The problem is that there is no consensus on what ought to be done to reform the PFIC rules. But I would see that as the most likely candidate, perhaps, for change over the next two years. What I would like to do is invite people to help us figure out what a constructive change is so that PFIC retains its vitality for the group of cases it was intended to reach. I include in that a little bit more than a foreign mutual fund, but not necessarily a foreign active manufacturer. But I think we sort of give a misleading impression of the law when we keep beating on PFIC. There is general agreement that PFIC needs to be reformed and the question is whether we can build a consensus on what that change ought to be.

The baskets for 10/50s, agreed, they create a problem. It means instead of having 6-8-10 baskets, a major multinational may have 500 baskets or I am told, in one case, 1100 baskets. Again, I think the 10-50 basket issue is one that is high on the list for simplification. I would point out though, that the only time it creates a problem, so to speak, is when you are either not being taxed at a 34 percent rate by the foreign jurisdictions and you want to bring in excess credit so that you then avoid the U.S. residual tax, or when you are being taxed over 34 percent and you want to use those residual taxes — it doesn't of itself create a double tax.

It does affect the averaging and also very much affects the administrative problems. We all agree on that. The administrative problems of having to allocate expenses and deductions across 1,000 baskets instead of across 8 is a monumental problem. I would put that up there slightly before PFIC as a candidate for reform. On the compliance issues, everyone can talk about the excesses of agents. In small areas I think the one thing we all agree on is that the IRS has an extremely difficult time auditing a company the size of Ford Motor Company, and there we just need to work together to get a rational system for you to provide more information, and for them to screen that information more intelligently.

I think the group that is in charge of the service is in tune to this and I would like to see continued progress, recognizing that we are never going to make it simple on the compliance side.

Q & A

Q: Would you clarify what you said about merging low rate with high rate corporate income?

Barnes: Philosophically I think double tax ought to be looked at on an item-by-item basis. That is completely impractical. No one would advocate it in the real world. But, if you ask me why is there double tax, I would say it is because an item of income has been taxed by both jurisdictions. The non-controlled 902 baskets clump a group of items of income. After putting the income you earn from this venture, in which you own say 40 percent, in its own basket, if the foreign jurisdiction taxes it at less than 34 percent and therefore we impose a residual tax, I would say there has not been double tax in any case because the U.S. tax is simply topping you up to 34 percent. Likewise, if the foreign jurisdiction taxed you at 40 percent, I would not say we are creating double tax by denying you the chance to use those excess credits against other income because again, I think in a perfect world, it is item of income by item of income. It is completely administratively incomprehensible that we would do it on an item of income by item of income basis. So, we have to have groups. Where I have a lot of sympathy on the 902 problem and I think many people do, is that it requires companies like Ford, Exxon and IBM to have a spreadsheet of baskets that will extend to the 500 or 1,000 range, spreading costs over a spreadsheet that is 1,000 columns wide. That makes no sense. So, let's go back and revisit those grouping rules, and figure out a way that we can bring the spreadsheet back to a narrower basis.

Tax Treatment of U.S. Investment Abroad – Panel 2

Panel Chairman: Robert N. Mattson
Assistant Treasurer
IBM

B. Anthony Billings
Tax Foundation Senior Research Fellow
Professor of Accounting, Wayne State University

Richard M. Hammer
International Tax Partner, Price Waterhouse
Chairman - Tax Committee
U.S. Council for International Business

John F. Brussel
Tax Director - International
AT&T

Robert N. Mattson

I think the second panel will bring up a few other additional items, but we would like to deepen and expand on the discussion of the first panel. I think it is important to see that competitive impediments are pervasive. What you will get today is not a deep understanding of each individual provision. I think, though, what you need is the full impact of what is happening in the economy. Business is being impeded in its active operations outside the United States where our competitors in Japan and Europe and elsewhere are not receiving anywhere near the degree, if any degree, of impediment.

I would like to quote a couple of commentators. I think the first one I will start with is Stan Ross, well-known in the technical sphere in the international tax area. He is a senior partner at Arnold & Porter. In a Special Report in *Tax Notes* this past April he refers to a significant transformation of U.S. international U.S. tax policy which has moved from a complex to a super-complex tax regime. I think that is the best understanding of it. He notes that the basic policies governing the U.S. taxation of international transactions were essentially established in the 1960s when the U.S. was a creditor nation, when its multinational corporations dominated global investment, where there was a fixed exchange rate system pegged to the U.S. dollar, and the U.S. was at a strong and positive balance of trade and payments.

The tax changes over the last quarter century have been piecemeal, and have not kept pace with the changing economic climate. Much of the balance achieved in the early '60s and the compromises made then have been lost as these changes have been made. U.S. tax policy for international activities, Stan Ross goes on to say, has barely begun to take account of these significant developments, and the 1986 rules were wrong, just plain wrong, in many respects.

Another commentator, and an interesting one, is Mr. Koroda, director of the international tax affairs division of the Japanese Minister of Finance, in a published paper at Princeton also this past April. Mr. Koroda says, U.S. international tax policy now seems dominated by the wish to squeeze "as much revenue as possible from foreign as well as U.S. persons. By the end of the 1980s, only foreign, including their own foreign-owned U.S. corporations, were drawing attention from tax policymakers. In 1985, the U.S. became a net external debtor for the first time since 1914, owing to the continued large scale external deficit. Therefore, it might be argued that the sudden change in its U.S. international tax policy is rational in the sense that as a net external debtor, the U.S. can only gain from stretching its rights as a source country to limit, even if other countries retaliated, their structure for operations outside the United States."

Let's ask, why can this high Japanese tax official see the problem so much more clearly than our government's tax policymakers? Maybe today we can shed some light on this question.

B. Anthony Billings

Anthony Billings, Professor of Accounting at Wayne State University, puts the conflict over the taxation of international investment in its historical context. The U.S. has a policy in place that owes its genesis to the 1962 Revenue Act when the economic environment was much different than it is today. The 1962 Act sought to slow the exportation of the U.S. capital overseas.

Dr. Billings cites numerous problems with regard to the taxation of foreign source income. For example, if a company does business in a hyperinflationary economy, the receipt of too much interest income can yield Subpart F income. Moreover, that company could incur a foreign currency loss from operating in the same jurisdiction and be denied the right to offset the loss against the interest income.

The area of interest allocation is also cited as a problem by Dr. Billings. Certain expenses such as interest charges and research and development may be allocated against foreign source income even though incurred in the U.S.

To deal with these problems, Dr. Billings suggests that U.S. policy do away with the focus of the early 1960s and adopt an even-handed approach to cross-border transactions. He also notes the importance of considering not just the statutory U.S. tax rate, but also the effective rate and the tax base. On a pro-active note, Dr. Billings suggests that U.S. tax policy provide greater incentives for research and development. He sees the greatest challenges of the 1990s for the U.S. as penetration of Eastern European and Pacific rim markets, increasing our global market share of high-tech products, and solving the budget deficit problem.

What I will try to do today is focus somewhat on the shortcomings of U.S. trade policy, offer some recommendations, and conclude by pointing out a few of the challenges I see in the new economic order for the 1990s which we are now more unsure about than ever before.

Research in the last five or ten years has focused significantly on differences between Japan, the U.S. and West Germany. During the debates in 1971 and 1985, on foreign sales corporation provisions, a number of thoughts were brought out in the Committee reports about what other governments are doing to influence trade balance. These strategies include such things as protective tariffs, the formation of export cartels, the offering of export subsidies, and the lightening of the tax burden on the foreign source income of its multinationals.

One may argue that these provisions, to a great extent, are subject to the body called the General Agreement on Tariffs and Trade. But as we have seen, maybe in the last five to ten years, their activities can best be described as an exercise in futility. Given the absence of an international policeman, if you will, in trade, national governments must be sensitive to the realities of the marketplace.

In this regard, the U.S., I think, falls short. We have a policy in place that owes its genesis to the 1962 Revenue Act when, it was pointed out earlier, the economic environment was much different than it is today. In 1962 conventional wisdom was that U.S. policy, with respect to foreign operations, encouraged the building up of South Italy rather than South Carolina, or West Germany rather than West Virginia. Given that wisdom, the 1962 Act sought to find ways of slowing down the exportation of U.S. capital. For example, a typical U.S. company that had profits overseas would invest such funds in passive-type activities whether for expansion or for later repatriation; that was seen as contributing to the capital drain from the U.S. to the European countries. As we know, in the 1990s, especially this year, there is hardly a day that we read the paper that we fail to see something else — some other building block of the new economic order falling into place. The world is changing so rapidly; and if we look at the Tax Code, when we do have changes, we seem to retrogress rather than to progress.

With this in mind, I will point out some of the problems with the taxation of foreign source income, and other areas in which we fail to support major economic incentives that are vital to productivity growth, which I think is a key ingredient to the trade position of any nation.

Let's now focus on some of the shortcomings in the way foreign source income is taxed. We hear a lot today about tax sparing and many other issues related to how foreign source income is taxed. But two of the major problems we face can be found under Subpart F. The third, the allocation rules of 861-A. I will not bore you with all the details. I will try to give you three examples of where I think we have the most problems.

The first relates to Subpart F. Take for example a typical U.S. company that decides to invest abroad in a country, let's say Brazil, which as you know has hyper-inflated currency. The holding of working capital, as you know, is vital and for a company that holds working capital in Brazil, significant interest income will be earned because of inflation. As you can guess, such income would be treated as Subpart F income and taxed immediately in the U.S. But if that same company has foreign currency losses, which again is typical, the loss would not be allowed to offset the interest income, but would be treated as foreign currency loss and allocated under section 904-D. The result is that the same transactions occurring in the same place are treated markedly differently.

Taken to the perverse extreme, if business is bad, the interest income can outpace manufacturing income, a company could have all its income, both manufacturing and the interest income, treated as, under the PFIC rules, U.S. source income. That has happened to a lot of companies today in countries with hyper-inflationary currency.

Another example would be the allocation of income under 861-A. As you know, expenses such as research and development, interest charges, and stewardship expenses are allocated, even though they are incurred in the U.S., against foreign source income. Indeed, for each dollar of foreign source income earned by a U.S. company, as much as 30 cents of the U.S.-incurred expenses would be allocated against the income.

What are the implications? Because of this allocation, no more than about 22 cents of foreign tax credit would be credited against taxes paid overseas. Even though taxes paid may have exceeded 50 cents, the dollar earned attracts 30 percent U.S. incurred expenses, and that reduces the foreign tax credit to 22 cents. The unused credit is carried forward. If relative tax rates do not change radically, then the credits will expire.

A third example would be a company that is seeking opportunities to expand abroad, maybe in the emerging markets of Eastern

Europe. If funds are needed to, let's say, open new plants or purchase new equipment, rational behavior would dictate borrowing such funds in the country with the lowest interest rate. However, if that company is in limitation under the foreign tax credit formula, the loss of foreign tax credit may motivate the company to seek funds in places other than the U.S., even though the best interest rate can be obtained here.

These examples, I think, tell a story of what is happening in the foreign area. Things were pretty much put together in the early 1960s, and in my mind, we have not progressed significantly since then.

With these things in mind, I will offer a few suggestions dealing with these problems. I think to be effective, U.S. policy must have both a passive and a pro-active dimension. The passive dimension means starting over—doing away with the focus of the early 1960s. You may say this is quite drastic, but this is what we need — a bold, new approach. In this regard, provisions such as Subpart F would at best be repealed or at worst be kept in check.

With respect to the allocation of U.S. incurred expenses — where do we stop? I think at some point we need to draw a line. No other country uses this approach. I think this again is one of the things that should be looked at and possibly be repealed as part of any new legislation in the next few years.

Another point that should be considered with respect to the passive dimension is that Congress should refrain from raising the effective corporate rate above what it currently is. One may argue that the U.S. statutory rate is lower than many other nations' in the world — 34 percent. Someone pointed out that it is 39 percent or 40 percent, when we consider the state income tax. But I think the statutory rate does not tell the whole story. As you know, the effective tax rate is based on a tax base and a rate. If we lower the rate but increase the base, what do we have? A higher tax burden. I think that is something that should be considered in any new legislation. We may feel very happy that the rate stays at 34 percent. But we must be very careful that the base does not increase to offset the low rate.

With respect to the pro-active approach, I think several things need attention. We talked earlier about research and development and capital spending. Many times companies consider research and development projects, or new plants and equipment, or ways to enhance productivity, but in the short term, these activities will be marginally profitable or probably will sustain a loss. What is done? They are often abandoned. These investments, however, are needed for long-term economic growth. This is where U.S. policy should at least seek to offer tax incentives to encourage these activities.

In countries such as Japan and Germany, significant low interest loans, tax credits and a variety of other programs are offered to encourage these activities. Even though they are not profitable over the short run, over the long run they do pay for themselves. At present, we offer no more than a token amount of credit that has little or no effect on R&D spending.

With respect to the challenges we face in the 1990s, I think there are three that are the most important. First, we must seek to aggressively establish a presence in the emerging markets of Eastern Europe and the Pacific rim. Second, we must find ways of reversing the declining trend in our global market share of high-technology products. For instance, recent data by the National Science Foundation shows that 10-15 years ago we had a 27.2 percent share of these sales. That has now been reduced to 19.6 percent. Last but not least, we should find ways of solving the budget deficit problem. If the U.S. does not meet these challenges, I think the we will be relegated to a role of a spectator rather than a world economic leader in the 1990s.

Richard M. Hammer

Richard Hammer, speaking on behalf of the U.S. Council for International Business, addresses the transfer pricing rules. He begins his talk with a note of his frustration with the tax treatment of U.S. multinationals. He feels that current tax policy has "run amok," with law changes being enacted without serious thought to underlying policy.

Regarding the transfer pricing rules, Mr. Hammer states that the U.S., along with most of the world, does subscribe to the arms length standard. The U.S. has made small attempts to reduce the dependence on true market criteria in what is or what is not arms length, such as the DISC/FSC administrative pricing formulae. A significant new deviation from the arms length standard would be the introduction of an arbitrary 50/50 profit split on products shipped to U.S. distribution subsidiaries by foreign parents, something discussed on Capitol Hill recently.

Some foreign fiscal authorities have criticized the so-called fourth method of transfer pricing as being a deviation from the arms length standard. Instead, Mr. Hammer asserts that this is nothing more than a "rough cut approximation" of the proper arms length profit allocation.

Mr. Hammer calls the superroyalty provisions introduced by the Tax Reform Act of 1986 the first major deviation from the arms length standard. This can lead to a problem of complete double taxation. The ultra-high royalties being paid to the U.S. developer of the intangible property may well exceed what the foreign jurisdictions will permit under their own rules subscribing to the arms length standard. It may not be deductible in the foreign jurisdiction, and yet still be subject to tax in the United States.

Introduction - General Remarks

I am here today in my capacity as Chair of the Taxation Committee of the U.S. Council for International Business. We have been terribly concerned with the drift of U.S. tax policy vis-a-vis foreign earnings of U.S. multinational corporations. Recently, our group, as did many others, including those represented here today, submitted papers in response to the ongoing simplification study initiated by the Ways & Means Committee. I hope the committee is serious about simplification and not just mounting a cosmetic, but substanceless, response to the crescendo of criticism of our tax law on this point.

Unfortunately, it is more than complexity that bedevils the U.S. tax law, and the policy behind it, in the foreign area. This is really just the tip of the iceberg. To me, it is more a case of tax policy run amok, of law changes enacted without serious thought given to the underlying policy, of a failure to update tax policy to the modern economic and investment environment, of overconcentration on stamping out possible abuses without focusing on how such amendments fit into the overall scheme. And the pressure for revenue neutrality does not help. To me, it is a case of congressional failure, perhaps even a complete abdication of its responsibility in shaping a coherent and sensible foreign tax policy.

Transfer Pricing

But so much for the soapbox! My assignment today is to address the important subject of transfer pricing, and the policy behind it. Bear in mind, as I discuss this subject, that transfer pricing affects purely domestic transactions, and it impacts inbound as well as outbound investments. In fact, right now the glare of publicity is on the transfer pricing practices of foreign multinational corporations bringing their products into the U.S. marketplace. I will not touch on this current controversy because of my spot of the program, but I think it is disgraceful to witness the manner in which the IRS has launched a campaign using the press to publicize its unproven allegations.

Arms Length Standard

From a general policy perspective, the U.S. subscribes to the well known "arms length" standard, in the transfer pricing area. This generally keeps us in step with the rest of the world, most of whom also adhere very strictly to the arms length standard.

The U.S. has made more attempts than other nations to reduce the dependence on true market evidence in establishing what is, or is not, arms length. So far, these attempts have been relatively benign, and restricted to narrow areas in our code, i.e. the DISC/FSC safe haven or administrative pricing formulae and the Section 936 profit split concept for possessions corporations in calculating their possessions tax credit. The latest attempt appearing in the current legislative session to introduce an arbitrary and rigid 50/50 profit split on products shipped to U.S. distribution subsidiaries by foreign parents is not so benign and limited so as to escape the notice of other countries, if it should be enacted in this session or later, as an important new deviation of U.S. tax policy from the arms length standard (following the superroyalty which I will address in a few minutes). But again this relates to inbound investment, not our panel's focus.

All the earlier attempts to inject formulae into the transfer pricing process (DISC, FSC, 936, etc.) have represented efforts to facilitate the identification of an arms length transfer price, using what might be called a "rough cut approximation," rather than any overt attempt to destabilize or reject the arms length standard. (I should note parenthetically, at this point, that the DISC provisions, as they were fashioned from 1972-84, did trigger a great deal of foreign criticism. Such criticism was not so much in the formulary transfer pricing mechanism, although the pricing rules certainly contributed to the net overall impact, but in the fact that the whole DISC concept was an alleged subterfuge to provide a subsidy to U.S. exporters, contrary to GATT's rules. No such criticism has been leveled against FSC, DISC's successor, which has precisely the same conceptual pricing mechanism.)

Before moving ahead to the first real breach of the arms length standard, I should mention, in passing, the so-called "fourth method" in transfer pricing of goods between affiliates. The rules in this area, as spelled out in 23 year-old regulations, mandate the use of comparable uncontrolled transactions (CUT) in establishing an intercompany pricing structure; but in recognition of the difficulty of finding third party evidence in many instances, an alternative to CUT is permitted, a fact and circumstances approach (the so-called "fourth method") may be used to allocate profit/loss on a stream of intercompany product sales. We at the U.S. Council for International Business did not believe the availability of this alternative method was a deviation from arms length (as some foreign fiscal authorities have asserted), but more, as before, a "rough cut" approximation of a proper arms length profit allocation. In fact, in our recent submission to the Ways & Means Committee on simplification in the transfer pricing area, we suggested that the policymakers in Treasury and IRS fashion some more guidance for taxpayers vis-a-vis the fourth method. We said:

"Several so-called fourth methods have been resorted to on an ad hoc basis in examinations by the Service of transfer pricing issues. These include return on assets, return on equity and the Berry method (ratio of gross profit to operating costs). The regulations on transfer pricing should be expanded to describe fourth methods and the conditions under which they may be applied. This will provide for consistency in application of these fourth methods for both taxpayers and auditing agents."

So much for "rough cut" approximations!

Superroyalty

With the advent of the 1986 Act, we see the first deviation from the arms length standard of major impact on the part of the U.S. Congress — the introduction into the Internal Revenue Code of the now infamous superroyalty provision dealing with the application of intercompany transfer pricing concepts to the area of intangible property rights (so-called intangibles). Unlike the earlier statutory formulary approach to profit allocation, the superroyalty is non-objective and seems, unfortunately, open-ended.

In a nutshell, the superroyalty provision in the statute requires that payments with respect to intangibles transferred to related parties, either by way of sales or licenses, must be "commensurate with the income attributable to the intangible." These deceptively simple words will become a nightmare for U.S. multinational corporations, as the rules for enforcing the new concept begin to evolve. Congress was concerned that geographic rights to intangibles were being licensed or transferred to foreign affiliates before the full value of the intangible asset was achieved; thus, if any intangible property turned out to be a blockbuster, a greater than deserved portion of the financial rewards would accrue to foreign affiliates which had not developed the particular intangible, while a less than warranted portion of the reward would inure to the developer (the U.S. parent). This issue became such a *bete noire* to the framers of our tax law that they insisted, despite much logical and practical opposition, on enacting the ill-conceived and misguided superroyalty rules.

White Paper

The White Paper, issued about 2 years following the 1986 Act, confirmed our worst fears about the arms length nature of this new concept. Obviously, I do not have time to dwell on the content of the White Paper. It is lengthy and detailed. But its basic theme, trying to breathe life into the superroyalty in a rational manner (an impossible task, I might add), only results in demonstrating why the concept is not arms length (and not rational).

Let me give only the briefest of summaries for you. The superroyalty should only apply to what are considered "high profit potential" intangibles. (I should note the paper states such intangibles are rarely transferred to third parties.) Since the quantum of profit potential is not known at the transfer or license agreement date, the "commensurate with income" standard of the code mandates that periodic upward adjustments to the amounts of royalties or sale prices to be paid to the U.S. developer are required indefinitely into the future. Such adjustments are to be made, and this is key, despite the fact that the arrangement was truly arms length at the time it was entered into.

The obvious scenario can be foreseen. A U.S. multinational corporation develops a new high tech product which it licenses, at arms length terms, to its local German, French, Japanese and UK subsidiaries. These four subsidiaries manufacture the product using the U.S. parent's technology, and they exert their best efforts to develop the local market through promotion and advertising carried on by their local staffs. The product turns out to be the blockbuster that so concerned the U.S. Congress. Enter the superroyalty, mandating that the U.S. company renege on its arms length agreements with the four affiliates and share further in their profits from the sale of the new product.

Double Taxation

The real concern to the U.S. multinational corporation in this plain vanilla scenario is the prospect of international double taxation. Will the German, French, Japanese and UK tax authorities be willing to grant tax deductibility to additional royalty/license payments that must occur in conformity with the superroyalty provision, particularly in light of the fact that the original license agreements were arms length?

Early indications are that deductibility may be hard to come by in most other jurisdictions. In my capacity as Chairman of the Fiscal Committee of the Business and Industry Advisory Committee to the OECD, I get the sense of both the foreign business community (despite the fact that superroyalty is a two way street, i.e., a foreign developer can charge superroyalty to its U.S. subsidiaries) and the foreign fiscal authorities that they view this provision as a breach of the sacred arms length principle to which they firmly subscribe. Of course, time will tell, but my crystal ball tells me that the foreign authorities are not going to roll over and play dead. This bodes badly for U.S. multinational corporations avoiding the inevitable double taxation that loss of deductions for superroyalties will entail, and at a time when they are suffering increasing amounts of excess foreign tax credits, it's even more disagreeable. Our tax policy in this area is on a collision course with the arms length principle embodied in the tax policy of our trading partners.

Deferral

The history of U.S. tax policy vis-a-vis deferral has not been a rational one since 1962. Prior to 1962, deferral was the standard, with few exceptions. (The foreign personal holdings company provisions only impacted high net worth individual taxpayers and not our multinational corporation community.) In other words, income of U.S.-controlled foreign subsidiaries was not taxed in the U.S. until remitted or repatriated. This was a sound approach and one that was generally subscribed to by all our trading partners. In 1962, the Congress enacted Subpart F, controlled foreign corporation provisions (to get at tax haven income), the first partial elimination of deferral that would impact U.S. multinational corporations. But at the time, no real thought was given to marrying the pre-existing FPHC provisions and the new CFC provisions, which could (and should) have been done. This was the first failure of our tax policy in this area. (The 1962 Act also enacted the foreign investment company (FIC) provisions, which did not have a major sting, as they did not affect deferral but converted gain on sale of FIC stock from capital gain to ordinary income, quite meaningless today.)

In the year following, numerous restructure amendments were made to the Subpart F provision, skewing them away from their original purpose and policy objective of preventing abusive use of tax havens. Many of these amendments were made simply to generate revenue. Then in 1986, PFIC entered the scene, ostensibly aimed only at foreign mutual fund type of investments, but unfortunately drafted (unintentionally, it says here) so broadly as to include CFC and FPHC (and Foreign Investment Corporation) within its orbit. Enter the scene — utter confusion, representing again a Congressional failure to develop a sound and sensible tax policy in the foreign income area. Some approach which uses a single set of provisions to eliminate deferral for the abusive types of passive income only while continuing deferral for all other income should be the goal.

The U.S. Council feels that this can best be accomplished by eliminating the multiple regimes that now exist for eliminating deferral for entities that generate passive income (PFIC, FPHC, and FIC). This could be implemented by keeping the PFIC provisions, albeit with some modifications, including one key change, and eliminating the other two. This important change to the PFIC rules would be the elimination from coverage of all U.S. shareholders of CFCs (as defined by the statute to be owners of at least 10 percent of the CFC's voting shares). At the moment, a proposal is kicking around the Congress to amend the PFIC statutory rules to eliminate the asset test, retaining only the income test. We support this amendment as well, but it doesn't get at the root of the problem.

In summary, then, only the PFIC rules would apply to all entities generating primarily passive income. Other U.S.-controlled foreign entities should continue to be governed by the CFC rules, also to be modified and perhaps eased. But to retain the integrity of the approach, passive income would continue to form part of the Subpart F income base, since a U.S. shareholder of a CFC would not be covered by the PFIC rules, if amended in accordance with our suggestions.

Conclusion

There are many more things that could be said in the area of deferral. But I should like to note, in closing, that several other countries have adopted a version of the CFC rules, most of which are less restrictive than ours (Australia, Canada, France, Germany, Japan, New Zealand, United Kingdom). Moreover, none of these other countries have adopted multiple sets of provisions to deal with offshore passive income, as we have. I am not implying that these other countries are the leaders in international tax thinking, but we, who at one time were the leaders in international tax thinking, have abdicated our leadership position. Today, our legislative process in the tax area is totally tied to revenue generation and loophole closing—losing sight of the logical thread, the rhythm, that a sound tax policy and tax system require.

John F. Brussel

John Brussel, Tax Director - International for AT&T, relates how AT&T has grown internationally from a few projects overseas in 1983 to a company today with over 160 subsidiaries and over 130 controlled foreign corporations.

As with most of the earlier speakers, Mr. Brussel points to the 10 - 50 percent basket as being a major problem. This is particularly true for the telecomunications industry because many foreign markets are dominated by an established governmental or quasi-governmental agency, giving AT&T little opportunity to form majority-interest joint ventures. Therefore, strategic investments made to implement the firm's global strategy fall into the 10%-50% basket and are deemed as having insufficient identity with U.S. shareholders to be treated as units of a worldwide business. Mr. Brussel clearly views these minority interests as units of the worldwide business, and insists that the nature of these activities transcends the ownership percentage held by the U.S. company. He also disagrees with Mr. Barnes' earlier assertion that items of income should be treated separately. Regarding the PFIC rules, he thinks the extremely short start-up rules were inappropriate.

Finally, along the lines of Mr. Hammer's earlier remarks, Mr. Brussel says tax policy does not exist today. "What exists in its place," he says, "is revenue raising."

Those of you who have followed the history of AT&T know that prior to divestiture, AT&T did not have international operations other than international long distance which had no particular international tax ramifications. At the time I joined the company in 1983 to create an international tax department, AT&T merely had a project in Saudi Arabia, a project in Korea, and seven representative-type offices with two or three people laying the groundwork for penetrating their local markets. Since divestiture, one of the three strategic goals of AT&T has been globalization. Today we have over 130 controlled foreign corporations and well over 160 subsidiaries, not counting our minority interest in Olivetti and its subsidiaries.

In the early years of our globalization effort, however, we learned that you do not just walk into a country, particularly one that already has a strong telecommunications infrastructure, and start selling your product. More often than not, you have to form joint ventures to penetrate the market. Virtually every one of our investments has been a strategic investment; strategic to the business of globalizing AT&T and strategic to being successful in a global marketplace. Because of their strategic nature, however, all of our joint ventures have been formed with well-placed companies or governmental or quasi-governmental agencies, and we therefore have had little or no control over whether we would be able to obtain a majority interest in the ventures.

U.S. "tax policy" made our task more difficult as a result of the creation of the "10 - 50 percent basket" in the Tax Reform Act of 1986. The House and Senate versions of the Act generally provided for look-through treatment for dividends as long as the U.S. shareholder owned directly or indirectly 10 percent of the voting stock. The conference committee changed the look-through threshold to require

CGC status for look-through treatment and created the 10 - 50 percent basket. The statement of the managers of the conference committee justified the restriction on the application of look-through treatment on two bases:

1. In the case of foreign corporations that are not controlled foreign corporations, there is insufficient identity of interest with U.S. shareholders to treat non-majority ownership positions as units of a worldwide business.

2. Minority U.S. shareholders may not have ready access to the tax and income information of the foreign corporation which is needed in applying the look-through rule.

I submit that neither of these bases for the 10 - 50 percent basket is persuasive. With regard to the first rationale, it is my experience that international joint ventures are an ordinary and necessary extension of business activities conducted by U.S. multinationals. These business activities are viewed in the same strategic sense regardless of whether there is a minority, majority or no foreign co-venturer. The nature of these activities transcends the ownership percentage held by the U.S. company and the residence of the co-venturer. These activities merely implement the business strategies of the U.S. companies regardless of whether the minority position arises voluntarily, by negotiation, by virtue of local law restrictions, or by perceptions as to the best way to penetrate a foreign market.

With respect to the second rationale, while taxpayers in isolated cases may not have ready access to the information necessary to apply the look-through rules, it is my experience that in the vast majority of cases such information is available. Furthermore, as a normal business practice, U.S. taxpayers by contract have required foreign joint venture companies to provide them with income and tax-related information necessary for them to comply with U.S. tax laws.

The minority U.S. shareholder of a 10/50 company is required under current law to obtain earnings and profits information as well as extensive foreign tax information in order to properly compute the indirect foreign tax credit. It seems inappropriate to argue as a general proposition that all this information can be obtained but that the minority U.S. shareholder won't be able to place the foreign corporation's income in the proper foreign tax credit limitation basket.

To demonstrate the inconsistent results created by the 10 - 50 percent basket provisions, consider the following real-life example: AT&T has a 51 percent interest in a fiber optic joint venture in Denmark. AT&T also has a 50/50 interest in a fiber optic joint venture in Korea. They are strategically alike, save for the countries in which they do business. They are essential to one of our core businesses, and yet, dividends from the Denmark venture will be included in our overall limitation basket, while dividends from our Korean venture will fall into a separate 10/50 limitation basket. With respect to both of these ventures, there is sufficient identity of interest with AT&T to treat the non-majority ownership positions as units of AT&T's worldwide business. Therefore, I submit that it is proper to include the dividends from both ventures along with AT&T's other active business income in our overall limitation basket. To do otherwise is completely illogical.

I should point out also that if our joint venture partner in Korea were a U.S. corporation, or for that matter, another U.S. corporation held a one percent interest in the venture, we would not have this problem because we would then have sufficient U.S. ownership, even though AT&T's interests would not have changed at all. Likewise, if the venture were a partnership or were treated as a partnership for U.S. tax purposes, we would not have this problem. I see no logical reason, whatsoever, for either dichotomy.

AT&T is second to none in supporting the need to move toward a balanced budget in the United States and we support broad-based tax measures as one of the ways to accomplish that worthy goal. What we oppose, however, is the appalling lack of movement toward a sound and rational international tax policy. Given the recent developments in Western and Eastern

Europe and the continued direct and indirect support and often subsidization by foreign governments of their multinational companies, we must develop an international tax policy which will permit U.S. companies to become more competitive in the global marketplace.

Session Two

Tax Treatment of Foreign Investment in the U.S. – Panel 1

Panel Chairman: Robert Ashby
Assistant Vice President, Taxes
Northern Telecom Inc.

Elliot L. Richardson
Senior Resident Partner
Milbank, Tweed, Hadley & McCloy
Chairman, Association for International Investment

Congressman Philip M. Crane (R-IL)
House Ways and Means Committee:
Trade, Ranking Minority Member

James M. Carter
Senior Tax Counsel, ICI Americas;
Secretary
Organization for the Fair Treatment of International Investment

Bruce R. Bartlett
Deputy Assistant Secretary for Economic Policy
U.S. Department of the Treasury

Robert Ashby

I have the distinct pleasure of being the panel chairman of the third panel this afternoon. The third and fourth panels will focus principally on the tax dtreatment of foreign investment into the U.S. — the inbound transactions.

Before we start these two panels, we would like to try to take just a few minutes to get an issue overview of the entire area from Mr. Elliot Richardson.

Elliot L. Richardson

Elliot Richardson, Senior Resident Partner, Milbank, Tweed, Hadley & McCloy, sounds a note of caution as the U.S. considers ways of dealing with the taxation of inbound transactions. He notes that there are now 26 bills pending before Congress that respond to the emotional uneasiness aroused by what has frequently been referred to as the "buying of America."

Mr. Richardson cites figures which show that the return on assets for U.S.-controlled domestic corporations in 1986 was 1.7 percent, while foreign-controlled U.S. corporations' return was -0.2 percent. On the surface these figures may suggest that foreign-owned companies doing business in the U.S. are raiding the tax fisc, but that is not necessarily true.

Mr. Richardson admits that these foreign companies may indeed have the opportunity to allocate a disproportionate level of expense to the U.S. subsidiary for insurance, interest, freight, etc., but these same policies can equally be used or abused by U.S. transnational corporations operating in other countries.

Again, Mr. Richardson hopes that congressional response should be

tempered by the thought of what other countries may do if we act with a crude and indiscriminate hand in dealing with this problem. In his view, the most useful effort that could now occur is one that seeks to bring about the maximum practicable level of coordination among countries.

I appreciate this opportunity to address members and guests of the Tax Foundation. There are several people back home in Massachusetts that would say of me, Elliot Richardson is a person who never met a tax he didn't like.

Indeed, I was attacked in 1984 in a Senate campaign for my insistence at the time that we were not about to grow our way out of the deficit. I would encourage those of you assembled here who are all experts on this subject, when you adjourn, to move as the case may be to Andrews Air Force Base or the Hill or wherever the summit is going on because I think those guys are going to need a little help. Nevertheless, I have just made a solemn bet with Ed Graham of the International Institute of Economics that they will somehow solve the problem.

In the meantime, what brings us here today is in a very real sense a manifestation of the consequences of the macro-economic imbalances that have resulted in the fact that, over a very short period, the United States has become the world's greatest debtor nation. Of course, it is an automatic corollary of that fact that money comes here to buy either U.S. property or U.S. debt. Whereas a few years ago the first section of the discussion here today on the tax treatment of U.S. investment abroad, would have seemed to be just about the only worthwhile topic, now we are suddenly in the situation in which the tax treatment of foreign investment in the U.S. is a matter of considerable urgency. It is a matter that belongs in the context of the 26 bills now pending on the Hill that would in one way or another respond to the emotional uneasiness aroused by what has frequently been referred to as the "buying of America."

I have testified once and I expect to testify again tomorrow on behalf of the Association for International Investment on proposals that would prohibit employees of foreign-owned U.S. subsidiaries from contributing to a PAC — a somewhat bizarre and probably unconstitutional and discriminatory proposition, given the fact that the nationality of the share ownership of the companies for which they work ought not in itself to be a basis for depriving those employees from the opportunity to contribute to a PAC.

Similar reactions have been manifested in the Ways and Means Committee as a result of its Oversight Subcommittee's investigation of 36 foreign-owned U.S. distributors of automobiles, motorcycles, and electronics equipment — companies with some $35 billion in retail sales in 1986. As I am sure all of you here know, the investigation revealed that more than half of the 36 foreign-controlled U.S. companies paid little or no federal income tax, while handling billions of dollars distributing foreign-made products in the U.S.

IRS data, however, revealed that the return on assets for U.S.-controlled domestic corporations for that year was about 1.7 percent, while foreign-controlled U.S. corporations' returns were -0.2 percent.

One could easily leap to the conclusion that the foreign-owned U.S. subsidiaries were evading U.S. taxes on a wholesale basis. But a little bit more reflection would lead to the conclusion that that may not be so at all.

Let me emphasize that as a representative of the Association for International Investment, I am not a spokesman for foreign interests. AFII is an organization dedicated solely to the U.S. national interest in the preservation of policies traditional to the United States that have favored a climate in which U.S. companies are as free as possible to invest abroad, and in which foreign companies are comparably free to invest here.

The tax policies that are addressed to the domestic arms of transnational corporations need to be seen in a context that seeks, so far as possible, consistency in the treatment of those companies, wherever they may operate. Take, for example, the whole subject of transfer pricing. It is alleged that this is a major source of tax avoidance, distorting the foreign-owned U.S. companies' level of profitability. Of course, the foreign parent corporation does have a considerable amount of opportunity to determine what price it is going to charge the subsidiary. On the other hand, if the bulk of technology, management, and production takes place in the foreign country and only the marketing of the product takes place in the United States, it can be fairly argued that the bulk of the profits earned should be attributed to the foreign country.

Again, it is possible to allocate a disproportionate level of expense to the subsidiary or charge U.S. subsidiaries more for insurance, interest and freight, than would be charged to unrelated U.S. firms. But of course all of these are practices that can equally be used or abused by U.S. transnational corporations operating in other countries, and the very same charges were made against American multinationals operating in other countries long before these practices were seen to be a problem here.

The congressional response, therefore, had better have in view the question of what other countries may do if we act with a crude and indiscriminate hand in dealing with this problem. The Congress, as you know of course better than I, has already in the Reconciliation Act of 1989 dealt with some elements of the problem in order to improve information reporting by U.S. subsidiaries and branches of foreign corporations. They did this in four ways: by expanding the parties subject to reporting; requiring records pertaining to reportable transactions to be maintained in the U.S.; requiring the designation of a U.S. person as the agent to receive IRS summons; and by authorizing the IRS, in its sole discretion, to disallow deductions for payments to a foreign party and redetermine the cost of goods sold by a foreign parent to a U.S. subsidiary.

Now, the Foreign Tax Equity Act of 1990 would extend these provisions to open tax years, if the records exist, extend the statute of limitations, and extend U.S. taxation to a foreign parent's sale of stock in a U.S. subsidiary. Various ideas, like a value-added tax on goods imported into the U.S. or an alternative minimum tax, are being talked about.

Before we resort to quick fixes, we should ascertain the nature of the "problem" Congress seeks to address. For example, is the "problem" the product of inadequate enforcement, or an inherently flawed foreign tax collection system? If the former, congressional attention should be focused on beefing-up the IRS's international enforcement efforts. However, if the latter, Congress's attention should instead be focused on fashioning an alternative tax collection scheme.

We should, I suggest, have steadily in view the fact that what we are basically dealing with is a situation in which the corporate domicile of the corporation or the place where the preponderance of its shareholders may live, is increasingly irrelevant to the determination of rational policies. Where the employees are, where the customers are, may be much more significant.

In any event, we must reckon with the fact that investment decisions will be made with little if any regard for national boundaries. The question of whether to invest in the U.S., Taiwan, or Malaysia for that matter, is a question addressed by a foreign corporation today in much the same manner in which a big U.S. company 20 or 30 years ago would have considered whether to invest in Tennessee, Arkansas, Mississippi, or South Dakota. Considerations of comparative political risk, local tax climate and so on are the relevant considerations. In the tax context, as in others such as the regulation of securities transactions and the accountability of the corporation in the technology transfer area, all of that points to the question of where responsibility should lie and how harmonization and consistency can be achieved.

I would like to conclude, therefore, with the thought that the most useful effort that could now go forward would be one that seeks to bring about the maximum practicable level of coordination among countries. I know this is a difficult problem. An example is the treatment of disclosure to investors under the securities acts of different countries. It obviously makes sense in an era of 24-hour securities trading around the world that there should be the harmonization of securities laws. And of course a lot remains to be done to achieve this, including further efforts toward the harmonization of accounting principles. But we need to make a comparable effort in the tax area also.

Bilateral treaties and mutual negotiated policies are not enough. The willingness of the IRS and the Treasury Department to enter into agreements with individual multinationals and their home country governments is useful as a preliminary step, but we need to go forward with a more comprehensive framework of harmonization as we move toward three great trading blocs — the European Community after 1992, North America, Japan and the Pacific Rim countries — increasingly interdependent with each other as the three great segments of a global economy.

Congressman Philip M. Crane

Congressman Philip Crane, Ranking Minority Member of the House Ways and Means Committee, states that we are increasingly living in an international economy and that foreign investment is a good thing. He makes this point by asking the rhetorical question, "Why else would so many American investors be foreign investors?"

He points out that it was only last year did foreign investment in the U.S. exceed the amount U.S. investors were investing abroad. Mr. Crane also notes that most of the bills in Congress have the name Japan on them in some way. Japan, with investment of $69 billion in the U.S. is far behind the U.K., who are number one, with $119 billion in foreign direct investment in the U.S. Congressman Crane argues that the anti-Japanese sentiment is unjustified and can be attributed to animosity left over from World War II. He shares experiences from his travel in Japan and observes that they learned from the U.S. to set up a tax system that rewards savings and investment. The U.S., however, has not heeded its own advice.

Mr. Crane concedes that the transfer pricing issue needs some attention. However, he considers the proposed tax on disposition of U.S. stocks by foreign investors who own 10 percent or more of the stock to be profoundly misguided.

Let me make just a few observations in an historical context on this question of foreign investment. That relates to who built this country. We take a lot of understandable pride in the initiative and the hard work put in by struggling Americans during our infancy, and up through the better part of the 19th century. The fact of the matter is this nation's mortal enemy, the number one enemy of this country in those years, was the nation that financed our growth. And it was a period that witnessed the most spectacular industrial development the world had ever seen. I'm talking about Great Britain. Great Britain was this country's natural enemy until just on the eve of our entry into World War I. If you were to poll Americans in that period and ask them who was our natural enemy, 90 percent would have responded, Great Britain. They turned that around at the same time that Germans were lobbying and trying to propagandize in this country to get us to side with them if we entered the war. The British understood American psychology a little better and we ended up taking sides with them and as you know, we have been an ally and friend of Great Britain ever since.

But think of this in terms of say, the post-World War II era until the last couple of years. What if we were in a state of total dependence for foreign investment in this country on the Soviet Union? That is the equivalent of the situation we were in from the time we managed to succeed in the independence effort, down until about 1890.

Now, foreign investment obviously is a good thing, otherwise why would so many Americans be foreign investors? Where in this debate, listening to some of those who try to use emotion rather than logic and reason to advance their case for protectionism, where were they in condemning the very same action on the part of Americans investing overseas? It was just last year that foreign investment from abroad exceeded in this country what we were investing overseas. If it is a bad thing, then Americans shouldn't be involved in this either, right? We should construct tax policies or some kind of protectionist devices to keep that money here in the United States. The fact of the matter is, we all know that that is unsound economic policy.

I had the opportunity to speak to about 60 Japanese CEOs in New York City last week and it was on this very question. One of the things I pointed out to them, with all due respect to any New Yorkers present, is that I am a biased mid-westerner. I was born and grew up in Chicago, and as a result, I have always viewed New York City as hostile territory, and perhaps the best excuse we had in the country for nuclear exchange. I said, "One of the benefits of visiting in the Orient is that you realize that we are still barbarians here in this country. After about 24 hours you start to lower your voice and speak more softly and you get more polite and you tend to bow and help people with the doors — the courtesies that we so frequently tend to forget." I said, "By contrast, walk out on the street from the Helmsley Hotel and note the contrast. The fact of the matter is, much of this debate on this question is really Japan-bashing. Those who don't have logic and facts to support their position are resorting to this emotional appeal because a lot of Americans still live who remember December 7, 1941."

I then recommended to my Japanese audience that their extraordinary marketing skills should be shifted just a little bit right now to marketing Japan, the Japanese people, and Japanese culture. They obviously have the ability to do it. They must recognize that in the ad hominem debate that protectionists are trying to fashion on this question, the Japanese are the easiest target. I am sure we all know friends who served in the South Pacific in World War II, and you don't have to scratch many of them very deep before you elicit some kind of anti-Japanese remark. The Japanese are actually far behind the British as far as their investment in this country. My recollection is that British investment here is about $119 billion; that of Japan — $69 billion. Japan just went ahead of the Netherlands for the first time last year.

Where was the condemnation of the British? Where was the condemnation of the Dutch? If this issue is a valid issue, then the condemnation should be spread evenly amongst all those who would dare to invest in this country.

I submit to you that increasingly we are living in an international economy. We are bound to countries all over the world. And ironically, many of the same people who argue against foreign investment in the U.S. are in the vanguard of urging investment from this country in the Soviet Union. We want to help those people make the transition to free markets and they don't have the capital to do it. The whole free market world is making investments over there to help those people make the transition to membership in the civilized world. I think that is sound policy.

To be sure, there are some areas that I think may warrant further study by Congress. One of these is transfer pricing. That may be a legitimate issue, but my distinguished chairman, Dan Rostenkowski, as you know, has a bill that goes beyond that. His bill would sock a tax to those foreign investors who own 10 percent or more of any American company. That has elicited an immediate response, even from the U.K., which has a higher capital gains tax than we do, but they have suggested that there would be reciprocity, and West Germany and France have indicated the same. I think it is a move in the wrong direction. It is perhaps well-intentioned but I think profoundly misguided.

There is one other disturbing problem facing us. That is, why are we in a position where we need over $400 billion a year in foreign investment. We were reminded of one of the reasons when I was with the American Productivity Center on a visit to Japan back in 1981. Our group was comprised of corporate heads, some academicians, professionals, and a few politicians. We were over there to do the tours and study various successful Japanese enterprises. At the end of the tours we would sit down with a Japanese CEO and direct questions to him. At one facility upon conclusion of our interrogation, the Japanese CEO said, "Excuse me, but before you leave may I ask you a question?" "Sure," we responded. "Fire away."

He said that after the war, America insisted that the Japanese send thousands of their people over to our country to study our economy so that they could become a major industrial power in the shortest possible time. That was in part for our own self-interest. But it was beneficial to the Japanese, too, as they readily acknowledged. He said that one of their teams went to the University of Chicago to discuss the tax question. Bear in mind that Milton Friedman, a Nobel prize winner, Friedrich A. Hayek, another Nobel prize winner, and George Stigler, another Nobel prize winner, all taught at the University of Chicago. These professors taught them to structure a tax code that rewards saving and investment. As a result, at the time of our visit to Japan they didn't tax interest, dividends or capital gains for all practical purposes. We sat back and marvelled that as a percentage of personal income they were salting away about 20-22 percent annually while we were at the bottom of the industrial nations of the world. He then asked, "Why do you punish your people for saving and investing?" To which the only appropriate answer is, "Because we're jerks, that's why!"

When my son was in high school, I was counseling him as you were all counselled by your parents and you are still going to counsel your kids, "Don't squander your pay check at the end of the week on instant gratification. Put something away for the proverbial rainy day." Right? My son replied, "Daddy, that's crazy." He added, "If I blow it at the end of the week and have a ball they only get at it once. "By contrast," he said, "when you invest an after-tax dollar and the corporation makes a profit, they get at it a second time, and with a dividend distribution, they hit it a third time, and finally when you sell your stock and enjoy a capital gain, they get at it the fourth time."

The ultimate obscenity in the Code is when you have the audacity to die and leave them — they are so filled with rage at the Treasury that they come in and bash your bereaved spouse and loved ones.

This sick tax code that we have goes back to the influence of John Maynard Keynes who counselled the way out of a depression by stimulating consumption and discouraging savings and investment. I think it was misguided back in the '30s; it is profoundly misguided today. As a result, we should be looking inward in terms of resolving some of the apprehensions we may feel about foreign investment in this country. There are ways we could build the appropriate incentives for saving and investment in this country by rewarding people for doing these good things rather than punishing them. I think that is the direction that the Ways and Means Committee should be taking in looking at the whole question. We should encourage Americans to save and invest and reward them accordingly for taking that kind of a positive action rather than engage in scapegoating and especially singling out one country over another the way we are doing at the present time, implying that there is some evil conspiracy behind it. The only concession I will make to my chairman, Danny Rostenkowski, is on transfer pricing, but the rest I think is sadly misguided.

James M. Carter

James Carter, Senior Tax Counsel, ICI Americas, suggests a number of points in defense of foreign-owned companies doing business in the U.S.

He begins with a reference to the often quoted negative $1.5 billion income for foreign-owned U.S. companies in 1986. Mr. Carter points out that the people citing this figure invariably fail to mention that these same companies also paid $3 billion in U.S. taxes in 1986. U.S. companies take full advantage of tax laws as they find them. He suggests that foreign-owned U.S. companies are also entitled to minimize their U.S. taxes.

Mr. Carter discounts the accusation that foreign-owned U.S. companies are using transfer pricing to eliminate U.S. profits and attributes the accusation to the "foreign-bashing" currently in vogue in the press and on Capitol Hill. He asserts that there is no fiscal authority in the world that will allow a manufacturer to export a product to its foreign subsidiary that does not take into account in the price the manufacturing intangibles that went into it.

Finally, Mr. Carter raises the question, "Who is foreign?" He cites statistics which show that roughly 40 percent of IBM's employees are foreign, including 18,000 Japanese. Whirlpool employs 48,000 people, mostly non-U.S. in 45 countries. He maintains that instead of throwing stones at so-called foreigners, we should try to bring some rationality to the U.S. tax scheme. Moreover, Mr. Carter emphasized that we should work on a cooperative basis with other countries, rather than institute unilateral policies that attempt to force the rest of the world to conform to our standards.

Senator Russell Long once wryly observed that the best tax policy is, "Don't tax you, don't tax me, tax that man behind the tree." All of a sudden, it turns out that the U.S. subsidiaries of foreign-based multinationals are the man behind the tree. If you believe some of the statements that have been made in the press and on Capitol Hill lately, these subsidiaries are in large part responsible for the national deficit. The figure of $25 billion was mentioned recently as the amount by which the U.S. subsidiaries of foreign-based multinationals have cheated, evaded, or defrauded the U.S. government out of taxes. The examples that are being given to demonstrate how that is done simply don't hold water, and I would just like to call your attention to a few of them.

The statistic that was most often quoted was the $1.5 billion negative income for 1986. That was mentioned by the Chairman of the House Ways and Means Committee; it was mentioned by the House Majority Leader; and it has been mentioned by a number of other people in talking about this problem. What they didn't mention was, at the same time, those same companies paid three billion dollars in U.S. taxes. You hardly ever saw that figure mentioned anywhere in the press.

NBC recently did a program, last Friday in fact, in which they talked about how transfer pricing was, in effect, evading taxes. That has been a recurrent theme in the press and on Capitol Hill for some months now. The year they are talking about was 1986 and I recall a study that was done by the Citizens for Tax Justice, and they showed that from 1981 through 1984 there were 50 U.S. companies that had a combined total of $56.8 billion in profit and they paid taxes of -$2.4 billion for that same period. That includes some very prestigious companies: General Electric, Boeing, and many others. No one said they were committing tax fraud when that happened. They were simply taking advantage of what every tax advisor in this room tells his client to do, "Take advantage of the tax laws as you find them." And in that respect the U.S. subsidiary of a foreign multinational is no different from a U.S. company that is owned by U.S. shareholders.

Right now foreign bashing is pretty much in vogue in Congress and in the press. When they cite these examples of the way in which the transfer pricing works, they will show a manufacturing cost and a distribution cost and they will show a large, undefined block of profit going to the foreign manufacturer. Nowhere in there does anyone mention the research and development that produced that technology, and the manufacturing intangibles. There is no fiscal authority in the world that will allow a manufacturer to export a product to its foreign subsidiary that does not take into account in the price the manufacturing intangibles that went into it. If you don't believe that, try asking Lilly or Searle or Bausch & Lomb because they have all been to court recently on that very principle.

It is further suggested as part of this — and I have to call it a fiction because to me there is no rational basis for what they are claiming transfer pricing does — it is also said that the foreign multinationals are trying to transfer profits to these other jurisdictions even though as we just saw this morning that the tax rates are higher. Perhaps they are not as much higher as it appears because there are certain practices there that permit the profits not to be so heavily taxed as the nominal tax rate would make it appear in some foreign jurisdictions. Nevertheless, it doesn't make a lot of sense for a company by transfer pricing to try and transfer out of the United States from the 34 percent bracket into a 50 percent bracket. Remember that the foreign companies aren't plagued by the Section 861 rules. They are not plagued by the baskets and the PFIC rules that we have been hearing so much about that are being dealt with by the U.S. companies.

What I would like to recommend is that instead of trying to force the foreign countries into using the same kind of rules to tax their people, the U.S. Congress ought to be looking at how to relieve the tax burden on the U.S.-owned companies.

The fact is that when you start talking about U.S. vs. foreign, what is foreign anyway? I am told, and somebody here can correct me if my numbers are off, but they were in testimony that was presented to the Congress, that roughly 40 percent of IBM's employees are foreign, including 18,000 Japanese. Whirlpool, it was said, employs 48,000 people, mostly non-U.S. in 45 countries. There are 200 U.S. companies that employ 100,000 people in Singapore, alone, making products to be exported all over the world.

Now, the question is, who is foreign? If you earn a lot of your profit from a foreign jurisdiction, and if your management policies are dictated by what it takes to compete in that global marketplace, you are a global company. Your policies are going to be dictated by what is the best marketplace in which to operate. You are going to try and save revenue and take advantage of all the tax laws everywhere. I do it for my company and I am sure all of you do it for your companies. In fact, you would be remiss in your duty if you did not do that.

The point I am trying to get at is that instead of throwing stones and calling names and saying that these nasty old foreigners are cheating us, we ought to try to bring some rationality to the U.S. tax scheme. We ought to try to do it on a cooperative basis and not simply try to say, that Americans are going to institute unilateral policies that will force the rest of the world to conform to our standards.

Bruce R. Bartlett

Bruce Bartlett, Deputy Assistant Secretary for Economic Policy for the U.S. Treasury, speaks about the general domestic tax system and its effect on foreign investment. He suggests that domestic tax policy is an important influence on the level of foreign direct investment. If this policy discourages domestic saving needed to finance domestic investment, foreign capital must, by definition, fill the gap.

Mr. Bartlett cites statistics which show the decline in the U.S. savings rate from an average of 16.3 percent of GNP from 1950-1979 to about 14.1 percent today. This decline in the savings rate occurred when gross private domestic investment continued at the level of about 16 percent of GNP. Therefore, he suggests that the flood of foreign investment in recent years is really a direct result of inadequate domestic savings.

The causes for the decline in savings are twofold. First, private savings by households have declined, and second, negative savings (budget deficits) have risen from less than 1 percent of GNP to 3.9 percent over the same period. There are a number of ways to increase the levels of savings.

Mr. Bartlett suggests that federal spending could decrease to the level of taxation. He views this as a superior option to raising marginal tax rates, which would tend to discourage savings at the margin. Mr. Bartlett uses this line of reasoning to support President Bush's proposal to cut the capital gains tax. With a capital gains cut would come increased realizations of capital gains, which would produce new revenues, at least in the short run, and tend to reduce the budget deficit.

Mr. Bartlett also attributes the high increases in foreign direct investment to the favorable U.S. investment climate of recent years. He maintains that increasing foreign investment in the U.S. is a sign of strength, not weakness. "Tax policy," stated Mr. Bartlett, "should encourage work, savings and investment and take as little out of the taxpayer's pocket as possible."

Domestic tax policy is an important influence on the level of Foreign Direct Investment. In particular, if domestic saving is insufficient to finance domestic investment, then by definition foreign capital must fill the gap. Obviously, tax policy can affect each side of the equation, either by discouraging domestic saving or by stimulating investment. In recent years we have done both, which largely explains the large inflow of foreign capital to the U.S.

Historically, the U.S. financed domestic investment from domestic saving. From 1950 through 1979, gross private domestic investment averaged 16 percent of GNP and national saving averaged 16.3 percent. Thus, during this period the U.S. was a net capital exporter. Since 1980, however, the situation has changed. Although gross private domestic investment was about the same, averaging 15.8 percent of GNP, national saving dropped to just 14.1 percent, thus leaving a gap of 1.7 percent which was financed through foreign capital inflows.

Thus the flood of foreign investment,

which has so alarmed many people, is really the direct result of inadequate domestic saving. Had we not obtained foreign capital we would have had less investment, thus lowering the standard of living for all Americans. Hence, the real cure for the perceived problem of rising foreign investment in the U.S. is to raise the U.S. saving rate so as to allow domestic investment to be financed domestically.

Why has domestic saving not been sufficient to finance domestic investment? There are two reasons. First, private saving by households has declined from 5 percent of GNP in the period 1950 through 1979, to 3.8 percent from 1980 through 1988. Second, negative saving by the federal government rose from less than one percent of GNP to 3.9 percent over the same period. By negative saving, I am referring to the federal budget deficit, which absorbs private saving to finance consumption by government. Conversely, a budget surplus would be a net addition to national saving. Indeed, state and local governments have run an aggregate budget surplus of 1.3 percent of GNP in recent years, thus helping to offset part of the deficit at the federal level.

One might conclude from this analysis that the quickest way to increase national saving would be to eliminate the budget deficit. While this is true, it does make a difference how this is accomplished. If spending were reduced to the level of taxation, then clearly this would lead to a decline in government consumption. Since private saving would be unaffected, the decline of negative saving by the federal government would be a net addition to national saving. On the other hand, if taxes are raised there is the danger that such taxes would discourage some private saving. This is especially so when many people seem to believe that the best way to raise taxes is by raising the top marginal income tax rate. Such an action would certainly reduce the incentive to save by those with the greatest ability to save, namely those with upper incomes. It is quite possible, therefore, that even if the deficit declines, saving may decline more. As a result, there would be no net increase in national saving. If there is no increase in saving, then clearly there will be no reduction in foreign capital inflows either.

Of course, investment is also affected by higher tax rates. If they reduce the rate of return, then investment may fall. If investment falls by an amount greater than the fall in saving, then foreign investment will be reduced. However, it will be reduced at the expense of our standard of living. Less investment will mean fewer jobs, lower productivity, and a lower rate of growth. Thus the price for reducing our dependence on foreign capital would be very high indeed.

Ideally, what we want to do is increase domestic saving and investment. This is why President Bush has been so adamant about cutting the capital gains tax. It accomplishes both goals at once. It will promote investment because the capital gains tax directly affects the rate of return on capital investment. And it will promote saving by increasing the government's revenue. It does so by unlocking sales of assets, such as stocks, which people avoid selling in order to avoid paying the tax. At a lower rate, many people will realize their gains and thus pay additional taxes.

Unfortunately, too many people continue to view a cut in the capital gains tax as some kind of give-away to the rich. In fact, the capital gains tax does not in any way affect the wealth of those with capital gains. It only affects the extent to which they pay taxes on such gains. This is because the tax applies only to realized gains. Gains on assets which are simply held and not sold are never taxed. Those who believe that a cut in the capital gains tax benefits the rich are implicitly assuming that without any cut in the rate they would realize the same amount of gains as they would with a lower rate and pay taxes on such gains at the higher rate. Although some gains would have been realized even at the higher rate, experience with the capital gains rate reductions in 1978 and 1981 suggests that enough new realizations would take place to raise revenue at least in the short run.

President Bush has also pressed for a

restoration of savings incentives which were scaled back in the 1986 tax reform. In particular, this legislation reduced the ability to contribute before-tax income to individual retirement accounts. Although there is still much debate on this subject, the best evidence indicates that IRAs were a strong source of new saving during the 1982 through 1986 period, when they were available to all workers.

Thusfar, I have been talking about foreign investment as a residual, resulting from inadequate saving. While this has largely been the case in the U.S., it is certainly not the only factor affecting the level of foreign investment. Clearly, the attractiveness of the U.S. or any country as a home for foreign investment is influenced by many factors. Together, we might talk about these factors as constituting the investment climate.

The investment climate of a nation is the fundamental determinant of foreign investment. If the investment climate is good, investment will be encouraged; if it is bad, it will be discouraged. From this it logically follows that when one observes an increase in foreign investment, it probably indicates the existence of a favorable investment climate. Declining investment would thus indicate a less favorable climate. Therefore one can conclude that the rise of foreign investment in the U.S. in the 1980s is evidence of an improving investment climate. Conversely, declining foreign investment would be an indicator of a deteriorating investment climate.

Although this is a simple argument, it has far-reaching implications for policy. It means that increasing foreign investment in the U.S. is a sign of strength, not weakness. It also means that it is probably impossible to have a strong economy without foreign investment, for the only means of reducing foreign investment would be by adopting domestic policies inimical to growth.

In the 1970s, the investment climate in the U.S. deteriorated. In particular, high inflation pushed individuals into higher tax brackets, sharply raising the average marginal tax rate, while corporate taxes also increased as inflation overstated inventory profits and reduced the real value of depreciation allowances.

I emphasize the role of domestic taxation, because I believe that this is the fundamental determinant of the investment climate. However, the exchange rate and government regulations are also important elements of the investment climate. In the 1980s all three of these factors contributed to the inflow of foreign investment to the U.S.:

1. The tax cuts of 1981 sharply lowered the marginal income tax rate while encouraging investment through liberalization of business depreciation allowances.

2. The dollar increased sharply in value in the early 1980s and continued as the world's reserve currency, making it extremely easy for investors to move funds from one place to another.

3. U.S. law does not discriminate between domestic and foreign investment, affording both national treatment.

For these reasons, the U.S. was an unusually attractive place to invest in the 1980s. Thus, to a large extent, the inflow of foreign capital was a sign of confidence in the American economy — a sign of strength rather than weakness.

Ironically, there are still those who take exactly the opposite view, seeing the inflow of foreign capital as a liability to be discouraged. It is exactly this view which is, to a large extent, responsible for much of the poverty in the Third World. Especially in Latin America, foreign investors have been viewed with suspicion. Severe restrictions were placed on where and how much foreigners could invest and on the repatriation of profits. These countries believed, in adopting such policies, that they were protecting their sovereignty. In fact, all they were doing is impoverishing their people.

We now know that Foreign Direct Investment is a powerful engine of growth in the Third World. It brings in desperately needed capital without the burden of debt which comes with bank loans. It brings in competent managers and technical skills often lacking in underdeveloped countries. And it provides access to foreign markets often denied to them. Consequently, we are now seeing many nations previously hostile to foreign investors and multinational corporations opening their borders to them and actively courting them.

It is interesting to note that one of the major actions usually taken to improve the business climate in such countries is a reduction in individual income tax rates. In a study I did last year, I found that between 1985 and 1989, 56 out of 86 countries — over 65 percent — had reduced their top marginal income tax rate. It turns out that companies are not eager to invest even where business taxes are quite low when income taxes on their managers is prohibitive. Moreover, for many developing countries the best potential source of foreign investment is from their own people, who may have taken their capital overseas or moved away themselves to escape confiscatory tax and regulatory policies. This is especially true in Latin America, where so-called flight capital may equal the total foreign debts of some countries.

I would argue that the same factors which make foreign investment attractive to developing nations make it attractive here as well. Japanese and other foreign investment is transforming many industries. In autos and electronics, for example, Japanese-owned plants in the U.S., employing U.S. workers, achieve productivity levels similar to those in Japan. Indeed, Honda is now exporting cars made in its U.S. plants back to Japan.

In conclusion, I would join with the other members of this panel in endorsing the positive view of foreign investment. In any event, the same tax policies which are most congenial to foreign investment are the same for domestic investment. We need a tax policy which encourages work, saving and investment. We need a tax policy which takes as little out of the taxpayer's pocket as possible to fund the legitimate and necessary functions of government. And we need to be sensitive to the international implications of our tax policies.

We live in an increasingly interdependent world in which capital and labor are relatively free to move. The emerging democracies of Eastern Europe and the struggling economies of the Third World, as well as our traditional competitors in Europe and Asia, are actively courting foreign investors to improve growth and the standard of living of their people. We cannot afford to do less.

Q & A

Q: Most foreign nations eliminate double taxation with the tax integration system. In fact, many foreign nations, in Europe in particular, discriminate against U.S. investment in their countries because we don't have an integration system, which we can trade off. Companies do not have the double tax on their corporate earnings. It seems to me that one of the issues that Treasury is looking at, but is not coming forth in Congress, is that U.S. structure, the U.S. tax system, is out of line with almost the whole rest of the world. When do you think the Congressmen will at least begin to understand the need for an integrated tax system?

Mr. Crane: "When" is hard to answer. What has me profoundly worried in these budget negotiations is if they come up with a budget package that has, say, a 50 percent tax increase component, anything can happen — none of it positive. Harking back to the 1986 so-called Tax Reform Act, when we got to conference with the Senate (because their version was considerably at variance with our own), trying to reconcile the differences to come up with something that was going to be revenue-neutral, there was no real evaluation of the merits, the long-term merits, of what they were putting in there. It was just how much money is involved. You know, this will get us $10 billion — this will get us $25 billion — put it in the package. When we're working in these short time frames, first you can be assured that the Joint Committee on Taxation has done studies of a variety of these proposals and they've probably presented them to the chairman. Maybe CBO has done some analyses — I doubt that they would have talked to Treasury because they would rather blind-side Treasury. But the fact is, they will have done their homework and they will know what the dollar amounts are and then we'll get a chairman's mark and the chairman's mark will include the targeted numbers.

On the minority side, we are going to say, "Well what the heck is all this?" when we start thumbing through in desperation. Then we will have say a week to get this off the table and Rosty is an imposing chairman. If you are not familiar with him, watch him in action when he is under a tight time frame. If he doesn't rap you down with a gavel, he is liable to rap you with the gavel. So if anyone suggests altering the chairman's mark, he better have an alternative revenue raiser that will equal exactly what is being taken out. And given that kind of a situation, I think that we're potentially in for an aggravation, a sorry aggravation, of the problems that we have instead of addressing some of the positive topics that you have suggested.

Mr. Bartlett: I am not working on the integration study, but I do periodically ask Michael Graetz how it's coming. My impression is that in the last few weeks they've had to basically stop work on it completely to devote all their resources to analyzing 10 million different tax proposals that have come up in these budget negotiations. So, my guess is that they're not going to finish it this year; it will probably be sometime next year.

Mr. Carter: I just wanted to make a statement to Congressman Crane. You were saying that you believe that there is a possibility that the transfer pricing issue might be a legitimate issue. I can't speak for other companies, but I can speak for my own and I don't think it is a problem at all in our company. But I would like to call to your attention the flap about the transfer pricing issue arose, using those 1986 statistics of 1.5 million negative income. And as I pointed out earlier before you came here, at the same time, those foreign companies nevertheless were paying $3 billion in taxes. Now these 1987 statistics of income figures are out, and indicate that the foreign controlled companies' income is now up to $5.6 billion positive and the tax liability is now increased to $4.2 billion. A KPMG Peat Marwick study that turned up those numbers predicts that it is going to continue to rise in future years. The trouble is that statistics for income are always two or three years behind what we are actually dealing with. I don't know that it is as big a problem as it's being made in the press.

Mr. Crane: I would agree with you on that and that's why I would only recommend hearings to find the answers to some of these questions because the last figures that we were provided with on the committee were the 1986 figures. And someone suggested at that time that you've got start-up costs. So, it is hard to absolutely determine this, but again it is one of those things that when you describe what transfer pricing is, yeah, hey, what a cute gimmick that is and what a way to avoid paying taxes. When you turn that kind of an argument loose on politicians, beware. It is one of the things that they can take and run with. And that's why, as I said, I would prefer to conduct hearings and get some of the experts who understand this better than we do on the committee to come forward and testify to see if indeed there is a basis for any action.

Tax Treatment of Foreign Investment in the U.S. – Panel 2

Panel Chairman: John G. Wilkins
Partner
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Peter A. Barnes
Deputy International Tax Counsel
U.S. Department of the Treasury

Harrison J. Cohen
Legislation Counsel
Joint Committee on Taxation

Richard Pratt
Economic Counsellor
Embassy of Great Britain

John G. Wilkins

I would like to see if there is some way we can tie together what we are talking about on this panel with comments made at the beginning of the day by Professor Graham and some of the comments made by Secretary Bartlett on the last panel. Specifically, as we learned earlier, outflows of investment have increased slightly, about $8 billion. Inflows have decreased dramatically, however, some $100 billion for a total swing since 1989-90 of over $110 billion, of which about one-half is direct and one-half portfolio investment.

We are finishing a period in the 1980s where that was not the case, where there was increased demand for U.S. assets, where there was a relatively strong dollar; imports were high and exports were low. It was this kind of picture that led many in government to question whether we had the right policies, whether we ought to encouraging or discouraging investment in the U.S.

Now that we see that the value of the dollar is getting weaker, imports may not be so strong; investment funds may be dropping; and possibly higher interest rates coming about as a result; and, hopefully not but possibly slowing growth. I think the question to policymakers is, will they now change their minds; will this encourage them to back off some of these harsh legislative positions?

Catherine T. Porter

Catherine Porter, partner in Miller & Chevalier, suggests that part of the problem in dealing with the whole foreign investment debate is that it is carried out on two distinct levels. On one level, the debate can take place in a very detailed and technical way. Tax practitioners are concerned with the tax code, good tax policy and economic studies. Ms. Porter includes the professional committee staffs on Capitol Hill and of course the Treasury Department in this group. On the political level of debate, there is the problem of explaining these issues to congressmen and the press.

Ms. Porter finds so much prejudice in the Congress against foreign investment that even sympathetic congressmen will not take the lead on the issue during a budget battle. She predicts that the battle in progress at that

time will yield only a few negative provisions for foreign investment.

As an illustration of how Congress and the media misinform the public on this issue, Ms. Porter read the script of a recent NBC News television broadcast featuring Tom Brokaw and Congressman Richard Gephardt explaining the "transfer pricing scheme."

One of the things that I was thinking as I listened to the other speakers is that we really are faced with two levels of the debate on this issue of foreign investment.

We've got one level of the debate which can be engaged in by those who are interested in a very detailed and technical analysis. Tax practitioners who are concerned with the tax code and good tax policy, who are interested in economic studies, who want to know all the information that Edward Graham gave us this morning, and all the other statistics that I would like to present to you. The people at the Treasury Department and the Joint Tax Committee are all very interested in the tax policy issues. They want to talk about transfer pricing and Section 482. They want to speak in Code sections and understand all the economic issues, too.

Then we have another level of the debate which is a very difficult one. We have a political level of the debate where we have to try to explain things to congressman and senators who are making decisions about tax policy. The issue of having a "political" level of discussion exists whenever one deals with Congress, whether we are talking about foreign investment or not. But one of the complicating factors with foreign investment is that there is prejudice against foreign investment. There are many different levels of prejudice, and there are no particularly strong advocates in favor of foreign investment in the Congress. Our law firm represents the Organization for the Fair Treatment of International Investment which is one of the coalitions of foreign-owned companies who lobby on these issues. It is very difficult to persuade congressmen, such as those you have heard today, Congressmen Brown and Crane, who seem knowledgeable or maybe a little sympathetic, to actually take a leading role on a particular issue. Something else is usually going to be much more important to their constituents than defending foreign-owned companies in the United States.

So, whenever there is a big budget bill with many issues on the table for discussion, this is definitely not the number one thing on their agenda to defend. They won't become experts and lead or educate their colleagues about the fairness and complexity of taxing foreign investment. Instead, the debate degenerates into simple grandstanding and a battle of phrases which can be used in television commercials.

There are two anecdotes I would like to share with you. First, on the way over here in the cab, I was listening to a radio talk show. Senator Packwood once told me that he always knew when an issue was going to be really hot if the cab drivers were talking about it. He said he knew that Section 89 (a pension provision) was going to be repealed when he was riding in a cab to a speech one day and as he got out of the car, the cab driver said, "By the way Senator, are they going to repeal Section 89?" He knew that this was a sign that it was gone — when the level of interest had drifted out that far.

Well, this talk show I was listening to on the way over was a call-in program. People were complaining about foreign investment. People were complaining specifically about Japanese companies and where they chose to locate. There were all sorts of statements of prejudice and misstatements of the facts. Unfortunately, the telling fact was that the general public may be prejudiced against or hostile toward foreigners, especially if they are Japanese.

We may not find that the particular budget bill we are all concerned about today is going to be the death blow to foreign investment. We may get by with just some of the compliance provisions of the Foreign Tax Equity Act included, and everyone will breathe a sigh of relief. That sense of relief is part of another sort of political game that is played frequently. A group is threatened with an absolutely horrible proposal, and then it feels very happy when it is only hit by the compliance provisions of the Foreign Tax Equity Act. The group feels it was just let off the hook because some sort of surcharge on foreign-owned companies or the 50/50 profit split proposal was not enacted.

The other little anecdote is something that Jim Carter, on the prior panel, alluded to. I really wasn't planning to read this. I hope it doesn't take too long, but I think it may be enlightening.

This is what NBC news did with this issue of taxing foreign investment. It just gives you, in a nutshell, the problem of trying to address these complex issues in the "political" forum. We can have a wonderful discussion at an ABA tax section meeting and Harrison will come, and Steve Lainoff and Phil Morrison will come and there will be a lot of nitty-gritty discussions. Or, we can have a debate like the following television news broadcast:

Program: NBC Nightly News
Date: September 21, 1990

Tom Brokaw (anchor): There still is no deal in sight on reducing the deficit. Meanwhile the deficit is not being helped by the fact that many U.S. subsidiaries of foreign-owned companies are evading tax in this country. NBC's Diana Koricke reports that this has gotten the attention of Congress.

(Visual of congressional hearing)

Rep. Richard Schulze - PA (R): We are going to be called upon not only by the administration but by our summit peers to increase taxes; I will be damned if I am going to do it while billions of dollars are floating overseas.

Diana Koricke reporting: Congress is mad and it is not going to take it anymore. A House Subcommittee just investigated ten years of tax avoidance by American subsidiaries of foreign companies. It found more than half of them paid no income tax. Japanese companies are among the worst offenders. The scheme is called transfer pricing. This is one way it could work.

(Graphic: Transfer Pricing): Say a Japanese company builds a car for $5,000. It sells the car to its own U.S. subsidiary at an artificially inflated price of $9,000. The parent just made a $4,000 profit. An American consumer buys the car for $10,000. The net result for the U.S. subsidiary after other costs is little or no profit and little or no tax bill, but the Japanese parent still has that $4,000 and no taxes due to the U.S. Treasury. The IRS reportedly is investigating these companies for illegal transfer pricing. The list reads like a Who's Who of Japan's biggest corporate names. A former employee of Toshiba said that the company's pricing in the U.S. just did not add up.

Unidentified Man: The book price was just some arbitrary figure that they came up with, I guess to keep their taxes down. The system taken in on trade whatever it would sell for was all profit and yet the way they accounted for it, only half was shown as profit. The other half was arbitrarily called cost. There were no costs associated with it.

Koricke: Japanese sales in the United States skyrocketed in the mid-1980s, but their declared income on which they paid taxes plummeted.

Rep. Ronnie Flippo - AL (D): The average working man and woman in the state of Alabama paid more income tax over the last five years than multinational corporations. Is that a fact or not?

Kenneth Gideon (Assistant Treasury Secretary): There are certainly circumstances that we are aware of where there has been little or no tax payment over a substantial period of years.

Rep. Flippo: So the answer to that is yes.

Gideon: Well, that would be one way to put it.

Koricke reporting: How have some Japanese companies been able to avoid U.S. tax payments? One reason is the administration's reluctance to alienate the Japanese.

Rep. Richard Gephardt (Majority Leader): It's kind of been a marriage of convenience. On the one hand our people here have been worried that we can sell our bonds to foreign investors, and they are the Japanese investors in many cases. In return for that there is some kind of wink that we won't really enforce our tax laws.

Koricke: This kind of sweetheart deal just goes to show how dependent the United States has become on Japanese money. Americans must ask whether we want Japanese investors to buy bonds to support the budget deficit, or pay taxes to reduce it.

I don't know this person and I don't know under what pressure she was to do such a story, but she didn't call us to talk about the facts at all.

It is a very frustrating situation that many of the foreign-owned companies find themselves in just trying to lobby this issue. So many of the points have already been brought to your attention. Foreign-owned companies employ lots and lots of people here and they try to go to their congressmen and say, "We are U.S. citizens — don't disenfranchise us." But they still fall to the bottom of the list when it comes to having an advocate in the Congress.

The foreign-owned companies which I represent do not want unilateral changes in the arms length pricing standards. There have been many overtures by the British government and by the German government to sit down in a multilateral fashion and to try to talk about some of these transfer pricing problems. There were some suggestions at the Oversight Subcommittee hearings that might develop into something like a Blue Ribbon Commission. This would permit people who are interested in good tax policy to come up with some solutions to problems, that are perceived, or problems that are real, with the way the arms length standard works at the moment.

Please look at Table 1 (page 74). These tables were just given to me early today by Lin Smith at Peat Marwick. The group that I represent, OFTII (The Organization for the Fair Treatment of International Investment), had commissioned Peat Marwick to do a study of the taxes paid by foreign-owned companies. Many of you are familiar with this because we have been talking about it since July. We submitted some testimony to the Oversight Subcommittee. We talked to the Joint Committee on Taxation. We talked to the Treasury Department about it, and I think there is no real disagreement about what the figures show.

Originally we only had 1986 data. These tables are updated to have the 1987 data. My feeling is that the more people are aware of the actual facts of what is going on and the extent to which these companies are paying tax, the better. Because then we will be talking about real problems, if there are any. We can then target our solution to whatever problem there really is. We will not simply be legislating on prejudice or television news stories like the one I just read to you.

Peter A. Barnes

Peter Barnes, Deputy International Tax Counsel for the Treasury, reiterates some of his earlier remarks, saying that the U.S. has to be aware that if we enact foreign tax policy initiatives, the foreign countries are likely to initiate comparable legislation. With respect to superroyalties and the controversy they have generated, Mr. Barnes states that just because they are different doesn't make them wrong. Whatever rule the Treasury uses to determine what the right royalty payment is when a foreign subsidiary of a U.S. company is using U.S.-initiated technology could also be used by the U.S. subsidiary of a foreign parent to allocate income back to the host country.

Mr. Barnes also addresses the earnings stripping legislation that emerged last year along with the problem of thin capitalization. He comments on the proposed stock gains tax by saying that many foreign jurisdictions have rules that tax foreigners on the sale of stock in local companies. Finally, Mr. Barnes repeats his invitation for efforts to further the move toward simplification.

By my count, in the two hours since I last stood up here, there have been ten people (I am leaving Bruce Bartlett off), who told you that the sky is falling. I guess I am up here to convince you that's true.

There are four points that I would like to make that grow out of the conversations we have had in the last hour. None of the points are new, and I don't mean to take a combative approach. I want to repeat what I said before: I think we have a lot more in common than we have differences. But if this conference is to be more than something of a pep rally to make us all feel good — or bad as the case may be — I think it's important to see some of the balance on the other side.

The first point is a point that Elliot Richardson made, which is that the U.S. has to keep in mind that when we enact foreign tax policy initiatives, foreign countries are likely to initiate comparable legislation. He used that, I think, as a warning to say, "Hey, at Treasury, let's watch ourselves." I think it is an appropriate warning and we think that is very much the issue we ought to be keeping in mind as we go forward. That doesn't, however, always counsel me that we shouldn't take action at all, because somebody else may do something in response.

I take as my first example the Section 6038A legislation that was enacted last year. Throughout that process the guiding principle, the single guiding principle, that Treasury was concerned about was what happens when Germany imposes an identical Section 6038A and IBM comes in to talk to us. Is this something we can look Bob Mattson in the eye about and say, "Hey, it's not so bad." I think that when our regulations come out, which is not going to be too far from now, I think the answer is yes. If you look at the legislation and the regulations that emerge from it, it is going to be a product that we can say that if the foreign tax administrators enact this, if they seek to impose it on IBM, on Ford, on AT&T, then it's something that we think is legitimate tax policy and legitimate tax administration.

Elliot Richardson was right to raise retaliation as an issue. All I want to say is I think that many U.S. tax policy people do keep that in the forefront of their minds.

A second example is the superroyalties.

We have been assailed, as you know, by foreign governments. Ireland has been in the forefront of that, and the U.K. But many foreign governments have come in and said, "Your superroyalty rules deviate from international norms — they're terrible, you have to change them." I think there has been a very constructive debate over the last four years between the U.S., the taxpayers and the foreign governments on this issue, and I don't want to get into the superroyalties here. I'm happy to do so at another occasion. But what we recognize, repeatedly, is that whatever test we come up with for determining the right royalty payment when a foreign subsidiary of a U.S. company is using U.S. initiated technology, that same formula should be used, would be used, and could be used by the U.S. subsidiary of a foreign parent. And that's a very important check on where we go with our superroyalties. Because, obviously, the U.K., the Dutch, the Japanese, all have U.S. subsidiaries that are using foreign initiated research and we have got to come up with a superroyalty rule that is going to be even-handed, and I think we will. I commend to you Elliot Richardson's warning, but I think it is a warning we have taken to heart and I urge you to remind us to take it to heart. I think by and large we have enacted policies so that we can look the foreign governments in the eye and say they're policies that we do not find inappropriate.

The second point I would like to make is that U.S. tax rules may be different, but that doesn't necessarily mean they are wrong, either wrong morally, wrong philosophically, or wrong theologically. The rules may be different from the rules that we had in the past or they may be different from the rules used in foreign jurisdictions, but I would underscore that simply because rules are different does not mean that they are wrong.

The first example I would take is the earnings stripping legislation that emerged last year. Let me make clear — we opposed the earnings stripping bill. Treasury opposed the earnings stripping bill. I don't want anybody walking out of here and saying Treasury did not oppose the earnings stripping bill. That said, let me go on. Thin capitalization is a serious problem in the U.S.; it is a serious problem in overseas jurisdictions. Typically, the foreign way to deal with thin capitalization is to say that this instrument is not debt but equity, and the stream of payments that accrue from that instrument are dividends, not interest. They may make the recharacterization at the outset or they may do it over time. We clearly keep within our jurisdiction a similar concept, that certain instruments, although called debt, are equity.

But the earnings stripping legislation was an effort to do something different; to say, no, the instrument is debt, and the stream of payments is interest. We will simply defer the interest deduction for a period of time. There are very important consequences that flow from keeping the character of that payment as interest rather than the character of that payment being transmuted into a dividend.

We recognized during the 1989 legislation that our approach was different from the approach used in many foreign jurisdictions. But I think that our approach has much to commend it. We think that the foreign jurisdictions in some cases are recognizing that and they are looking at our rules. I think right now one of the serious questions that we have to face and are facing is how do we match our earnings stripping rules, which maintain the character of the payment, and rules in the foreign jurisdiction, which has different rules.

But the bottom line point, which is that the U.S. came up with a different approach, doesn't necessarily mean that the U.S. approach was absolutely wrong. It may, in fact, be an improvement and I would suggest that eight or ten years from now we revisit the question of earnings stripping and thin capitalization and you may find that our system has a lot to commend it.

I would take a similar point on taxing stock sales. Let me emphasize, Treasury opposes the proposal that a capital gains tax be levied when a foreign person sells a 10 percent interest in a U.S. corporation. We oppose! But let me say that the fact that the U.S. policy, if that initiative goes through, will differ in the future from our policy in the past, does not in and of itself tell us that the new policy is wrong. Today, we treat sales of assets different from sales of stock, but many other countries have rules that tax foreigners on the sale of stock in local companies. It is not a heinous thought in international tax. And I don't think we move the debate forward by simply saying this new rule is different. I think it's important for people to go beyond that and say, it's different and for reasons A, B, and C, we think it's wrong. I just invite you to have an open mind because I think tax policy does evolve and I think in many instances the simple fact that there has been a change doesn't tell us one wit about whether the change is a good change or a bad change.

We can speak about the pace of the changes and I am very sympathetic to the argument that the pace of the changes causes us problems. But that's different from saying that because it is a change, it is wrong.

The third point I'd like to make is to harp on an old favorite of mine, which is simplification. I invite you to look in your hearts and tell me whether companies are serious about simplification or do we just want to sit here today and make everybody feel better.

If you are serious about changing U.S. tax policy, you are going to go out of here, you're going to revisit the pamphlet that was issued in June. You are going to revisit the proposals that you made and you're going to come up with packages, not a grand package that reforms all of international tax, but a package that takes a few of these problems. It does it by accepting the cardinal ground rule of today, which is revenue neutrality. Because if you don't accept that ground rule — and I already see Dick Hammer shaking his head — you are implicitly buying into James Carter's point that you aren't taxing you, you aren't taxing me, you are trying to shift the tax to that man behind the tree. Somebody is going to pay for that and, frankly, I am disappointed that the discussion today has ignored the question of revenues, because I think we can't ignore the deficit. If we're going to have a constructive debate going forward, we need to keep that in our minds.

The fourth point I would make is to say I'm not sure it is a fair statement to say the U.S. is always undermining its companies, but the foreign countries are always helping their companies. That implicit view has been expressed several times today.

I take as my point Robert Ashby's home country of Canada. For instance, if you look at the U.S./Canada Tax Treaty, it has extraordinarily high withholding rates on interest and royalties, if you consider that it's a treaty between two developed countries with an enormous flow of technology, interest payments, and everything else back and forth across the border.

Why are the rates so high? It's not because the U.S. wanted them there. The U.S. would be eager to drop the withholding rates on interest and royalties. It's because Canada has said no — when a U.S. company has a subsidiary in Canada and wants to repatriate royalties or interest, we are going to extract a fairly substantial withholding tax. I don't point the finger at Canada on this. They have an articulate reason for why they do what they do. We're working on the treaty to see if anything can be done. I don't know if it can.

But the point is, there are lots of countries that for lots of reasons make investment decisions and tax decisions, and I don't think it is appropriate for us to assume that the U.S. is always inhospitable and other countries are always hospitable, because that's simply not the case.

We think that tax policy helps all taxpayers best by giving all components of the tax system fair treatment. And I want to stress again, remember the U.S. company with U.S. business. When you walk out of here, think about the points you are making, or points you are willing to make, when you sit down with your neighbor or businessperson who has a purely domestic company. Be sure you are comfortable in saying, "Look, yes, my deal is the right deal, notwithstanding the fact that my deal may have consequences for you." Most of the people in this room will probably remember the runaway plants issue that came up a few years ago. Fortunately it was not enacted, but I don't think runaway plant legislation is gone forever. Frankly, we have to be conscious of the fact that in enacting international tax policy that will give U.S. companies a legitimate opportunity to earn income overseas, we can't do it in a way that opens us up to criticism on the runaway plant issues. I dare say that would be very negative for all of us, and I think we would be prudent to keep in mind the risk of future runaway plant legislation.

Harrison J. Cohen

Harrison Cohen, Legislation Counsel for the Joint Committee on Taxation, speaks about problems that inevitably arise when companies that do business across borders have different incentives to provide information. The U.S. has a tax system that requires companies to get a tremendous quantity of data from overseas operations in order to categorize income for tax purposes. As long as we rely on labeling income as dividends, interest, or gains, we will need extensive information reporting to arrive at a dollar and cents figure.

Mr. Cohen acknowledges the valid objections that are raised when the suggestion is made that the U.S. move away from the arms length standard for transfer pricing. However, these objections do not necessarily prove that nothing other than the arms length standard can ever be used. Ultimately, taxpayers, Congress, and Treasury may conclude that another standard would be superior because it may be inappropriate to ask for reams of material and to try figure out this illusive arms length price between related parties.

On the stock gains tax, Mr. Cohen finds the insistence on taxing dividends, but not stock gains, contradictory. He hastens to add that we should not tax the gains in cases where treaties forbid it.

I had heard criticism about some of the proposals that are before Congress now before I came here today. I didn't hear many of the presentations today, but I will take Peter's characterization of it.

Think about why we are doing these things. I was in a meeting the other day of some foreign legislators with people on the Hill and we were talking about whether or not transfer pricing was a problem as far as they knew. They named a couple of American companies and said, "They are doing business in our country and they seem to be running all their operations, even though they are done in our country, through Bermuda and the Bahamas." I silently thought to myself, I am proud to be an American tax lawyer. It's possible that companies domiciled overseas would be interested in doing some of the same things with respect either to their own home country tax systems, or with respect to the U.S. tax system.

I remember talking to people about why we are in the position we are today with H.R. 4308. I started saying this really goes back to last year. The House thought it was doing something not particularly controversial and it got some heat. The IRS developed what it thought were some suggestive statistics. They went public, and members of Congress picked up on them. Others decided that the statistics were wrong and came back with some rebuttal. In addition, I recall a case involving a foreign multinational company that was doing business over here. The IRS was trying to audit it by reference to some of the records that it kept overseas. A communication was apparently sent by the company's home country government saying it is a breach of international relations between our two nations for the IRS to be asking for this material.

If that is the attitude of companies that do business across borders, and yet we have a tax system that requires the IRS to get that kind of data from overseas, then I think that whatever we think about the data and the inconvenience and the inefficiency of requiring reams of information, we will be in a position where we will need these compliance related proposals to force the information out of companies that would rather not provide it.

I'd have to say that it is a fair question whether that is the best system that we could have for taxing cross-border transactions. In fact, there has been a debate for years over whether using arms length prices between related parties and trying to respect those makes sense.

As you know, some of the alternatives even within ordinary 482 practice involve profit split, which determines the profit from an entire operation, and then divides it between jurisdictions, without regard to what prices unrelated parties would set at arms length. In fact, studies have been done over the last 10-15 years showing that in many cases you can't find a comparable price. The inevitable result of that is that you do look at some sort of unified profit and loss figure and try to divide it up.

We have heard a lot of criticism about ideas like that — ideas that depart from the arms length standard. Certainly people are very harsh in their criticism of the states' unitary taxation methods and many do not believe that they provide an equitable or correct division of income. They often say that if you want to know what the worldwide income of a company is, you will be trying to compare apples and oranges. You would be trying to compare income computed under U.S principles with income computed under foreign principles. Those problems are valid. On the other hand, they don't prove that that type of a system, or a system that uses some sort of a proxy for investment or activity in order to divide up a worldwide profit, is inferior to the arms length system we have now. Ultimately the taxpayers, Congress, and Treasury may conclude that some such system would be superior, because at some point in the future it may not be appropriate to ask for reams of material and to try and figure out this elusive arms length price. It may be that a product is only being traded between related parties because that's the economically efficient thing to do. If it was efficient to trade that good or service between unrelated parties, there might actually be an arms length price that you could find.

If you think about why something other than the arms length prices ought not to be used, I think you have to ask yourself in the same vein why, for example, interest paid between related parties is something that should clearly be deducted. Peter said all countries have to worry about the problem of thin capitalization. If it's a payment of interest or a payment of royalties, it may be that the geographical nexus of the income related to that payment is sufficiently elusive or theoretical that something more concrete would be a more appropriate criterion to use. That goes to, for example, the issue of why we have zero withholding on interest and we do not have zero withholding on dividends under our treaty policy. Of course, interest is deductible and dividends are not.

There seems to be a premium being placed on labels. I would think that would be productive of the kind of complexity and splitting hairs that may have given rise to criticisms of the complexity or the burdensomeness of our tax system. Nevertheless, if we want to have a tax system that uses those kinds of distinctions to reach dollars and cents results, then we have to be prepared to provide the IRS with the kind of information that is being called for under the proposals.

Finally, there has been a lot of talk about stock gains taxes, and Peter has said Treasury is definitely not in favor of the stock gains tax. Some of the people here before were not either. But, it also may be hard to distinguish why stock gains should not be taxed, whereas dividends must be taxed. I think there is a relationship between the two when there is a sufficient level of control. It seems that if you own stock in a company that pays no dividends, the result that you should be taxed not at all, as opposed to the case where you hold stock that does pay dividends and you are taxed, is the ultimate case of bail-out that we used to be concerned about when we had differential rates between ordinary income and capital gains. There could be reasons not to tax gains in specific cases, and you will notice that the provision that was put forward in H.R. 4308 did not override treaties, so it would leave the status quo in those cases where the United States and another country had together decided not to impose those taxes. But that is simply another example of the kind of tax issues that must be faced if we're going to design a tax system that looks at distinctions like dividends, interest or gains, or looks at things like arms length prices between parties that do not have arms length relationships, in order to determine the taxes that ought to be paid.

Richard Pratt

Richard Pratt, Economic Counsellor for the Embassy of Great Britain, expresses his amazement at the degree of self-doubt and lack of confidence in its economy displayed by the U.S. The advance of European countries and of Japan is a U.S. policy success, not a failure.

Mr. Pratt applies this same thinking to the area of foreign investment. He explains that the U.S. is the biggest foreign investor in the U.K., and of all U.S. investment in the European Community, the U.K. takes in approximately 40 percent. Just as the U.K. welcomes American investors, so too they welcome the influx of Japanese talent and production facilities, particularly in the automobile industry.

Mr. Pratt finds it strange that the U.S. would consider reducing the return on capital to foreigners investment with a stock gains tax at a time when it so dearly needs foreign capital. Moreover, he cites the U.S. tendency to consider the possibility of overriding an existing treaty to be very troubling for our trading partners.

He also shares how the U.K. deals with the transfer pricing problem. They simply assume that companies are manipulating these numbers and go in and make adjustments to their transfer prices to compute.

Let me begin by making the point that the ambivalent attitude about foreign investment that we see in the U.S. seems to me to be partly based on what is, to British eyes at least, a quite astonishing and completely unjustified lack of confidence in the American economy by policymakers here in Washington.

It is a degree of self-doubt, which one sees in newspapers, and it is apparent from hearings in Congress. It is based particularly on a comparison between the American and Japanese economies, but also on comparisons between the American economic performance and the European performance. It is unjustified because when you look at the United States from Europe, you see the largest and most powerful economy the world has ever seen. You see American workers — still the most productive in the world — way ahead of the European and streets ahead of the Japanese (when you take the analysis on the basis of output per hour across the whole economy). The U.S. is the only country capable of mounting the operation we see in the Gulf. Other European countries and the Japanese are clearly gaining ground in the sense that they are becoming richer, and thus the gap between the U.S. and the other countries is perhaps narrowing. Moreover, the proportion of the world economy that is made up of the American economy is perhaps declining from say, 40 percent after the end of World War II, to 30 percent now. However, the advance of European countries and of Japan represents a success for U.S. policy and not a failure. The restoration of those economies was what the original Marshall Plan was all about.

These factors reinforce my view that it is astonishing to see a lack of self-confidence about the U.S. economy here in Washington. What is particularly serious is that, in my perception, it leads to an uneasiness about the extent of foreign investment from your friends and allies.

I would regard the doubts about foreign investment, of course, as being quite unjustified too. As many others have been speaking about this all day, I won't go through all the points I had intended to make. I will, however, just emphasize that we in Britain benefit from substantial foreign investment. The U.S. is the largest foreign investor in the U.K., and we receive something like 40 percent of all U.S. investments into the European community. We also take about the same figure of Japanese investments into the European community; about 40 percent comes into the U.K. By and large, I think we welcome that investment. There have been a number of examples of greenfield sites opened; new plants operated by the Japanese, Americans and others where productivity levels, for example in auto manufacturing, have attained world standard.

Some people in Britain began to think that we had become incapable of producing mass volume automobiles. Our auto industry had suffered a decline over many years. Japanese companies have come to the U.K. with new investment, new know-how, new managers. The result is that we have shown we can produce cars competitively. Similarly in electronics, we saw our television industry decimated in the 1960s and 1970s by foreign competition. Now the U.K. is once again a net exporter of color televisions. Japanese investors have come in and built new plants. They have brought new management techniques and new investments. They have created a large number of jobs and a new exporting industry.

We therefore see foreign investment as a major advantage for us. We find it difficult to see why there is so much ambivalence about it here in the U.S.

One further point I would make about foreign investment is that it increases the ties between our economies. This seems to me to be healthier as it makes us far more dependent on each other and forces us to look to each other's interests. Along with the increasing uneasiness about foreign investment, we have seen increasing concern in the U.S. about whether or not foreigners are paying their fair share of tax. For some, the response has been to urge an increase in tax paid by foreign investors.

Of course, all companies, domestic and foreign, should pay their fair share of tax. But I think it fair to point out that the U.S. has a continuing need for inward flows of foreign capital as a result of the continuing trade deficit. It seems to be an odd response to that position for the U.S. to want to decrease the return on that foreign investment by imposing a new level of tax, such as a capital gains tax on certain foreign-owned assets, as has recently been proposed. It seems odd for a country that needs a continuing flow of foreign capital to try and reduce the return on that capital.

Perhaps in the end the U.S. is in the same position as all the rest of us in wanting to borrow money but not wanting to pay the full interest on it!

This concern about the tax paid by foreign investors is perhaps also reflected in the different attitudes toward the international tax structure and to tax treaties. The U.S. clearly sees the need to negotiate treaties with other countries. However, when a treaty doesn't work out as was originally expected by the U.S., then we sometimes see moves to act unilaterally to change that treaty to the benefit of the U.S.

Let me demonstrate how this looks to a foreigner by giving you an example from our own experience. In the U.K. we have a system for avoiding double taxation of dividends. This involves the payment of tax credits to shareholders when they receive their dividends from the companies in which they hold their stocks. When we negotiate tax treaties with countries with similar systems, we usually negotiate that the tax credits should be paid to stockholders from that country as well. The U.S. is the only country which doesn't have a similar system but to whom we pay the tax credit anyway.

Now, why do we do this? Some people may argue that Congressman Crane may have one answer — because we are jerks. Perhaps it is just because we like the United States so much. But whatever the reason, my point is that over the time since we concluded the U.K./U.S. treaty, some analyses have suggested that the balance of flows of revenue between the U.K. and the U.S. have been very much to the advantage of the U.S. Despite this, you do not see in the British Parliament a move unilaterally to override the treaty.

This self restraint causes us to be most upset when we see proposals in the U.S. to alter those elements of tax treaties which may not, on their own, work in the favor of the U.S. Other speakers have mentioned earlier both earnings stripping and unitary taxation. Let me just make a small point about both of those.

The U.K./U.S. tax treaty is quite clear about how to deal with earnings stripping. There is a specific provision in the treaty. It is broadly speaking as Peter Barnes described it. The U.K. deals with earnings stripping precisely in line with that provision. By contrast, the original proposals put forward by the U.S. Congress last year to deal with the problem of thin capitalization were not consistent with the treaty. The proposal was quite different. It might have been a better way; it might have been worse; but it was different from that which we had already agreed in the tax treaty as the way to deal with the problem. The issue is not whether the U.S. Congress had found a better way or not found a better way. The issue was and is: Has the United States the right unilaterally to change the system which was built into an agreement that both sides reached?

The answer is quite clearly "No." In the event, the outcome of the debate about earnings stripping last year left it open to the Treasury in regulations to produce a system which was consistent with our treaty. Of course we hope they will do so.

The same issue arises with respect to unitary taxation. It is true that if the entire world operated a unitary taxation system; if everybody had the same formula for deciding what profits were attributable to their country; if every country and taxing authority had the same rules to determine what was income and what was deductible, and if every country in the world had the same accounting standards; yes, a unitary system might well be made to work. But a unitary tax regime is not what the tax treaties assume. The tax treaties assume an arms length system for attributing profits between different jurisdictions. So, when Harrison Cohen said that it is open to the U.S. Congress and legislators to consider that the arms length method for allocating income may be the wrong way and that another way is more appropriate, that is all very well. But it is vital to remember that there are other parties involved. These are the foreign treaty partners who have all signed tax treaties with the U.S. on the assumption that the arms length system is the internationally agreed regime. They have to agree before any change is made.

So, I come back to my point which is that one does see a tendency to feel in the U.S. that where a tax treaty does not operate in the way in which it was originally intended, that the right thing to do is take action unilaterally.

I think that I will just go on to say that some aspect of this results from the U.S. Constitution, and in particular the leading role of the House of Representatives in raising taxes; the leading role of the Senate in ratifying treaties; and the role of the Administration in negotiating treaties. It would be impertinent for me to comment on that. Nevertheless, we as foreigners, tend to get left in the middle. We certainly do not regard the U.S. Constitution as justifying any departure by the U.S. from its obligations under international law.

Let me just comment on a point that was made earlier and then I will come to an end. We discussed the allegations of tax cheating by foreign-owned companies. Although the British government doesn't accept that the statistics submitted to the Oversight Subcommittee demonstrate that there is widespread tax cheating by foreign-owned companies, I think we would be stupid to pretend that manipulation of transfer pricing does not go on. That is why in Britain we have staff in the Inland Revenue whose sole job is to adjust transfer pricing of multinational companies to avoid exactly this kind of manipulation.

I don't think we do ourselves a favor by saying that this manipulative activity doesn't go on. It clearly does. What I think we ought to do though is accept, and we in Britain have taken this view, that if there are multinational companies that are cheating the U.S., the chances are that they are cheating the U.K. too. So, if we are going to go after them, let's go after them together. That is why the British Chancellor of the Exchequer has proposed an international study by the tax authorities of different countries — the authorities that can already exchange detailed, confidential tax information — to determine the cause and extent of tax avoidance, and then, to find the right way to deal with it. This multilateral approach seems to me the right way of dealing with this issue and far more effective than unilateral action by any one country.

Let me end by returning to my first point which is that the ambivalence toward the tax practices of foreign companies and indeed toward foreign investment seem to result from a lack of self-confidence in the U.S. economy. It is odd for a Briton to have to say this to a U.S. audience. But I do urge you to cast aside this lack of self-confidence and accept that this is the most powerful economy in the world. You have no need to fear foreign investment from us or indeed from any other country.

Appendix 1

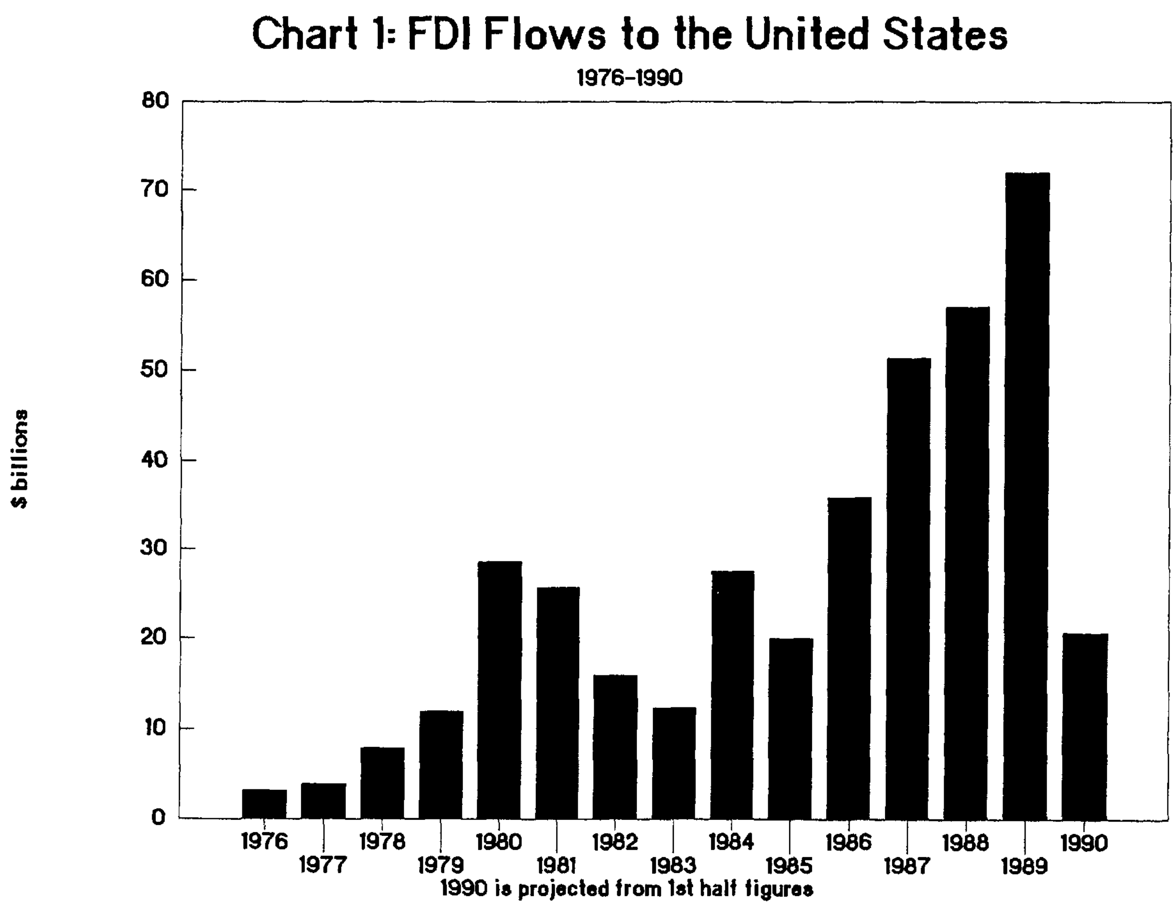
Chart 1: FDI Flows to the United States
1976-1990
$ billions
0
10
20
30
40
50
60
70
80
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1990 is projected from 1st half figures

Chart 2
Measures of FDI in the United States
Relative to the US Economy

FDI Stock as a Percentage of the Total Net Worth of Non Financial Corporations	(1989)	14.7%
Assets of Foreign-Controlled Manufacturing Affiliates as a Percentage of all Assets of Manufacturing Corporations in the US	(1988)	14.7%
Sales of Foreign-Controlled Manufacturing Affiliates as a Percentage of all Sales of Manufacturing Corporations in the US	(1988)	12.2%
Employment of Foreign-Controlled Affiliates as a Percentage of all US Employment	(1988)	4.1%
Employment of Foreign-Controlled Manufacturing Affiliates as a Percentage of all US Manufacturing Employment	(1988)	8.5%
Value-Added by Foreign-Controlled Affiliates as a Percentage of US GNP	(1987)	3.4%

Note: parantheses indicate the latest year for which base data are available

Source: E. M. Graham and P. R. Krugman, Foreign Direct Investment in the United States, 2nd edition (forthcoming); from BEA and Census Bureau base data

Appendix 2

Tax Foundation Seminar
September 25, 1990

The Competitive Burden:
Taxation of U.S. Multinationals

Arthur Young Study Results: Update

Tax reform in Germany, Japan and the Netherlands have resulted in many changes. The fundamental answers provided in the study, however, remain the same except for the following changes in Germany and Japan. In the row "Home Country Recognition of Foreign Losses" under the column Germany, this should no longer include subsidiaries. In the row "Overall v. per Country Limitation", under the column "Japan", there is a per country limitation on the use of foreign tax credits resulting from a tax rate in excess of 50%.

Raymond Haas
September, 1990

THE COMPETITIVE BURDEN
TAXATION OF U.S. MULTINATIONALS

ITEM	U.S.	THE NETHERLANDS	JAPAN	GERMANY
EXEMPTION OR DEFERRAL OF HOME COUNTRY TAX				
Exemption of Foreign Business Presence Income from Home Country Tax	No (with minor exceptions for Foreign Sales Corporations and possessions operations)	Yes	Generally no (with significant exceptions for certain income and exemptions under tax sparing treaties)	Yes, by treaty for most developed and many developing countries
Inclusion of Foreign Operating Income, or Dividends from Controlled Foreign Subsidiaries, in Home Country Tax Base	Yes	No	Yes (with certain exceptions noted above)	No, by treaty for most developed and many developing countries
Loan by Foreign Subsidiary to Parent Without Home Country Tax	No	Yes	Yes	Yes
Current Home Country Taxation of "Tainted" Non-Repatriated Foreign Subsidiary Earnings	Yes	No	Yes (but less encompassing rules than U.S.)	Yes (but less encompassing rules than U.S.)
Home Country Recognition of Foreign Losses	Yes, for branches; no, for subsidiaries	Yes, for branches no, for subsidiaries	Yes, for branches and developing country subsidiaries	Yes, for branches and subsidiaries

ITEM	U.S.	THE NETHERLANDS	JAPAN	GERMANY
FOREIGN TAX CREDIT UTILIZATION				
Overall v. per Country Limitation	Overall, but with 10 separate categories of limitations	Overall or per country, * depending upon whether a treaty applies	Overall	Per country
Availability of Deemed Paid Foreign Tax Credit on Dividends	Yes	No (but not generally necessary)	Yes	Yes
Blending of Foreign Tax Rates on Different Types of Income	No	Yes *	Yes	Yes
TAX SPARING CREDIT				
Tax Sparing Treaties	No	Yes	Yes	Yes

* Applies to Very Limited Categories of Income

Item	Switzerland	Italy	France	Belgium
EXEMPTION OR DEFERRAL OF HOME COUNTRY TAX				
Exemption of Foreign Branch Income from Home Country Tax	Yes	No, however possible exemption from local income tax,	Yes	Either with reduced rate of income tax or exemption under most tax treaties.
Exemption of Dividends from Controlled Foreign Subsidiaries in Home Country Tax Base	Yes	Inclusion of 40% of dividends from foreign subsidiaries	Yes	Yes with respect to 90-95% of dividends
Loan by Foreign Subsidiary to Parent without Home Country Tax	Yes	Yes	Yes	Yes
Current Home Country Taxation of "Tainted" non-Repatriated Foreign Subsidiary Earnings	No	No	No, with exceptions for tax havens	No
Home Country Recognition of Foreign Losses	No, generally, for branches; No, for subsidiaries	Yes, for branches; no, for subsidiaries (may write down investment)	Yes for subsidiaries; no for branches	Yes,for branches; no, for subsidiaries

Item	Switzerland	Italy	France	Belgium
FOREIGN TAX CREDIT <u>UTILIZATION</u>				
Overall v. per Country Limitation	Per country and category to very limited categories of income if based on tax treaty	Per country	Per country (but generally not relevant)	Per country and to limited categories of income
Availability of Deemed Paid Foreign Tax Credit on Dividends	No (but not generally necessary)	No	No (but not generally necessary)	Yes, but limited to non-permanent participations
Blending of Foreign Tax Rates on Different Types of Income	No	No	No	Yes
<u>TAX SPARING CREDIT</u>				
Tax Sparing Treaties	Yes	Yes	Yes	Yes

Item	Australia (see notes)	Canada	UK
EXEMPTION OR DEFERRAL <u>OF HOME COUNTRY TAX</u>			
Exemption of Foreign Branch Income from Home Country Tax	No	No	No
Exemption of Dividends from Controlled Foreign Subsidiaries in Home Country Tax Base	No	Yes for dividends, paid out of active business income in treaty countries; No otherwise	No
Loan by Foreign Subsidiary to Parent without Home Country Tax	Yes,	Yes	Yes
Current Home Country Taxation of "Tainted" non-Repatriated Foreign Subsidiary Earnings	No	Yes (but less encompassing than U.S.)	Yes (but less encompassing than U.S.)
Home Country Recognition of Foreign Losses	Yes, for branches; no, for subsidiaries	Yes, for branches; generally no for subsid-iaries	Yes, for some branches; no, for other branches and all subsidiaries.

<u>Notes re: Australia</u>

- Proposed CFC rules from 7/1/90.
- Income of CFC in designated countries subject to attribution (excluding dividends)
- Other foreign source income, including branch income, exempt from tax.

Item	Australia	Canada	UK
FOREIGN TAX CREDIT UTILIZATION			
Overall v. per Country Limitation	Overall	Per country	Per source
Availability of Deemed Paid Foreign Tax Credit on Dividends	Yes	Yes, for taxable dividends generally exempt from tax base	Yes
Blending of Foreign Tax Rates on Different Types of Income	Yes	Yes, with some limits	Technically, no; effectively, yes, through use of first tier holding companies
TAX SPARING CREDIT			
Tax Sparing Treaties	Provisions for, but no effective treaties yet.	Yes	Yes

EXAMPLE 1: HOME COUNTRY TAX CONSEQUENCES FOR DIVIDENDS RECEIVED FROM SUBSIDIARY WITH SINGAPORE TAX HOLIDAY

	HOME COUNTRY CONSEQUENCES			
	U.S.	JAPAN	GERMANY	NETHERLANDS
A. Dividend	$1,000,000	$1,000,000	$1,000,000	$1,000,000
B. Statutory Tax Rate	34%[1]	56%[2]	50%[1]	35%
C. Tax Liability	$340,000	$510,000	0[3]	0[3]
D. Foreign Tax Credit	0	(320,000)		
E. Tax Payable	$340,000	$190,000	0	0

1 Excludes state/municipal taxes

2 Includes local enterprise tax

3 Effectively exempted

EXAMPLE 2: ILLUSTRATING DOUBLE TAXATION OF FOREIGN EARNINGS OF U.S. MULTINATIONALS AFTER 1986 TAX REFORM

Fact: Multinational has a 100%-owned foreign subsidiary and a 49%-owned foreign corporation which all engage in the same type of business operation.

P&L Statement	Domestic Operations	Foreign Total	100% Foreign Subsidiary	49% U.S. Owned Foreign Corporation
Gross Income	$ 4,000		$ 2,000	$ 2,000
Interest expense	(2,000)		(1,000)	(1,000)
Profits before tax	2,000	$ 2,000	1,000	1,000
Tax 53%			(530)	
15%	SEE BELOW			(150)
Combined -34% rate		(680)		
Dividend received by MNC		$1,320	$ 470	$ 850

ANTICIPATED TAX CONSEQUENCES

Grossed-up Foreign income	$ 2,000
Domestic Income (less expenses)	2,000
Total Income MNC	4,000
Tax at 34%	x .34
Domestic Tax Liability	1,360
Less Anticipated Foreign Tax Credit	(680)
Anticipated U.S. Tax Liability	680
Plus foreign tax paid	680
Anticipated Total Tax Liability	$ 1,360

ACTUAL TAX CONSEQUENCES

Grossed up Foreign Income	$ 2,000
Domestic Income (less expenses)	2,000
Total Income MNC	4,000
Tax at 34%	x .34
Domestic Tax Liability	1,360
Less Foreign Tax Credit (see attached)	(320)
Residual U.S. tax liability	1,040
Plus foreign tax paid	680
Total Tax Liability	$ 1,720
Double Tax Liability	$ 360 = 18% of foreign income

EXAMPLE 2: U.S. DOUBLE TAXATION AFTER 1986 TAX REFORM (FOREIGN TAX CREDIT CALCULATION)

Fact: Multinational has a 100%-owned foreign subsidiary and a 49%-owned foreign corporation which all engage in the same type of business operation.

Foreign tax credit limitation - U.S. system now contains two significant features that create double taxation: extensive apportionment of parent company's interest expense to repatriated foreign operating profits and separate foreign tax credit limitations for different "baskets" of income (e.g. non-controlled foreign corporation and controlled foreign subsidiaries.)

Assumed facts for interest apportionment: assets of multinational corporation itself.

Home country assets	$ 20,000
Equity in foreign subsidiary	10,000
Equity in uncontrolled foreign corporation	10,000
TOTAL ASSETS	$40,000

NOTE: This results in 50% of interest expense incurred in domestic operations being apportioned against foreign source income.

UNITED STATES

	Controlled foreign subsidiary	Uncontrolled foreign subsidiary
1. Foreign Tax Credit Available	$ 530	$ 150
2. Limitation on foreign tax credit $\frac{1{,}000 - [2{,}000\ (10{,}000/40{,}000)] \times 1{,}360}{4{,}000}$	170	170
3. Foreign Tax Credit (Lesser of 1 and 2)	170	150
4. Total Foreign Tax Credit Allowed	$320	

Appendix 3

Table 1

Net Income and U.S. Tax Liability for
Foreign Controlled Domestic Corporations
(Billions of dollars)

	1983	1984	1985	1986	1987
Net income					
Net income for firms with income	12.4	15.4	14.5	12.7	19.8
Net deficit for firms with deficit	-10.6	-10.8	-11.5	-14.3	-14.2
Combined net income less deficits	1.8	4.5	3.0	-1.5	5.6
Net U.S. tax liability	3.4	4.5	3.6	3.0	4.2

Note: detail does not add to total because of rounding.

Table 2

Selected Information on Foreign Controlled Domestic Corporations by Major Industry Group, 1987
(Dollars amounts in billions)

Industry	Number of Returns	Total Assets	Net Worth	Total Receipts
Agriculture	1,103	2.1	0.8	1.2
Mining	1,657	34.3	19.2	11.9
Construction	1,013	4.6	0.8	6.2
Manufacturing	4,155	369.5	146.2	265.6
Transportation, Communications & Utilities	1,117	14.7	4.3	15.1
Wholesale & Retail Trade	16,464	130.5	29.1	305.2
Finance, Insurance, & Real Estate	12,399	370.8	46.7	61.3
Services	6,832	32.5	8.5	19.8
Total	44,862	959.4	255.5	686.8
Combined total of Manufacturing; Trade; and Finance, Insurance, and Real Estate	33,018	870.8	222.0	632.1
Percent of total	73.6%	90.8%	86.9%	92.0%

Table 4

Comparison of Foreign Controlled Domestic Corporations
with All Other Corporations using Net Income

	1983	1984	1985	1986	1987
Percent of tax returns reporting positive net income					
FCDCs	40.6%	40.9%	43.3%	39.0%	41.2%
AOCs	58.6%	58.8%	58.1%	58.4%	57.3%
Net income less deficits in billions of dollars					
FCDCs	1.8	4.5	3.0	-1.5	5.6
AOCs	181.4	221.5	229.5	262.8	298.5
Net income less deficits as a percent of total assets					
FCDCs	0.3%	0.8%	0.5%	-0.2%	0.6%
AOCs	1.9%	2.1%	1.9%	2.0%	2.1%
Net income less deficits as a percent of net worth					
FCDCs	1.3%	2.9%	1.7%	-0.7%	2.2%
AOCs	7.3%	8.2%	7.4%	7.7%	8.4%

Table 5

Comparison of Effective Income Tax Rates using Net Worth and Total Assets[a]

	1983	1984	1985	1986	1987	1983-87 Average
Effective U.S. Tax Rate						
Total assets						
FCDC	0.6	0.8	0.5	0.4	0.4	0.5
AOC	0.5	0.6	0.5	0.5	0.5	0.5
Net worth						
FCDC	2.5	2.9	2.0	1.4	1.6	2.1
AOC	2.0	2.2	1.9	2.1	2.1	2.1
Effective World-wide Tax Rate						
Total assets						
FCDC	0.8	1.0	0.7	0.5	0.5	0.7
AOC	0.7	0.8	0.7	0.7	0.7	0.7
Net worth						
FCDC	3.0	3.4	2.4	1.6	1.9	2.6
AOC	2.7	3.0	2.7	2.7	2.7	2.8

[a]The effective world-wide tax rate computation assumes that reported foreign tax credits claimed are equal to foreign taxes paid. To the extent firms are in an excess credit position the world-wide effective tax rate may be understated.

Table 9

Comparison of Foreign Controlled Domestic Corporations with All Other Corporations by Major Industry Group using Cost of Goods as a Fraction of Total Receipts

	1983	1984	1985	1986	1987
Manufacturing					
FCDC	.627	.620	.627	.644	.649
AOC	.659	.650	.635	.618	.645
Wholesale & Retail Trade					
FCDC	.860	.850	.848	.830	.839
AOC	.761	.753	.745	.735	.735
Finance, Insurance, and Real Estate					
FCDC	.331	.381	.283	.337	.366
AOC	.186	.200	.198	.231	.291
Total					
FCDC	.696	.699	.696	.683	.701
AOC	.597	.587	.571	.556	.563

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