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THE ROLE OF THE EXTRATERRITORIAL INCOME EXCLUSION ACT IN THE INTERNATIONAL COMPETITIVENESS OF U.S. COMPANIES

HEARING

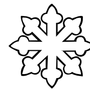
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

JULY 30, 2002



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THE ROLE OF THE EXTRATERRITORIAL INCOME EXCLUSION ACT IN THE INTERNATIONAL COMPETITIVENESS OF U.S. COMPANIES

TUESDAY, JULY 30, 2002

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:10 a.m., in room 215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Also present: Senators Lincoln, Grassley, Hatch, Kyl, and Thomas.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

Just a few minutes ago, Senator Grassley and I, Ambassador Zoellick, and Secretary of Commerce Evans had a press conference just extolling the benefits of the conference report on TPA, Trade Adjustment Assistance, the Andean Trade Preferences Act, et cetera.

It is a bipartisan effort. It is an effort that is supported by the leadership of both bodies, by myself, by Senator Grassley, by Congressman Thomas, and certainly by the President.

It is, I think, legislation that will move this country forward to help restore American prestige and trade, and give benefits to displaced workers, that is, who otherwise would not receive benefits, and help, particularly, to restore our relationship in the Andean region of South America, the South American countries who are very much dependent upon and look forward to trade agreements.

So I want to thank my good friend Senator Grassley, Ambassador Zoellick, and Secretary Evans, who were all there. I hope it helps move the conference report to a large vote later this week.

This hearing is on another trade matter. Today the committee hears testimony on the Extraterritorial Income Exclusion Act, known a the ETI Act. It is legislation we enacted in the year 2000 in a good-faith effort to comply with the World Trade Organization decision in the Foreign Sales Corporation matter.

In a dispute brought by the European Union, the WTO found the FSC to be an impermissible export subsidy. It also found that the FSC did not qualify under an exception to the subsidy rules for provisions to avoid double taxation of the same income.

Following that earlier WTO decision, we worked diligently in a bipartisan fashion to bring our law into compliance with WTO rules. We eliminated the export contingency of the provisions at issue, broadening them to include other categories of foreign-source income. Our replacement was designed to avoid double taxation rather than confer a subsidy.

Nevertheless, the WTO appellate body found that the ETI Act failed to cure the problem. This triggered an opportunity for the EU to seek authority to impose sanctions against the United States. That proceeding is still pending in Geneva, with a decision now expected in mid-August.

I would like to spend a moment recalling how we got to where we are today. To be perfectly blunt, the EU's challenge to the FSC is a case that never should have been brought. Back in 1981, we reached an agreement with the European community to resolve challenges to each others' tax laws. That agreement provided the foundation for adoption of the FSC.

Recognizing the validity of the FSC, the EU refrained from challenging it for over 15 years. Then, only after losing the Beef and the Bananas cases in the WTO, the EU cast aside our 1981 agreement and launched the FSC dispute. In short, this was a case brought by bureaucrats eager to even the dispute settlement score.

I am extremely disappointed that the EU has forced the issue to this point, but I recognize that there is no use in trying to replay the last inning. Rather, we need to decide the best plan for moving forward. To that end, I suggest a few guiding principles.

First, whatever amount of sanctions the panel authorizes, the EU will not be required to retaliate. Indeed, I would suggest that, given the complexity of the issue, opposing sanctions would be decidedly unhelpful in bringing about a long-term solution. The only way to resolve this matter once and for all is by working together and not playing tit for tat.

A second principle that should guide us here is the goal of leveling the playing field. The January appellate body decision, together with earlier decisions in this matter, leave the playing field significantly skewed. On the one hand, we are told that countries have a sovereign right to choose their own tax systems.

On the other hand, WTO rules now have been interpreted to heavily favor one type of system over another. If you rely primarily on what the WTO calls indirect taxes, such as the value added tax, or VAT, you can rebate those taxes when goods are exported.

But, on the other hand, if you rely primarily on direct taxes such as income taxes, you risk violating WTO rules if you exclude from taxation certain income from export sales. This is an entirely artificial distinction. It reflects an overly-simplistic view of how international corporate taxation works.

To eliminate this artificial distinction and to ensure that countries do, indeed, enjoy the sovereign right to choose their own taxation systems, we must revisit the interplay between WTO subsidies rules and taxation.

That is why the conference report on the Trade Promotion Authority bill, which I referred to a few minutes ago, directs the U.S. negotiators to address this very issue. It is my expectation that the USTR will give this objective a high priority and make sure that

the issue is included in the agenda for the current round of WTO negotiations.

We are fortunate to have USTR Bob Zoellick with us today. We look forward to hearing from Ambassador Zoellick on how he proposes to carry out this objective in the round.

A third principle to guide us through this matter is the "do no harm" principle. In fixing ETI, we should not create incentives for U.S. companies to move abroad. This may sound like a statement of the obvious, but it needs to be said because there are proposals under discussion that would do harm. I believe there are workable options with far less drastic consequences. Those are the options we should pursue.

Finally, we must recognize that whatever the solution to the FSC matter, it will take time. There are some who favor taking the hand we have been dealt and using it to bring about radical reform of the corporate tax system. I do not agree with that approach. Wherever the ultimate answer lies, legislation, negotiation, or a combination of the two, it is likely to take several years to finalize.

Acknowledging that doing this right will be a slow process, we should develop an understanding with the EU on how to operate in the interim. This will reassure businesses on both sides of the Atlantic. It will also help to ensure that FSC does not hinder our efforts to make progress in the new WTO round. Those are the issues.

We are honored to have before us today two of the administration's key players, USTR Bob Zoellick and Deputy Treasury Secretary Ken Dam. We look forward to hearing from them, and from all our witnesses. I hope that their insights, and I expect their insights, will help us all point the way toward a solution that I think most of us are seeking.*

Senator Grassley?

Senator GRASSLEY. Yes. I am just going to put my statement in the record. It is too long to take the time of the committee right now. So, I will just put it in the record.

The CHAIRMAN. All right. Thank you, Senator.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. Does the Senator from Wyoming have a statement?

Senator THOMAS. No, Mr. Chairman.

The CHAIRMAN. All right.

Senator THOMAS. I do want to just take a second to thank the Trade Representative and his group for the great work they have done on soda ash that was just determined in the last few days. Thank you, sir.

The CHAIRMAN. I assume, Senator Kyl, yours is just the right length?

Senator KYL. I have a 3-year statement. [Laughter.] I am anxious to hear the witnesses.

The CHAIRMAN. All right.

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*For more information on this subject, *see also*, "Background and History of the Trade Dispute Relating to the Prior-Law Foreign Sales Corporation Provisions and the Present-Law Exclusion for Extraterritorial Income and a Description of the Rules," Joint Committee on Taxation staff report, July 26, 2002 (JCX–83–02).

We are very honored to have with us, as I mentioned, Ambassador Zoellick and Secretary Dam.

Ambassador Zoellick, we all know all about you, so why do you not proceed? No introduction is needed.

STATEMENT OF HON. ROBERT ZOELLICK, U.S. TRADE REPRESENTATIVE, WASHINGTON, DC

Mr. ZOELLICK. Thanks, Mr. Chairman. First and foremost, I want to begin by thanking you and Senator Grassley and the other conferees for completing action last week on the TPA package. I deeply appreciate your leadership, your persistence, your cooperation, and your support in breaking an 8-year log jam.

With the House approval of TPA, only one step remains. I believe, with the Majority Leader's strong interest in completing action this week, we can get this done. As you and I just discussed in another setting, time really is of the essence because, as President Bush has stressed, the passage of this trade legislative package will send a signal to the American people that the executive and legislative branches are working together to strengthen the economy and open markets for farmers, ranchers, workers, and consumers, and businesses.

About 25 percent of America's growth in the past 10 years was based on exports, and about 12 million people have their jobs because of it. So, there is a lot at stake in a real way. In addition, the Andean countries, the four countries in Latin America that lost their Andean Trade Preference pact, have really been hammered by this.

I spoke to the president of Bolivia over the weekend, and he said that the message went through the South American Summit like lightening, that the House had passed this over the weekend, and how important it was to get it done.

The African countries are excited about getting the AGOA II amendments. There are over 100 developing countries that look forward to getting their generalized system of preference benefits that expired last September.

Finally, this will allow us to take the offense on the trade agenda. As the Chairman also mentioned, this is a package that includes comprehensive benefits for America's workers to help them with change as well, and that is a strong component.

So I want to thank you both for putting together a package that will give America a chance to regain its economic leadership, and I would like both of you to know, and the committee, that as you said, Chairman, at the press conference, it is imperative we work closely with you as we go forward with this.

I also want to thank you, Chairman, Senator Grassley, and members of the committee, for addressing this FSC and ETI issue. My colleague, Ken Dam, will address the tax policy issues, so I will just briefly comment on some of the trade aspects.

I will discuss the reasons why I believe a legislative solution is necessary to ensure that we comply with our international obligations and to avoid damaging trade remedies that hurt those same farmers, ranchers, businesses, and others in the American economy.

Over 30 years, as you mentioned, Mr. Chairman, Congresses and administrations have devised and revised U.S. tax laws to try to enhance our international competitiveness. Other countries have challenged the consistency of some of those policies with trade rules and administrations of both parties have defended them vigorously.

But, notwithstanding these efforts of different administrations, the GATT, and now the WTO, has found consistently that the FSC and ETI tax exemption is a prohibited export subsidy. We have tried four times; we have lost four times. The last time, to show the high priority we placed on this, my colleague, Deputy Secretary Dam, argued the case personally.

So now we need to look at ways of enhancing U.S. competitiveness beyond the Foreign Sales Corporation. I noted there is a growing group of experts, from AEI, to Brookings, to former chairman of the Ways and Means Committee Bill Archer, who believe the changes to our tax system, and laws, and international tax policy could be useful because the current rules actually diminish our competitiveness.

Now, in the findings that the WTO made about the ETI Act, they basically stressed three dimensions of finding a prohibited export subsidy. First, that the act conferred a subsidy by exempting income that would be taxed under otherwise applicable U.S. tax rules. Second, that the subsidy is export-contingent, to be provided only if the goods are exported.

Third, that the export subsidy is not protected as a measure to avoid double taxation of foreign-source income because it systematically exempts domestic-source income.

So the upshot of this decision, is that simply trying to alter the FSC/ETI regime through a new mechanism for the same benefits will not be compliant with the WTO rules.

So the next step that we face, as you mention, Mr. Chairman, is the WTO arbitration. That is proceeding to determine the amount of retaliation that the EU could have. We have a broad difference on this. The EU has argued $4 billion of retaliation; we have argued about $1 billion. As you said, we just got word this week that we now expect the decision, I think thrice postponed, in the middle of August.

Commissioner Lamy has repeated to me, and publicly, that his focus is on U.S. compliance, not on retaliation, and I take him at his word. We managed to keep this dispute in a position so far where we intend to try to hold off retaliation by explaining our intention to comply and by pointing, as you said, to the challenges of Congressional consideration.

To continue managing this, we are going to need to be able to point to some serious action or proposals and progress by the Congress. On this, again, I appreciate, Mr. Chairman and Senator Grassley, that you were both willing to meet informally with Ways and Means Chairman Thomas and Mr. Rangel to start that discussion. I know, Chairman, that in other contexts you have led previous bipartisan efforts to try to reform international tax rules.

The Ways and Means Committee has held hearings. I was struck there that the consensus, again, across a broad spectrum, is that trying to alter the FSC/ETI regime with the same distribution of

benefits will neither meet the requirements of the WTO ruling, nor serve our competitive interests.

Now, I am aware of the preference in some quarters of trying to hold off implementing any action and try to seek a solution in the Doha negotiations.

I certainly appreciate the apparent appeal of trying to defer the problem, but I have to honestly advise you that I believe this strategy will lead to trade retaliation, with the effect on farmers, workers, and businesses. It is fundamentally a problem of timing.

We were just able to launch the Doha Development Agenda last November. It is not scheduled to be completed until the beginning of 2005, assuming everything goes as planned. And, as a practical matter, the EU is highly likely to retaliate if we take this course.

As you said, Chairman, there are aspects about our tax policy that we may want to discuss here and later while we pursue it in the WTO agenda. But at this point I just want to say that I appreciate the Finance Committee's willingness to take on this difficult issue, and will be pleased to try to work with you to bring the U.S. into compliance with our international obligations, and to ensure that we enhance our overall international competitiveness.

The CHAIRMAN. Thank you very much, Mr. Ambassador.

Secretary Dam?

STATEMENT OF HON. KENNETH W. DAM, DEPUTY SECRETARY OF THE TREASURY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. DAM. Mr. Chairman, Senator Grassley, distinguished members of this committee, I appreciate the opportunity to appear today and I commend the committee for holding the hearing on this matter of vital importance to U.S. workers and U.S. businesses in today's global marketplace.

I will not repeat the procedural aspects of the WTO litigation that Ambassador Zoellick has gone over, and I do have a much more complete statement on the tax aspects that I will ask to be placed in the record, and I will summarize that portion of my testimony now.

Let me just point out that, following the adoption of the arbitration report that you have been talking about, the European Union will be authorized, under the WTO rules, to begin imposing trade sanctions on U.S. exports up to a level that is set by the arbitrators, and the authority for such sanctions will continue thereafter until such time as the United States rectifies the WTO violation.

So, this is an urgent matter that we are discussing today which requires our immediate attention. The threat of substantial retaliatory sanctions against U.S. exports is not something that any of us takes lightly.

Such sanctions, if imposed, would do real damage to U.S. businesses and American workers. The imposition of such sanctions would also have serious adverse consequences for the overall trade relationship between the United States and the European Union beyond those sectors that are directly targeted with sanctions. In addition, sanctions would have a direct and detrimental effect on U.S. consumers.

Now, the President has spoken on this. His message is clear: the United States will honor its WTO obligations and will come into compliance with the recent WTO decision. To do that, it will require legislation to change our tax law.

The administration is committed to working closely with the Congress in the development and enactment of legislation necessary to bring the United States into compliance with the WTO rules.

Given our analysis of the current WTO rules reflected in the decision in the FSC–ETI case, we do not believe that legislation that simply replicates FSC or ETI benefits will pass muster in the WTO. As Ambassador Zoellick has said, we have tried four times and we have lost four times, so trying it again does not seem to be very wise.

The WTO appellate body has made clear that a benefit such as is provided through the ETI provisions that is tied to export activity is not permitted. Therefore, it will not be fruitful to pursue another, similar replacement of the ETI provisions. Rather, addressing the WTO decision through our tax law will require real and meaningful changes to our current international tax legislation.

In stating his commitment to compliance, the President also made clear that we must enhance the competitiveness of U.S. business operating in the global marketplace. The reason is, competitiveness is the key to protecting American jobs. At its core, this case raises fundamental questions regarding a global, level playing field with respect to tax policy.

The ETI provisions, like the FSC provisions that preceded them, represent an integral part our larger system of international tax rules. These provisions were designed to help level the global playing field for U.S.-based businesses that are subject to these international tax rules.

There is much that we can and must do to rationalize our international tax rules through reforms both small and large. The U.S. international tax rules can operate to impose a burden on U.S.-based companies that is disproportionate to the tax burden imposed by our trading partners on the foreign operations of their companies.

The U.S. rules for the taxation of foreign-source income are unique in their breadth of reach and their degree of complexity. Both the recent activity involving so-called corporate inversion transactions and the increase in foreign acquisitions of U.S. companies are evidence that the competitive disadvantage caused by our international tax rules is a serious issue.

It has significant consequences for U.S. workers, businesses, and the U.S. economy as a whole. We must address these tax disadvantages in order to level the playing field for U.S.-based companies relative to their counterparts in our major trading partners.

There are many areas in which we could improve our international tax rules to promote competitiveness. In my written testimony, I explore three areas in some detail. Here, I will just go into one of them, reform of the Subpart F rules.

Now, as you know, our system, generally speaking, taxes income earned by foreign subsidiaries of U.S. companies when the money is repatriated back to the U.S. parent. However, Subpart F, en-

acted in the 1960's as an anti-abuse rule, provided for the immediate taxation of certain types of income earned by foreign subsidies of U.S. companies so that taxpayers could not unduly defer taxation of foreign-source income. That was the 1960's theory.

One area particularly worth consideration is Subpart F's reach beyond passive income to encompass some forms of income from active foreign business operations. No other country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity.

Please let me illustrate this point with an example under Subpart F. Under Subpart F, a U.S. company that uses a centralized foreign distribution company to handle sales of its products in foreign markets is subject to current U.S. tax on the income earned abroad by that foreign distribution subsidiary.

In contrast, a local competitor in that country making sales in that market is subject only to the tax imposed by that local country. Foreign competitors, a competitor from some third country that similarly uses a centralized distribution company and makes sales into the same markets, also generally will be subject only to the tax imposed by the local country.

The Subpart F rule has the effect of imposing current U.S. tax on income from active marketing operations abroad. U.S. companies that centralize foreign distribution facilities therefore face a tax penalty not imposed on their foreign competitors.

Now, this is just an illustration of the mischief arising from these originally well-intended 1960's-era rules. The world has changed since the 1960's, however, and it is time to consider some changes to Subpart F. As I say, that is just one area in which I think we have to modernize our rules.

Now, in closing, allow me to emphasize that we must ensure that U.S. tax rules do not adversely affect the ability of U.S. workers and businesses to compete successfully around the world.

As we make the changes to our tax law that are needed to comply with the WTO rules, we must keep our focus on the objectives served by the FSC and ETI provisions and look to removing biases against U.S. ability to compete in today's global economy. Such reforms allow the United States to retain its world economic leadership. Such reforms will protect American jobs.

Let me assure you that the administration is committed to working with the Congress, and with this committee in particular, to satisfy the twin objectives of meeting our WTO obligations and assuring that we protect the competitive position of American workers and businesses. Thank you very much.

[The prepared statement of Mr. Dam appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Secretary.

The basic question, a couple of them in my mind, is how quickly will the administration come together with the various components on a single view on what approach we should take with respect to this problem? Second, the beginnings of what you think it should be.

This is obviously complex. There are trade ramifications and there are tax ramifications. On the surface, it seems like the solution must include a combination of both, in some respect.

Now, maybe one at the exclusion of the other, but on the face of it, both. Frankly, I do not think, personally, that the solution which completely just repeals our FSC language to satisfy the Europeans is the right solution, for a couple of reasons.

One, it discriminates against certain U.S. companies. Second, it agrees to, I think, an incorrect premise. Number one, the companies that it discriminated against are those who primarily export and have no foreign operations, but primarily export to other countries.

Number two, it adopts a flawed premise. The premise is that the current system is fair enough, so we should not try to resolve it. What I am getting at is the premise that indirect taxation systems can have subsidies and direct taxation systems cannot.

So I would just like to ask both of you, I guess, number one, do you think that we should address the premise here or not? Also, we think that the European system itself is subject to attack under some provisions of the WTO rulings.

I will start with you, Mr. Secretary. Do you think that we should try to address the trade laws here? That is primarily the bailiwick of Ambassador Zoellick, and I would ask him the same question.

But do you or do you not think we should attempt to address the basic premise underlying the rulings so that we can better level the playing field of the U.S. taxation system versus others?

Mr. DAM. Mr. Chairman, I agree with Ambassador Zoellick in his testimony when he said we have to face up to the fact that we have lost this case and we have to comply with the U.S. rules. The President has made it very clear that that is the administration position.

That does not mean that in the round we cannot discuss it. I think Ambassador Zoellick said that we were prepared to do so. I will let him speak for himself on that. I know in the trade legislation there has been some discussion of that.

But we have to do what we need to do now, because the consequences of retaliation are very great. The time that will be required to reach this issue in the Doha round goes well beyond what the Europeans, at least, have said is their retaliation schedule.

But there are some things we can do. I have mentioned the Subpart F as one example in tax legislation itself. After all, you mentioned exporting companies. Changing Subpart F would help exporting companies that do not have manufacturing plants abroad. It would allow them to only suffer U.S. taxation when they pay dividends, to the extent we are able to change Subpart F rationally.

So, there are things we can do right now in the tax law to level the playing field, but on the question about the premise, I think Ambassador Zoellick is better able to address that question than I am.

The CHAIRMAN. I appreciate that. But in your written testimony you state, “There is no compelling rationale for disparate treatment of direct and indirect taxes. Reconsideration of this distinction in the treatment of direct and indirect taxes under the WTO rules will be part of the discussion of WTO matters in the new round,” which to me indicates to some degree that you do agree that the basic underlying problems have to be addressed.

Mr. Zoellick, if you could also comment on this basic question. I know basically where you're coming from, but I'd just like to know how you are going to handle the provisions in the trade promotion authority bill that is going to pass that directs us to look at that.

Mr. ZOELLICK. All right. I appreciate, Chairman, there are a number of elements tied in here. Let me break them into three pieces, because this is a core of a lot of what we are all struggling with here.

The CHAIRMAN. Sure.

Mr. ZOELLICK. First, as the Deputy Secretary and I have both tried to make clear so there is no mistake on this, we have a real time issue here, which is the question of trying to come into compliance.

I do not believe there is a chance to get the Doha negotiations done in time to do that and avoid retaliation. So that is point one, that I do not see how we can escape.

Second, as you have mentioned, there is language in the TPA bill about focusing on the distinction between direct and indirect taxes. That is something that I think we would want to discuss further with you and your staff. Let me just give you a couple of the issues we will need to discuss.

Many economists question whether it has any measurable economic effect on trade, that distinction that is left. As you also know, Mr. Chairman, because you have been a leader on this, that would take us right into the subsidy provisions in the negotiations, which, with your guidance, we are otherwise trying to stay very clear of.

So this raises the inevitable question of trade-offs with other issues that we would just as soon hold the position that you have advised us to hold, so that is going to be something we will have to work on together.

The third element, is that I think you are exactly right, that the economic theory, as I know it now, says that the distinction between direct and indirect taxes that led them to use a different treatment for the VAT as an indirect tax and allow a rebate versus a direct tax, say a corporate income tax suggests that the logic no longer holds, that basically over time all those taxes are passed through.

The question is then, does it affect our competitiveness? Here, just take the first part. The way that a VAT would work, is that you rebate the VAT so that the good that is then sold, for example, in the United States would be subject to sales tax. So it still has a tax, but it has our sales tax.

That is very similar to what would happen in the United States where we do not charge a sales tax on what is sold abroad. Instead, it is subject to the VAT.

Now, the second step, where may tax lawyers focused on this, they said, yes, but by excluding the VAT, you are allowing the Europeans and others to have a tax system that relies more on those types of taxes than corporate income taxes.

The problem with that argument, is if you actually now look at the corporate income tax as a share of the overall economy in Europe it is about 3.6 percent as opposed to about 3.2 percent in ours, so you do not really see a benefit of that.

Then that leads then to the third question, which I think is what the Congress has always tried to get at with some of the ETI issues, and I have seen in the testimony. That is, how does this affect our overall competitiveness? What provisions should we have, given the fact that we have sort of a global income standard as opposed to territorial income?

Here, the tricky piece is that what the ETI and FSC is focused on, is domestic-source income as opposed to the global nature of our tax system.

I apologize for going into detail, Mr. Chairman. I think the key point, because I know you and I have talked about this, is I am certainly pleased to discuss with you and others the strategy we take on these issues in the Doha negotiation.

As we do so, we have to be careful we do not run into some other things we do not want to run into. I am just saying that, in working with you, I hope we can think through what best enhances U.S. competitiveness. That is a separate question from how we deal with the immediate problem.

As I have mentioned to you, I do not believe Commissioner Lamy is eager to retaliate. You have probably seen my public statements that, like yours, said this would be devastating for the trade system.

But, on the other hand, I think we are going to have to show some progress and movement. I cannot say exactly what that is. I appreciate this hearing as a start on the Senate side.

The CHAIRMAN. Thank you very much.

Senator Grassley?

Senator GRASSLEY. I know that we are anticipating a legislative solution. But just in case there are negotiations on this issue, I want to bring up this concern with respect to negotiations on FSC that we might negotiate some sort of resolution that entails giving up some of the concessions that we seek from the European Union and the WTO on agricultural policy, or that we might soften our aggressive stand with respect to the European Union's agricultural policies in the WTO negotiations.

Ambassador Zoellick, I would like to have you assure me that, if there are negotiations on FSC, that that would not be something we would bargain away.

Mr. ZOELLICK. I assure you of that. I also will say that, as I have just mentioned with the Chairman, as your question started out, I do not think we can resolve this with negotiation. It is going to require a legislative solution.

Third, I want to thank both of you for being strong supporters of the aggressive position we have just taken on agricultural liberalization in the WTO last week.

Senator GRASSLEY. Then following up on the Chairman's first question, I am going to read, since I did not read my opening statement, a very short part of it.

In a process similar to that used in the successful package of the ETI regime, we created a bicameral, bipartisan working group that included the staff of this committee, the Ways and Means Committee, Treasury, and USTR.

This working group received input from all concerned parties, including the business and legal community, labor, and anyone else

wishing to have a say on the resolution of what was then the FSC case.

I think we need to put a similar process in place, and this effort needs to be led by you two gentlemen, the USTR and the Treasury. I cannot stress the importance of this process enough. I think only the USTR and Treasury have the resources and the expertise to see that we ensure the success of the process.

So, I would throw that out, not for your response, because I have questions. But I would like, since it worked so well before, to see it work now. I think that follows up on the Chairman's concern.

Now, in regard to a legislative solution, and I will direct this towards the Ambassador, how long will the European Union, in your judgment, allow us to work on the ETI issue before they impose sanctions, and do you have some sort of a timeframe?

Mr. ZOELLICK. I cannot answer that with precision, Senator, other than to say that Commissioner Lamy has told me privately, and he has said publicly, his focus is on compliance. He is not eager to retaliate, so he has used words like "good faith" and "progress."

Now, I have certainly spent a long time explaining to him the constitutional imitations of our system and how the executive branch can only do so much, and it depends on passage by both Houses of Congress. He certainly is well aware of our calendar.

My best judgment, Senator, is that if we can show some substantial progress over the course of the rest of this Congress, and I realize there are not many weeks left, and a commitment because of the separation of powers to move on it next year, then it gives me a fighting chance to argue to Commissioner Lamy, as Chairman Baucus did, that retaliation would be counterproductive. I cannot assure you of that, but I will certainly make my best argument for it.

I think, as Commissioner Lamy's statements have emphasized, if the United States basically takes the position that we are going to wait forever on negotiation, or just not get to this problem, then I think you are going to expect retaliation, and farmers will be on the list.

Senator GRASSLEY. And we have heard that threat from the European Union, at least some people there. Let me withdraw my statement. I just said that I did not want your reaction to my suggestion about a working group. I would like to have your response, both of you, to the suggestion I made of a process that was similar to what we used when we wrote the ETI.

Mr. DAM. Well, Senator, I think that that is perfectly appropriate. When the President made his announcement when the decision was taken that we needed to comply, there were only two other things that the President emphasized.

One, was we had to keep in mind, as we did comply, the competitiveness of U.S. industry. The second, was we needed to work with the Congress. That is one of the reasons why, while we are testifying, we have not sent to the Congress a detailed proposal.

We want to work that through with the Congress as a whole and with each of the relevant committees, so I think that the method you suggest is certainly one which we could work with quite easily and quite energetically.

Senator GRASSLEY. Could you answer it? My time is up, but I would like to have your response.

Mr. ZOELLICK. Yes, Senator. Obviously, the Treasury Department takes the lead on the tax issues, but I would be delighted to work and help in any way I can.

Senator GRASSLEY. Well, I guess I suggested USTR because that was the process previously, plus the fact of the trade issues that are involved, not just tax issues that are highlighted.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Kyl?

Senator KYL. Thank you, Mr. Chairman.

First of all, let me compliment the witnesses on both your oral presentations and your written testimony. It is very helpful. If we had this kind of information provided to us on a regular basis, I think we would probably make much wiser decisions.

I have a question, though. Given the fact that we need to demonstrate a commitment to the WTO officials and others about our willingness to make changes to avoid the kind of actions that we want to avoid here in terms of retribution, would it not be helpful to have specific recommendations coming from the administration, not simply a hope that Congress will act? Now, I am not done with the question yet, because the answer is, clearly, yes, that will be helpful, I think.

I suspect that one problem in developing specific administration recommendations is the politics that people can play with that. I would like to have you comment generally on the phenomenon that many of the things that make sense globally and for U.S. tax policy are susceptible to partisan political criticism here at home, and therefore create a problem because nobody wants to be out in front talking about closing loopholes in a tax system and subject themselves to criticism from someone else that this is supporting the fat cats, that this is just for rich investors.

To further flesh out my question, let me quote two things from your very excellent testimony, Secretary Dam. You say, "One aspect of the U.S. tax system is that the income from an equity financed investment in the corporate sector is taxed twice.

Equity income or profit is taxed first under the corporate income tax. Profit is taxed again under the individual income tax when receive by the shareholder as a dividend or as a capital gain on the appreciation of corporate shares.

In contrast, most other OECD countries offer some form of integration under which corporate tax payments are either partially or fully taken into consideration when assessing shareholder taxes on this income, eliminating or reducing the double tax on corporate profits."

Then you go on further to say, "This integration typically is provided at the OECD countries by reducing personal income tax payments on corporate distributions rather than by reducing corporate-level tax payments.

International comparisons of corporate tax burdens, however, sometimes fail to account for differences in integration across countries and consider only corporate-level tax payments to be meaningful comparisons between the total tax burden faced on corporate investments by U.S. companies and those of foreign multinational

companies, and must take into account the total tax burden on corporate profits at both the corporate and individual levels."

Now, I can just see what happens when you make a specific recommendation to Congress about correcting that problem: you are trying to support the wealthy as opposed to the many. When, of course, speaking of our global competitive position, this is exactly the kind of reform that is necessary for jobs and for everybody working in our economy, it seems to me.

You spoke specifically to the Subpart F, but could you speak to this kind of issue and how important it is for us to work this kind of reform and to be able to educate people about the importance to all Americans, not just those who may happen to have some kind of investment that may receive some favorable tax treatment as a result of integrating the personal and corporate tax, as is done in many of the OECD countries?

Mr. DAM. Well, Senator, you point to an important part of all tax proposals. They are always subject to criticism from the standpoint of a particular group, whether it be a company, political party, and so forth.

In working with the Congress, I am not sure where we would come out on the best and smartest ways to change our legislation. But, clearly, we have to do something to make American business more competitive, to the extent that we are taking away a set of legislation, the FSC and the ETI, which was designed to deal with the competitiveness issue.

On the question of integration, we have not made that as a proposal. We are working on tax reform, in general, and that is certainly something that every administration has considered and expressed an opinion on because it is baked into the situation. You have only to cross the border into Canada and you find a system that does provide for partial integration of the personal and corporate income tax.

Corporations pay taxes in one sense, but in another sense, all taxpayers are individuals. They are the individual investors in corporations. The total burden is what determines the competitiveness of our system as opposed to other systems in international commerce. Today, international trade is so important to jobs and corporate competitiveness, that one logically has to look at all aspects of the competitiveness issue.

So, you are suggesting some of the reasons why it might be wise for us to work closely with the Congress in figuring out what aspects of this we can tackle at this time in doing what we must, which is to change our system in order to comply with the WTO decision.

Senator KYL. Thank you, Mr. Chairman. I think we have an education obligation, and that can be done by members of this committee, and certainly by the administration.

If we can get the message out that is conveyed in your statement very well, it would help lay the foundation for the kind of hard work that we have to do, and potentially get over some of the political hurdles that might be thrown in our way.

Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Lincoln, your turn.

Senator LINCOLN. Thank you, Mr. Chairman.

Welcome, gentlemen. We are pleased that you are here today.

Just a couple of very quick questions. Ambassador Zoellick, I read in the paper this morning that the President wants to create a formal office to shape U.S. image abroad.

I think probably at first glance to most of us, it seemed—at least to me, anyway—to be a duplication of really the stated mission of the Department of State, which had its inception in 1789 when Thomas Jefferson served as its first secretary.

However, I think as the U.S. Trade Representative, I thought that you could provide maybe me and others some insight as to the uniqueness of this new office, and will this new government bureaucracy serve an important function to your office, will it be something that will aid you in your attempts abroad.

Mr. ZOELLICK. Well, Senator, obviously you should get the fullest answer from the White House, but let me relay this, because I have had this conversation with some of the senior officials at the White House.

Part of what I think is driving this interest is the recognition that, on a number of fronts, the United States has a tremendous story to tell abroad. For example, the things that this committee and the Congress is going to try to do in terms of helping a number of poor countries on trade, which I hope we will be able to finish up this week.

Part of the focus came out of the experience with Afghanistan, where a lot of people were unaware of, for example, of what the Taliban did to women and women's education. Part of the challenge for the United States is not only to have the right policies, but to be able to present those effectively.

I think the purpose of this office is not to replicate, but to help sort of guide and counsel other departments as they go around the world. Let me give you a practical example that I talked about with one senior White House person.

When I went to Morocco to talk about the possibility of a free trade agreement, I made a point of going to one of the micro lending facilities that the United States AID sponsored, primarily women borrowers, creating additional independence and empowerment. So, that became the news in Morocco.

So as opposed to me just there in a suit, talking to the king, which I enjoyed, I was also out in the souk talking to women who had loans of $200, and that was part of what America stood for. So part of this, is how can we do that better as a country?

Senator LINCOLN. It sounds like you did it very well there in Morocco.

Mr. ZOELLICK. Well, I hope so. I think the goal is to try to coordinate that more effectively, which will serve all of our interests.

Senator LINCOLN. Thank you.

Just to follow up a little bit on what Senator Grassley was mentioning in terms of the question of whether what we need to do is actually, statutorily, something that the Congress needs to do or is it something that we can work through and continue negotiations through your efforts and the Office of USTR.

I would just like to maybe reflect a little bit on some of the debate, discussions, and negotiations we have gone through with the

TPA, trade promotion authority, from the insight of our constituency.

I would just hope that we could encourage further negotiations from USTR, at least giving that a little bit more time, or perhaps opportunity, to evolve and to work through the solutions that we need in the concerns that the European community has, just simply because in the debate that we had on TPA, it seemed as if there was an erosion in our constituency and in the majority of the groups that we represented, an erosion in their trust in our ability to get out there and negotiate in trade agreements.

I think it is going to be important for us to hopefully continue a little bit on that line as opposed to just jumping to statutory or Congressional initiatives that may work there. I think if we can just look towards the negotiations with the Europeans, looking for a solution out there and keeping at that, it would be my recommendation.

But, certainly, if you have anything to add that, and I know that you had expressed to Senator Grassley perhaps that you thought maybe it would be easier through a statutory solution.

Mr. ZOELLICK. Senator, you have been one of the great leaders on trade, and I very much appreciate the opportunity to work with you. You are the last person I would want to disappoint.

The reality is, on this one, Commissioner Lamy has said publicly—and we have a good working relationship—that he is not eager to retaliate. He wants the United States to come into compliance. On the other hand, this is a process that has been going on since about 1999 and we have lost four cases.

So, the problem on the negotiation on this one, is the only possible vehicle is the Doha negotiations, which, at the earliest, gets done at the end of 2004, 2005.

My best judgment is, they will not wait that long. There is a separate question about how easy it would be to do in that, and what other issues it might invoke in the subsidies area that this Congress is very sensitive about.

So, where I can, I hope, play a constructive role, but this is where we need to have a close partnership of the type that the Chairman and Senator talked about, is I can certainly make the argument that the Congress needs time to work on this. Look, I have made the case to say that, I will tell you frankly, you cannot expect to get this done this year. It is not going to happen.

On the other hand, if we are going to be able to hold off a retaliation into some point next year, I think it is important, by the end of this Congress, there is a sense of movement, of understanding, of coming into compliance. That is where we can work together.

Senator LINCOLN. Well, I am a fan of yours as well, and know well your negotiation skills and ability. Maybe that is it. I just keep thinking that you are going to make it all happen right off the bat. But I appreciate it. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

Senator Hatch, do you have questions you want to ask the panelists, or a statement?

Senator HATCH. I want to welcome both of you to the committee. We appreciate the work you are doing.

Mr. Ambassador, I want to commend you for your work, both of you, but your work in particular, leading up to last week's bipartisan trade promotion authority conference report in the House.

As a member of that conference committee, I know how critical your leadership was in crafting this historic legislation. I also want to thank Chairman Baucus, Senator Grassley, Chairman Thomas, and Charlie Rangel, the Ranking Member over there, for their work in helping to put together the conference report in record time.

This legislation is important for America. I know that the President and Ambassador Zoellick will use their trade authority to benefit our country at large.

But 2 years ago when the WTO determined that the Foreign Sales Corporation regime was an illegal trade subsidy, the Treasury led the way in developing the Extraterritorial Income Exclusion Act. Unfortunately, the WTO has determined that this, too, was an illegal subsidy.

Now, some policymakers, such as the chairman of the Ways and Means Committee, seem to have concluded that our only alternative in this situation is to immediately repeal the ETI. Does the administration share that view?

Mr. DAM. Perhaps I could respond to that, Senator Hatch.

Senator HATCH. Sure.

Mr. DAM. We do believe that we have to replace the ETI with provisions that are substantially different. We have tried to, in ETI, as a country, replicate FSC under slightly changed language and so forth. That will not work. The possibility of that passing muster with the WTO is nil, and certainly the European Union would challenge any such legislation immediately.

Therefore, in my testimony I have suggested some things we might want to work on which would benefit the competitiveness of American businesses, especially those facing international competition, that would leave American business in as favorable a position as it was before.

Of course, when you change tax laws, there are little wrinkles here and there. Not every company would be in exactly the same position. But we suggested, in my testimony, some possible paths which would benefit all American business, and therefore all American workers, and the entire American people by attacking some things that put American business at a disadvantage in selling abroad.

Orally, before you got here, I went through a 1960's provision called Subpart F which was enacted out of good motives in a closed world, where we really were the dominant exporter.

But now we are no longer in that situation, and Subpart F, in my view, should be amended to restrict it to what it is really useful for, which is dividend and interest income or passive income, and keep it away from what I will call active business income. That would be one step that could be taken that would achieve the same basic objectives as ETI and FSC without running afoul of the WTO rules.

Senator HATCH. Some observers of this process have suggested a possible replacement to the ETI would be formulated based on Footnote 59 of the WTO agreement on subsidies and countervailing

measures, which is an excellent exception to that agreement's general prohibition against export subsidies. Has the administration ruled out that possibility?

Mr. DAM. No, I would not rule out that possibility, Senator Hatch. But when it was proposed publicly by a group working on this, it was joined to a bunch of other provisions which almost certainly would not pass muster. Anything based on Footnote 59 that would pass muster would, at best, be much narrower than FSC and ETI.

I think that is recognized by those who proposed in a report that approach, because they did have to put in a whole lot of other stuff in order to come up with a package they thought was adequate.

Senator HATCH. In your opinion, do the WTO rules favor the European value added tax approach over the United States' income-based tax regime?

Mr. DAM. Well, yes, certainly in terms of the rebate provisions for the VAT, if that is what you are referring to.

Senator HATCH. Since that is so, what are the implications for competitiveness for U.S. manufacturers, farmers, and ranchers?

Mr. DAM. Ambassador Zoellick spoke about this earlier and gave some reasons why the distinctions may not be quite as important as it would appear in the abstract. On the other hand, American business feels that it does make a big difference, and I think there is a lot to what they say.

So this is something that can be, and as I understand from Ambassador Zoellick will be, discussed in the Doha round, but that would be too late to meet the need of the moment. In any event, there are some trade-offs that he has spoken of, and he can speak of better than I can.

Senator HATCH. Which agency, and which official in the agency, is taking the lead in coordinating the administration's efforts on the ETI issues?

Mr. DAM. Well, certainly Treasury is responsible for tax legislation, and we accept that responsibility. I have been the person within the Treasury more directly involved, together with a lot of excellent tax lawyers and tax economists in our department.

Senator HATCH. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

I just have the impression that any objective person watching all of this would conclude, number one, that we have got to find a solution to the ETI problem, but second, there is none yet. Third, it is a little confusing and it is unclear as to how quickly one will arrive.

I say that, in part, because it is my experience, back when we were worried about how to prepare FSC, there was a weekly meeting of top staff from Joint Tax, Ways and Means, Finance, Treasury, USTR, and outside consultants, and so forth. As I said, this was weekly, to try to resolve the issue and how to find a replacement. Within 8 months, they came up with ETI.

Now, that did not pass muster, but I suggest that among all the different provisions that we have floating out there, the ideas out there, A) it is confusing, and B) some people certainly get hurt more than others, depending upon the solution that is advocated,

that that working group get back together again and we find a solution here.

In some sense, I am a little concerned that the administration— and I know the administration is terribly busy. You have got all kinds of things on your mind, you have got lots to do—has been a little bit derelict and not working well enough together within the administration, and second, with the Congress, to kind of quietly, without a lot of demagoguery and a lot of stuff, come up with an American solution.

There are different views here. It is complex and it takes a little work here. I think some manufacturers, some exporters are really concerned about just a total replacement solution, that it is going to hurt them unnecessarily.

So I am not the administration, so it is a little hard for me to do this. But I would like you both to work with us, and I am going to try to get that working group back operating again so we can work better together to try to find a solution.

The administration cannot kind of give this to Congress, and the Congress cannot just wait for the administration. We have got to get together here. I have not figured out exactly how I am going to put that group back together, but we are going to do it because I think that it is probably the best approach to resolve this. I would be curious if either of you have any comments on that.

Mr. DAM. Well, let me just say that I appreciate the spirit of your comment. We have been working hard on the subject in the Treasury, on the tax legislation that would be required. We have a lot of ideas. The President said we were to work with the Congress, and we plan to do so. We have, in fact, been, but perhaps not as vigorously, because obviously Congress is busy, too.

Whatever you propose that we do, we will do it with you. We realize that there might be different views in the House of Representatives. We are not involved in that kind of question. But we will work with Congress, we will work with this committee, and we will work with you, Mr. Chairman.

The CHAIRMAN. Well, I am going to call a working group together. It is going to include your agency, your departments, as well as Ways and Means, Finance, Joint Tax, and patterned after the last one.

Hopefully, the next one will come up with a solution that survives, but at least I think this approach is probably going to work better than this kind of disparate, everybody-advocating-his-own-point-of-view approach that it is a little less organized and a little more chaotic.

Thank you both very much for your time and attention. We deeply appreciate you both attending and giving us your views. Thank you.

Mr. ZOELLICK. Thank you, Mr. Chairman.

Mr. DAM. Thank you.

The CHAIRMAN. All right. Thank you again, both of you, for all the time it takes for you to come up here and testify. I know you have got lots of things you have to do.

Let us begin here. Our panel consists of Mr. Pierre Chao, managing director of Credit Suisse First Boston; Mr. F. Lynn McPheeters, vice president and CFO of Caterpillar; Mr. Dan

Kostenbauder, general tax counsel of Hewlett-Packard; Mr. Dwight "Dyke" Messinger, president of Power Curbers, Salisbury, North Carolina; Mr. David Bullington, vice president for Taxes, Wal-Mart; and Mr. James Zrust, vice president of Tax for Boeing.

Gentlemen, we will start at the left end here. Why do you not begin? Again, you all know the main ground rules here. First, 5 minutes. Your statements will all be included in the record. I would urge you, during your 5 minutes, to get straight to the heart of the matter.

Mr. Chao?

STATEMENT OF PIERRE CHAO, MANAGING DIRECTOR, CREDIT SUISSE FIRST BOSTON, NEW YORK, NY

Mr. CHAO. Mr. Chairman, distinguished members of the committee, my name is Pierre Chao. I am a managing director with the Equity Research Division of Credit Suisse First Boston, a global financial institution.

As part of my everyday job, I am required to assess the impact of economic, financial, political, and technological events on corporations and their stock values.

At CSFB, we have analysts and economists that follow practically every sector of the economy, although my particular area of expertise is the aerospace and defense sector.

Thank you for giving me this opportunity to discuss the impact of the repeal of the ETI/FSC provisions of the U.S. Tax Code.

Allow me to start by stating that I am approaching this issue with the belief that capitalism does work, that open trade is beneficial to an economy, that trade and national competition should occur on a fair and level playing field, and that the United States should abide by the rulings of the WTO.

That being said, we are all aware that there are distortions in the international marketplace, some deliberate, some unintentional. The irony of this current discussion is that the ETI/FSC rules were put into place to offset an existing distortion in the marketplace, the fact that countries using tax laws that are based on territoriality, do not tax, or significantly lower the taxes on exporters, thereby putting U.S. companies at a direct disadvantage when competing in third party markets.

A U.S. and foreign company could be identical in every respect, with the exception of location, and the U.S. company would be forced to keep its prices higher in order to make up the tax rates or suffer lower margins.

Mr. Chairman, I agree with you. I was consistently surprised with this very common-sense element was often missing in the WTO debates.

Nonetheless, the WTO has made a ruling, and ETI/FSC must go away. The Congress has heard quite a bit of expert testimony over the last few years on this topic. Economists and tax specialists have discussed how economies and firms theoretically respond and adjust.

I would like to bring us to the real world, and the here and now. The repeal of the ETI/FSC will act as an instant tax on U.S. exporters, hitting industries such as agriculture, electrical equipment,

aerospace, defense, manufacturing, and certain parts of high technology particularly hard.

Without relief or change, I believe the companies will have little ability to respond in the very near term, which will serve to increase their effective tax rate and lowering earnings per share.

All else being equal, the decline in earnings per share will impact the stock prices and market capitalization of these exporters in a fairly rapid fashion.

The mathematics are actually extremely simple. The same pretax income, higher effective tax rate through the repeal of the FSC/ETI, will create a lower earnings-per-share. Using the same valuation multiples will result in a lower stock price.

Some very quick calculations done based on the 2001 earnings results of these companies reveal, and everything else being equal, key exporters such as Boeing and United Technologies could be hit by up to as much as $3–$3.5 billion of market capitalization; Caterpillar, Deere, and Walt Disney could lose about $1 billion worth of market capitalization; Archer-Daniels-Midland and DuPont, about a half a billion dollars; and stalwarts like Harley-Davidson and Tyson Foods could lose a couple hundred million dollars, not to mention the estimate that the impact on GE and Intel's market capitalization could be as high as $15 to 20 billion in the marketplace. That is quite a kick in the teeth to battered investors who have already suffered a market meltdown.

This is a time when I believe we should be reassuring investors and trying to get them to invest in solid American firms, not giving them a reason to flee.

Naturally, management teams will have to respond. Unfortunately, their options are limited: either raise prices to offset the impact of the increased tax, making them less competitive internationally; or accept lower margins and earnings, thereby impacting their ability to attract capital; or, third, lower costs to offset the increased tax rate.

Lowering costs in this world often translates into laying off people, moving work offshore to lower-cost areas, or fundamentally restructuring how you operate your factory floor, which, again, usually results in firing people and also takes quite a bit of time.

The fact that the ETI/FSC repeal disproportionately hits key, good-wage, high value-added U.S. exporting industries like aerospace, manufacturing, agriculture, and high technology, is particularly disturbing.

I would submit to you that finding a WTO-compliant replacement to the ETI/FSC exclusion is critical, worthy of taking the time, and in the end, a matter of fundamental fairness.

I would be more than happy to elaborate further during the questioning period.

The CHAIRMAN. Thank you, Mr. Chao, very much.

[The prepared statement of Mr. Chao appears in the appendix.]

The CHAIRMAN. Mr. McPheeters?

STATEMENT OF F. LYNN McPHEETERS, VICE PRESIDENT AND CFO, CATERPILLAR INC., PEORIA, IL

Mr. MCPHEETERS. Good morning, Mr. Chairman and distinguished members. I am Lynn McPheeters, vice president and CFO

of Caterpillar. I thank you for this opportunity to discuss the future of the extraterritorial income regime and its impact on international competitiveness of U.S.-based exporters like Caterpillar.

Let me, briefly, give you a few facts about Caterpillar. For more than 75 years, Caterpillar has been helping build the world's infrastructure, and in partnership with Caterpillar dealers, is driving positive and sustainable change on every continent.

With 2001 sales and revenues of nearly $21 billion and 72,000 employees worldwide, Caterpillar is the world's leading manufacturer of construction and mining equipment, diesel and natural gas engines, and industrial gas turbines.

We also provide financing, insurance, and logistics services to a global customer base. The models before you represent Caterpillar products manufactured in the U.S. that have helped build the world's infrastructure during our 75-plus year history. I will talk more about the significance of those models later in my comments.

Caterpillar has long maintained a strong commitment to free trade principles, and I applaud your leadership, Mr. Chairman, and strong support by members of the committee to pass the TPA bill.

However, I am concerned that the loss of ETI, without a suitable replacement, could undermine the ability of U.S. exporters to compete in a global trade environment. The consequences of such actions could have a detrimental impact on capital and job growth in the United States.

Repeal of the ETI provisions of the U.S. Tax Code would immediately impose a more than $5 billion tax increase on the Nation's exporters, making it difficult for U.S.-based exporters to remain competitive versus our foreign counterparts.

This additional cost would be factored into investment analysis models most firms use when determining where to invest shareholder capital.

For exporters, an obvious alternative to investing in the U.S. is to produce closer to where the product is being sold. If returns from investments in the U.S. decline, U.S.-based exporters will have a disincentive to invest here, ultimately leading to a loss of high dollar value export-related jobs in the U.S.

Caterpillar's business model is somewhat unique because we are one of a handful of Fortune 100 companies that successfully compete globally from primarily a U.S. manufacturing base. Over 60 percent of our global manufacturing assets are in the U.S. To maintain this base, it is important to continue to competitively access international markets from here.

Of the $21 billion in 2001 sales I mentioned, over $5 billion was attributed to U.S. exports, directly supporting 16,500 high dollar value U.S. Caterpillar jobs, and an additional 33,000 U.S. supplier jobs.

By 2010, we estimate that approximately 75 percent of our projected $30 billion in sales will be outside the United States. As exports increase, so do the number of high-paying U.S. jobs needed to support them.

The models you have before you help emphasize the importance of Caterpillar's exports to our ability to create jobs in the U.S., a trend we plan to continue. Each model has a tag that shows the

percentage of U.S. production exported to countries around the world.

For example, this D–9, 60 percent of the production from the United States is shipped outside this market. With our continued growth, we have the potential to create a large number of additional export-related jobs for American workers in the future.

However, our ability to increase export-related employment is primarily dependent on our ability to compete in the global marketplace. This includes ensuring U.S. tax laws help us remain internationally competitive and incent U.S. exporters like Caterpillar to make capital investments and create jobs in the U.S.

By way of background, in 1971, Congress passed the Domestic International Sales Corporations, or DISC, legislation to help partially level the playing field for U.S. businesses.

In the last 31 years, global competition has increased substantially. As a result, the impact of U.S. tax rules like ETI on international competitiveness of U.S.-based exporters is much more significant today.

The fundamental policy considerations Congress used to develop the DISC, and later the FSC and ETI, remain important, and we believe law makers recognize that.

But now we have a series of challenges to our Tax Code by the EU, requiring Congress to consider changes to our laws. There is an important consideration to note as Congress considers alternatives to ETI.

Even with ETI, many of our foreign competitors enjoy an advantage over U.S.-based multinationals because their governments use border adjustable tax regimes that do not tax income earned outside their borders.

A repeal of ETI without a suitable replacement would only increase the competitive disadvantage U.S. companies face internationally.

I believe the ideal outcome will consist of a WTO-compliant solution that keeps U.S. exporters competitive and contains elements of both tax law changes and negotiations with the EU.

We believe the U.S. has the responsibility to comply with its WTO obligations, but it is time to develop the right overall tax policy to avoid making the creation of capital and jobs more attractive in foreign countries than in the United States.

Mr. Chairman, on behalf of Caterpillar, I appreciate the opportunity to offer these comments.

The CHAIRMAN. Thank you very much, Mr. McPheeters.

[The prepared statement of Mr. McPheeters appears in the appendix.]

The CHAIRMAN. Next, Mr. Kostenbauder.

STATEMENT OF DAN KOSTENBAUDER, GENERAL TAX COUNSEL, HEWLETT-PACKARD COMPANY, PALO ALTO, CALIFORNIA

Mr. KOSTENBAUDER. Thank you, Mr. Chairman and members of the committee. My name is Dan Kostenbauder. I am general tax counsel at Hewlett-Packard, based in Palo Alto, California.

After our merger with Compaq Computer Corporation earlier this year, our revenue, based on last year's totals, will be over $80

billion. Over half of that revenue is from outside of the United States, which implies, and is a fact, that we are a major exporter from the U.S. We also have a tremendous amount of international activity, so we care about the FSC/ETI rules, as well as the international rules of the U.S. Tax Code.

I am also appearing on behalf of AEA, formerly the American Electronics Association, with 3,500 members, as the largest high-tech trade association in the U.S. Again, most AEA members are addressing global markets and are interested in both the international provisions of the Tax Code as well as the provisions relating to exports.

It is our view that the process that we are engaged in may very well lead to the repeal of the ETI rules. If so, we have some thoughts about what might be a replacement. We certainly think that the replacement should help any sectors of the economy that are currently benefitting from the ETI rules and should also improve our international competitiveness.

AEA particularly suggests four items, two in the Subpart F area and two in the foreign tax credit area: one would be to repeal the foreign-based company sales and service income rules; another would eliminate the restrictions on the active rents and royalties with respect to software from the Subpart F rules.

Also, we would suggest that the legislation increase the foreign tax credit carry-forward period from 5 to 10 years, and also repeal the limitation on the use of the foreign tax credit to offset corporate AMT. Today, foreign tax credits are only allowed to offset 90 percent, and they should be allowed to offset 100 percent to achieve the goal of eliminating double taxation.

Let me review the context of the Subpart F provisions. As you know, the U.S. taxes corporations on a worldwide basis. There is deferral of the active earnings of control led foreign corporations. Subpart F provides exceptions to that deferral.

Subpart F has provisions to currently tax passive income, and no one is suggesting in this context any change in those rules. But the base company rules operate in such a way that active business income, active operating income that is earned offshore, is currently taxed in the U.S.

Let me give you a little example of how those rules work. They apply to sales or purchases from a related party accompanied by activity outside the country of the controlled foreign corporation's incorporation.

So, these are called base company rules. It is the only place in the world that I have ever heard this term. The way I think about it is to use the concept of a trading company.

Think about the following business situation. Assume we have 10 factories outside the United States in 10 different countries and 10 sales companies outside the United States in 10 different countries. If each of those factories wants to sell to each of the sales companies, you have, all of a sudden, 100 different transactions, 100 different computer systems that need to be organized, you have VAT registrations, you have Customs responsibilities that need to be organized. If you add one more factory, all of a sudden you are adding 10 more linkages. If you add another sales company, you again are adding a lot of complexity.

If you put a trading company in the middle, each of the factories sells to one place. Each of the sales companies purchases from one distribution or trading company and the whole process becomes much simpler and much more effective.

Someone asked me, why do you put those trading companies in low-tax jurisdictions? I said, why would they be located in high-tax jurisdictions? Certainly our international competitors would not do that.

The Subpart F rules relating to foreign base company sales, when they were instituted in 1962, had a much greater concern about the transfer pricing rules that would apply. That really was a concern with those trading companies in 1962.

However, today the U.S. tax system and the international tax system have much better enforcement of the transfer pricing rules. We have a lot more reliance on advanced pricing agreements, disclosure requirements, and penalties.

Eliminating the foreign base company sales income rules would encourage U.S. exports to the extent that we export from the U.S. through one of these trading companies that I referred to, because current Subpart F income would not be imposed on the transaction.

Another broad characteristic of the way the world market works is that U.S. companies predominantly export to foreign affiliates of U.S. companies, to controlled foreign corporations, including these trading companies.

A other huge advantage of repealing the base company rules would be tremendous simplification. These Subpart F rules are very complex, and eliminating them would provide a lot of simplification in the Code, and for the operation of companies abroad.

Thank you.

The CHAIRMAN. Thank you. That was very interesting.

[The prepared statement of Mr. Kostenbauder appears in the appendix.]

The CHAIRMAN. Next, Mr. Messinger.

STATEMENT OF DWIGHT "DYKE" MESSINGER, PRESIDENT, POWER CURBERS, INC., SALISBURY, NORTH CAROLINA

Mr. MESSINGER. Thank you, Chairman Baucus and members of the committee, Senator Hatch. My name is Dyke Messinger. I am the president and CEO of Power Curbers, Incorporated.

Power Curbers manufactures and distributes concrete paving equipment to over 80 countries worldwide. We were founded 50 years ago, and sell almost $25 million in machinery worldwide.

We employ 130 people at facilities in Salisbury, North Carolina, Cedar Falls, Iowa, and White House, Tennessee. International sales account for 20 percent of our revenue, and these sales are responsible for about 12 percent of our profits.

With stiff competition from our European competitors, our profit margins overseas are less than those in the U.S. market. I do not need to review the history of foreign sales corporations and their use in this country, but I would like to give you some statistics about FSCs used by small- and medium-sized companies.

According to a NAM survey in 2000, small- and medium-sized manufacturers saved, on average, about $124,000 annually by using a FSC. Of all exporting manufacturers in America, 93 per-

cent are small- and mid-sized manufacturers. These firms employ anywhere from 10 to 2,000 employees, and together employ roughly 9.5 million people.

Research shows that small- and mid-sized manufacturers that export add jobs 20 percent faster than firms that remain solely domestic, and are far less likely to go out of business.

For a company like Power Curbers, selling products in the international market means more than reaching a few additional customers. International sales contribute to the growth and health of power Curbers, ensuring our survival.

We use the FSC benefit to help us create a margin when our European competitors drive the price down in an effort to keep us out of the foreign market. With the FSC benefit, we are able to compete more effectively and still make a profit.

Benefits provided by FSC and ETI justify the additional efforts needed to go into overseas markets and compete. The tax systems in European countries heavily favor local suppliers. FSC/ETI helps level the playing field. You just cannot pull away incentives that allow small- and medium-sized manufacturers to actively pursue overseas markets.

Moreover, the loss of tax incentives like those provided by FSC/ETI would have a tremendous impact on our company. If these sales slump, Power Curbers would be forced to lay off some of our workforce, plain and simple.

Given the release of the WTO arbitration panel's sanctions report, we are pleased that the European Union recognizes the difficulty of the situation and has agreed to delay any sanctions until at least next year.

However, 5 months is not enough time. It is clear that the international tax issues involved are complex and a considerable amount of time will be required to develop and implement an appropriate legislative response.

In crafting a proposal to address the FSC issue, it is imperative that the United States strive to maintain approximately the current level of benefits for all exporters and continue to work toward a level playing field and a competitive environment for U.S. companies.

As a small, U.S.-based manufacturer, I am concerned that some of the proposed solutions are targeted to multinational corporations with subsidiaries, operations, and employees outside of the U.S.

These changes will not benefit small exporters like Power Curbers with operations only in the United States, and thus will not serve as an adequate substitute for the FSC/ETI.

From a legislative perspective, one approach would be to look at broad-based business tax relief and simplification of the Tax Code to ease our tax burden and make us more competitive overseas. However, I do not think we need to go into that today.

Chairman Baucus, like the others, I applaud your efforts in this area and we appreciate your holding this hearing.

The CHAIRMAN. Thank you, Mr. Messinger.

[The prepared statement of Mr. Messinger appears in the appendix.]

The CHAIRMAN. Next, Mr. Bullington?

STATEMENT OF DAVID BULLINGTON, VICE PRESIDENT FOR TAXES, WAL-MART STORES, INC., BENTONVILLE, AR

Mr. BULLINGTON. Thank you, Mr. Chairman, Senator Hatch.

I have a written statement that I would like to submit for the record, which I will now summarize.

Senator HATCH. Could I interrupt?

The CHAIRMAN. Sure.

Senator HATCH. I am going to submit written questions to you, if you would all answer those as quickly as you can. I am sorry, I have to go the floor, Mr. Chairman. But this has been a very, very interesting hearing. Thank you all.

The CHAIRMAN. Thanks, Senator.

Senator HATCH. By the way, I have 20 grandchildren. [Laughter.]

The CHAIRMAN. That is one of them right there. Thank you.

Mr. Bullington, go ahead.

Mr. BULLINGTON. I appear before you today on behalf of the International Mass Retail Association, IMRA. IMRA is the world's leading alliance of retailers and their product and service providers.

As IMRA retailers have expanded into the EU, Mexico, China, and other international markets, there has been new demand created for U.S. products.

The timing and amount of U.S. tax that U.S. vendors and retailers are required to pay on foreign-source income impacts directly our international competitiveness. Thus, IMRA has a vested interest in ETI, ETI alternatives, and solutions that Congress is considering.

Wal-Mart is an excellent example of how success internationally generates jobs and economic growth in the United States. As we increase our number of stores overseas, we provide additional markets for the U.S. products we sell. Agricultural products from the United States are sold in our stores internationally.

We support international operations at our headquarters in Bentonville, Arkansas, where we employ over 15,000 people. Fifteen hundred associates in our information systems division are responsible for coordinating our worldwide distribution systems that move product anywhere in the world to the shopping carts of our customers.

In addition, our numerous suppliers employ people throughout the country to support our overseas efforts. Several thousand of these employees reside in Arkansas. For example, Proctor & Gamble has 200 employees, and Coca-Cola has 100 employees at our Bentonville headquarters supporting their worldwide sales to Wal-Mart.

As Congress considers reform of the tax system to enhance international competitiveness, there are a number of approaches that merit consideration.

First, the U.S. is not a low-tax company for corporations. With U.S. taxation of worldwide income and the flaws in our deferral and foreign tax credit mechanisms, the most meaningful action that Congress could take to enhance the international competitiveness of U.S. corporations would be to reduce the U.S. corporate tax rate.

However, I realize that such reduction may not be feasible in today's environment, and I will therefore focus on various changes that could, and should, be made to Subpart F and the foreign tax credit provisions of the Code.

There are four specific proposals in my written submission which illustrate the manner in which the current foreign tax provisions of the Code compromise American international competitiveness.

I will summarize two of the most important. First, due to the cyclical nature of the retail business and the associated large amounts of working capital required to address such, the current working capital de minimis exception rule in Section 954 creates a situation where, in many cases, the U.S. retailers' income from working capital is taxed currently in the U.S., even though such working capital is required for the active conduct of its business.

For these reasons, Section 954 should be amended to preserve deferral for working capital of a controlled foreign corporate attributable to active business operations.

This could be accomplished by either returning the current threshold to its original 1962 level, or Congress could create a working capital exemption from the 954 foreign-based company income inclusion provisions.

Second, under Subpart F, certain inter-company sales and services income of a controlled foreign corporation is classified as foreign-based company income and is thus not eligible for deferral, even though such income is generated in the active conduct of a trade or business, with the exception of transactions in the same country.

The same country exception which permits deferral should, at a minimum, be revised in the case of the member countries within the EU or within China, Hong Kong.

An even more preferable approach is to eliminate in its entirety the foreign-based company rules. The income accomplished by the foreign-based company sales and services income rules is active business income of the type frequently not taxed on a current basis by other countries that have enacted anti-deferral regimes. Such income should not be subject to current U.S. tax.

The remaining points in my written submission focus on the need to revise the stacking rules for foreign tax credit utilization and the interest allocation in order to assure double taxation is avoided and aid in international competitiveness for all U.S. multinationals.

Additionally, the carry-forward period for unused foreign tax credits should be increased from the current 5 years to 10 years.

Thank you, Mr. Chairman. I am happy to answer any questions you may have.

The CHAIRMAN. Thank you, Mr. Bullington.

[The prepared statement of Mr. Bullington appears in the appendix.]

The CHAIRMAN. Now, finally, Mr. Zrust?

STATEMENT OF JAMES H. ZRUST, VICE PRESIDENT OF TAX, THE BOEING COMPANY, CHICAGO, IL

Mr. ZRUST. Thank you, Mr. Chairman.

I am James Zrust, vice president of Tax at the Boeing Company. On behalf of more than 170,000 employees who work for the Boeing Company, as well as our nearly 26,000 supplier companies, I want to thank you for the opportunity to present our views on the impact on aerospace workers and suppliers if the ETI regime is repealed without a suitable replacement. We applaud your efforts to address this issue.

As America's largest exporter, we do not believe that an appropriate response to the WTO's decision would be to simply repeal ETI. The effect of such an act would be a tax increase on American exporters.

More importantly, for Boeing this could result in a potential loss of nearly 10,000 high-paying, high-tech American jobs. For suppliers, this could mean the loss of another 23,000 jobs.

This would be especially devastating to the U.S. aerospace industry overall, an industry that employs nearly 800,000 highly-skilled workers, and one that is still suffering from the effects of last September's events.

Without an even playing field, companies will lose substantial portions of their export business activities and be forced to either eliminate or transfer these U.S.-based jobs overseas.

In the year 2000, the aerospace industry was the largest net contributor to the U.S. trade balance, producing an industry trade surplus of almost $27 billion.

A recent U.S. Government report indicates a one-month trade deficit of some $37 billion. This deficit will increase substantially if U.S. aerospace exporters lose ETI benefits.

Today, ETI helps level the playing field for U.S. companies competing against foreign firms, especially when our competitors are often heavily subsidized by their governments and enjoy tax rebates on their exports. We need a suitable replacement for ETI.

Some 70 percent of all Boeing commercial aircraft are exported and sold to foreign airlines. We rely on a rules-based trading system where everyone follows the rules and trade is fair.

That is why we take very seriously the need for the U.S. Government to ultimately comply with the WTO's decision. I think the question before this committee really is, how should that compliance take place?

The Boeing Company, our suppliers, and our workers take great pride in the fact that we are a pure exporter. Rather than establish foreign subsidiaries historically to produce and distribute our aircraft, we have relied on ETI and its predecessors, FSC and DISC, in making our long-term investment decisions.

Those decisions have allowed us to strengthen our production capabilities and employment in the U.S. We know this approach has helped strengthen the industrial base of our country and we feel very strongly that we should hardly be punished for taking this approach.

Boeing has major operations in 26 States, with employees and suppliers through all 50 States. We are the single largest employer in the States of Washington and Kansas, and the largest manufacturing employer in both California and Missouri.

Using a conservative multiplier effect of 2.4, Boeing today generates about a half a million jobs in this country, many of which are with small- and medium-sized businesses.

In short, our Boeing team has been, and hopefully will continue to be, an important engine of economic growth and technology in this country.

But let me stress, the loss of a tax provision that allows U.S. exporters to compete fairly with foreign competitors may well translate into a reduction in research and development, result in higher capital costs, and ultimately loss of market share.

The effect of that will be a reduction in our workforce and supplier base. I submit to you that this is a scenario that neither Boeing, nor suppliers, nor the Congress wants to see unfold.

Mr. Chairman, we will look forward to working with you and your committee to resolve these very difficult issues facing Boeing and other exporters who choose to retain jobs at home in the United States.

Thank you.

The CHAIRMAN. Thank you, Mr. Zrust.

[The prepared statement of Mr. Zrust appears in the appendix.]

The CHAIRMAN. Mr. Chao, if you could, in a little more detail, explain what you believe to be the adverse effect of earnings per share if ETI were repealed, all things, as you say, being equal?

Mr. CHAO. All things being equal is the key phrase, to the extent that everything else is kept the same. Actually, you can visibly see the impact. A very quick perusal through any of these companies' annual reports will indicate what benefit they are picking up from the FSC/ETI in terms of the hundreds of millions of dollars being saved in the tax rate.

A repeal of ETI without a replacement of some form or another would eliminate that exclusion, would force them to pay those taxes, thereby lowering the earnings to the corporation.

Either you accept that passively and take the hit in terms of the market, and as we have found out in the last couple of weeks it is extremely efficient. To the extent that the market thinks that it is a permanent repeal, would be very quick in terms of factoring that into the values of these American companies, to the extent that their margins or profits are lower, as well, the companies have to respond.

The CHAIRMAN. But would eliminate of ETI for future years reflect current earnings?

Mr. CHAO. The marketplace would take that into account. The marketplace being a discounting mechanism, looking into the future, would take that impact today.

The CHAIRMAN. What about a replacement where more foreign-source income is deferred and/or greater use of foreign tax credits?

Mr. CHAO. It would offset it to the extent that the multinationals would be able to take advantage of some of that. It would help defer some of that impact, some of the magnitude that I spoke about. To the extent that the pure exporters may not be able to take it, they would feel the real brunt of this.

The CHAIRMAN. All right.

I would like to just go down the table here and ask, again, all things being equal, what the effect of your company and/or industry would be if FSC/ETI were repealed.

We will start with Mr. McPheeters?

Mr. MCPHEETERS. It is difficult to say from a pure dollar and cents standpoint. But the repeal of ETI, as I mentioned, will certainly factor into the investment decision model that we, and I think all companies, use to determine where investments are made.

It would have to then be factored into where we would expand manufacturing capacity. In addition to that, it certainly would have an immediate impact on earnings, as Mr. Chao has pointed out.

The CHAIRMAN. Mr. Kostenbauder?

Mr. KOSTENBAUDER. Two thoughts. One, is if the FSC/ETI were repealed, and that alone, certainly it would be very detrimental.

The CHAIRMAN. That is, to Hewlett-Packard.

Mr. KOSTENBAUDER. To Hewlett-Packard. It is clear, on the other hand, that if it is offset—if that amount of revenue was offset with other provisions of an equal magnitude, although the distributional effect will not be identical, it certainly would have a more balanced effect and it would mitigate that negative impact.

The other thing is, AEA as a trade association, and Hewlett-Packard as a company that sells globally, really do want to make sure that the trade friction that exists with our major trading partners is eliminated.

So, again, elimination of the FSC/ETI may, in fact, if it does occur as a part of that overall solution that needs to be negotiated and resolved, help foster more global trade, which would be beneficial.

The CHAIRMAN. What do you say to the other companies represented here, Caterpillar, Boeing, and so forth, who say, hey, this is going to hurt us? It may be all right for the multinationals, but we are basically pure exporters. What do you say to them?

Mr. KOSTENBAUDER. What we have offered up are some provisions that would help international competitiveness, and certainly I would expect them—and I think they have—to bring forward other ideas and other thoughts that would be beneficial to those sectors.

So, I think part of the role of this committee and the Congress is to balance these various perspectives. It certainly appears that the FSC/ETI, in its current form, is going away. It does not appear likely that we are going to be able to, as a country, negotiate in such a way to keep it in its present form.

So, I think that our role as representatives of companies that are involved in international commerce is to bring to the committee ideas that we think will help the Tax Code become more competitive. I think the companies here that are most reliant upon FSC/ETI have the obligation to bring forward to you ideas that they think would help them compete.

Certainly we think the ideas that we have brought forward would be broadly beneficial to many companies, not specifically Hewlett-Packard or the American Electronics Association. These are provisions that have very broad impact across the economy.

The CHAIRMAN. It is kind of a small world, and it is sometimes ironic. Your boss's father was my law school tax professor.

Mr. KOSTENBAUDER. Is that right?

The CHAIRMAN. Yes. [Laughter.]

Mr. Messinger, how does it affect you?

Mr. MESSINGER. Well, I think I can speak for most smaller companies. Business is on a deal-by-deal basis, so we now have a limited amount of leeway when we come to a competitive situation, particularly with our European competitor, who is our biggest international competitor.

So, we would have to pick and choose the deals that we would participate in. Over time, we would choose not to participate in certain business. Then, presumably, we would lose that business. And we have American competitors, other companies facing those same decisions.

So I cannot say that it would be immediate, but if you take the impact of all of the small- and medium-sized manufacturers beginning to make those decisions, I think over time you begin to see some layoffs. Our company would have to, if we started to not get the deals that we expected.

The CHAIRMAN. Any response to Mr. Kostenbauder's challenge, that it is up to those guys to come up with solutions that help them?

Mr. MESSINGER. Well, we are a pure exporter. My company does not have the ability to understand it. I think the National Association of Manufacturers does, certainly Boeing; people like that that are pure exporters can participate. But we would be happy, as an organization, to participate in any way.

The CHAIRMAN. Sure. Thank you.

Mr. Bullington, how is it going to affect Wal-Mart, just straight repeal?

Mr. BULLINGTON. The elimination of the ETI benefit would have minimal, if any, effect on Wal-Mart. On the other hand, however, it would affect certain of our supplier/vendors.

As to the other companies that are almost pure exporters, we would hope that some provisions outside of the export arena could be devised that may offset some of the impact, or much of it, whether it is for a defense contractor, a more enhanced research development credit, or things like that in a different context. That may be the way to take on some of the adverse impacts that they no doubt will suffer.

The CHAIRMAN. All right. Mr. Zrust, you pretty well described how it is going to affect Boeing. What other solutions do you have here?

Mr. ZRUST. I think one of the things we need to look at is the proposal put forth by one of the coalitions, the NFTC, that Senator Hatch, I believe, mentioned a little bit earlier. That was the provision that would look at the subsidy and countervailing measure agreement within the WTO, and Footnote 59, specifically.

There is a proposal that was put in place. It is not in any form of what I would say would be final. However, I think it can be something that can be worked off of and provide some opportunity.

I would like to say the effect on Boeing as well, and it is pretty easy. The effect is about $200 to 250 million per year. So, it is a big number.

We have heard some of the other proposals mainly dealing with the elimination of base company sales and service income. I might add that those provisions would provide no benefit to us as well the way we are presently structured.

The CHAIRMAN. What do you think about the approach of trying to get at the basic WTO rules in the first place?

Mr. ZRUST. What we would like to see done, I think there needs to be some negotiation that takes place that, first of all, can serve to mitigate potential retaliation. That has to be something done by, I think, both Congress and the administration working together. Obviously, we would like to see some suitable replacement for the present ETI legislation.

Within the negotiation, we need to level the playing field, where clearly the WTO rules, in our opinion, are biased against a direct tax system as opposed to the indirect tax system that the European countries have.

Finally, we need to make sure, in whatever solution we might provide, that we are not providing an incentive to move jobs offshore, which some of these proposals might lead us to.

The CHAIRMAN. Mr. Bullington and Mr. Kostenbauder, do you agree with Mr. Zrust that we should try to "level the playing field," and any solution we come up with should not, on its face, tend to push jobs overseas? I mean, your industries are a little bit different from his.

Mr. BULLINGTON. I think that has to be certainly the goal of it. At the same time, we do want to ensure that those provisions that are making us anti-competitive in some instances abroad, that we try to address those, too.

Mr. KOSTENBAUDER. Certainly we ought to have a U.S. Tax Code that encourages jobs and employment activity in the U.S. I would agree with that.

The CHAIRMAN. What I am getting at is the degree to which we should go after "leveling the playing field." That is, not just to willy-nilly agree with any WTO ruling, that hey, Americans, we do not like what you are doing, so change your laws, versus, hey, as I mentioned earlier, your premise is incorrect, and let us go back and "level the playing field" here in the Doha negotiations.

Mr. KOSTENBAUDER. Well, certainly the idea of a level playing field has been a broad characteristic of our National trade policy for a long time, and certainly that would be consistent with our views of how the international tax and trade rules should work.

The CHAIRMAN. Is Footnote 59 broad enough to pursue? Anybody want to take a crack at that? Some have suggested that it is not very broad.

Mr. ZRUST. Well, it is not as broad as, let us say, comparing our change going from FSC to ETI, which I think essentially replicated benefits of beneficiaries of the exports.

I think, with a Footnote 59 solution, I think many exporters will receive, not a replication, but I think they may receive a substantial amount of the benefits that they presently receive with ETI.

I think there needs to be more analysis. Certainly, I think the multinationals, the larger companies, would probably be in that case. I think there would have to be some review with the agricul-

tural industry, and probably some smaller businesses to see how they are affected.

The CHAIRMAN. Well, I appreciate all of your testimony very, very much. It has been quite constructive. I am going to put together this working group, and you all are invited. Whoever comes, comes. Whoever does not, does not.

But I just think I am going to invite essentially the same participants that participated in the last one, and try to find a solid, American solution, private, public, and both ends of Pennsylvania Avenue solutions.

So, thank you very, very much. This has been very helpful. I appreciate it. Thank you.

The hearing is adjourned.

[Whereupon, at 11:59 a.m. the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF DAVID BULLINGTON

Mr. Chairman and members of the Committee, I am David Bullington, Vice-President for Tax at Wal-Mart Stores, Inc. Based in Bentonville, Arkansas, Wal-Mart is the nation's largest retailer, with facilities in all 50 States and in 10 foreign countries. As of June 30, 2002, the Company had 1,617 Wal-Mart stores, 1,140 Supercenters, 512 SAM'S CLUBS and 33 Neighborhood Markets in the United States. Internationally, the Company operates units in Argentina (11), Brazil (22), Canada (196), China (19), Germany (96), Korea (12), Mexico (572), Puerto Rico (17) and the United Kingdom (255). Wal-Mart also owns a 6.1% interest in Seiyu, Ltd. with options to purchase up to 66.7% of that company. Seiyu operates over 400 stores located throughout Japan. Wal-Mart employs more than 1 million associates in the United States and more than 300,000 internationally.

I appear before you today on behalf of the International Mass Retail Association ("IMRA") – the world's leading alliance of retailers and their product and service suppliers. IMRA members represent over $1 trillion in sales annually and operate over 100,000 stores, manufacturing facilities, and distribution centers nationwide. Our member retailers and suppliers have facilities in all 50 states, as well as internationally, and employ millions of Americans. As a full-service trade association, IMRA provides industry research and education, government advocacy, and a unique forum for its members to establish relationships, solve problems, and work together for the benefit of the consumer and the mass retail industry.

Introduction and Summary

I welcome the opportunity to participate in this hearing, which focuses on the role of the Extraterritorial Income ("ETI") Exclusion Act on the international competitiveness of U.S. companies. As IMRA member operations have expanded into the European Union ("EU") and other countries such as China and Mexico, there has been an unleashing of pent-up demand for U.S. goods. U.S. retailers and our vendors are clearly the largest employers in the U.S., and to the extent we are able to compete successfully worldwide, we generate employment opportunities in the United States, create additional markets and enhance economic growth in our country. Of course, many of the U.S. vendors that supply the retail products we sell overseas export through and realize the meaningful benefits of foreign sales corporations ("FSCs"). Because the U.S. tax that retailers and vendors pay directly impact the price we pay for goods and, thus, charge our customers world-wide, we have a direct interest in FSC and FSC alternatives that Congress will be inclined to develop as a result of the World Trade Organization ("WTO") ruling that the FSC/ETI regime constitutes a prohibited export subsidy.

There is an emerging consensus that, in light of the WTO decision, it is not feasible for Congress to enact new legislation that simply replicates the benefits of the FSC/ETI regime. Consistent with this emerging consensus, many in Congress have begun to focus on proposals designed to increase the international competitive position of American companies in a manner consistent with the obligations of the United States under the international agreements to which it is a party. For the reasons summarized in this statement, we share the view that it is vitally important for Congress to develop legislation that will not only assist those sectors of the U.S. economy that currently benefit from the FSC provisions of the Code, but which will enhance the competitive position of *all* American businesses in the global marketplace.

The most effective action that Congress could take, within the context of the current structure of the U.S. tax system, would be to enact a significant reduction in the corporate tax rate. This would improve American competitiveness internationally as well as at home. Moreover, and whether or not a significant reduction is enacted, if foreign source income continues to be subject to U.S. tax, Congress should revise the subpart F and foreign tax credit provisions of the Code in a manner that will both enhance American competitiveness and simplify the operation of those provisions.

Taxes and International Competitiveness

The international competitive position of American businesses is an integral factor in the health of our economy and the well being of our citizens. The U.S. federal income tax system has a significant impact on the international competitiveness of American businesses. Unfortunately, however, our current system frequently functions in ways that undermine, rather than strengthen, American competitiveness at home and abroad.

There are several fundamental points about our current tax system that the Committee should keep in mind. First, as discussed more fully below, when compared to EU member countries and other members of the Organization of Economic Cooperation and Development ("OECD"), the United States is not a low tax country for corporations. Because the United States, unlike a number of other countries, taxes corporations on their worldwide income, these comparatively higher rates of taxation have effects on international as well as domestic competitiveness. Second, while the foreign tax credit provisions of the Code aim to avoid double taxation of foreign source income, these provisions have been amended in such a manner that full relief from double taxation frequently does not actually occur.[1] Third, while the U.S. tax on foreign source income earned through controlled foreign corporations (CFCs) generally is deferred until those earnings are distributed as a dividend to the U.S. Parent corporation, the limitations on deferral contained in the subpart F provisions of the Code are broader than those of many other countries with whose businesses we compete around the world.[2] As a result of all of these factors, "a U.S. multinational frequently pays a greater share of its income in foreign and U.S. tax than does a competing multinational company headquartered outside the United States."[3]

In hearings conducted by this Committee in recent years, others have quite properly emphasized that it is essential for Congress to address the adverse effects of the current tax system on American competitiveness in a comprehensive manner. The revenue that would be generated by the repeal of the ETI provisions of the Code provides Congress with the resources to do so. The competitive position of American exporters

[1] International Tax Policy for the 21st Century, National Foreign Trade Council, Vol. 1 at p.3.(NFTC Study)
[2] Id.
[3] Statement of Peter Merrill Before the Committee on Ways and Means, United States House of Representatives (February 27, 2002).

should of course not be ignored, but Congress should also take this opportunity to improve the international competitive position of all American businesses.

Wal-Mart is an excellent example of how success internationally generates jobs and economic growth in the United States. As we increase our number of stores overseas, we provide additional markets for the U.S. products we sell. Agricultural products from the United States are sold in our stores internationally. We support our international operations at our headquarters in Bentonville, Arkansas where we employ over 15,000 people. Fifteen hundred associates in our Information Systems Division are responsible for coordinating our worldwide distribution systems that move product anywhere in the world to the shopping carts of our customers. In addition, our numerous suppliers employ people throughout the country to support our overseas efforts. Several thousand of these employees reside in Arkansas – for example, Proctor and Gamble has 200 employees and Coca-Cola has 100 employees at our Bentonville headquarters supporting their worldwide sales to Wal-Mart.

As Congress considers reform of the tax system to enhance international competitiveness, there are a number of approaches that merit consideration. The balance of this statement outlines a series of tax law changes that Congress should consider as part of the process of maintaining and strengthening the position of American businesses in the global economy.

Corporate Tax Rate Reductions

As noted earlier in this statement, the United States is not a "low tax" country for corporations. The U.S. corporate tax rate of 35 percent is higher than that of the home countries of corporations that directly compete with U.S.-based multinational firms and many of these countries have lowered their rates in recent years. For example, the corporate tax rates imposed by the U.K. and Australia are 30 percent while France has a 33.3 percent rate. Mexico has joined this increasingly global trend and provided for a stepped rate reduction from the current 35 percent to 32 percent by 2005 and Canada has likewise enacted similar stepped rate reductions. More generally, "the average central government corporate tax rate in OECD member states has fallen since 1986 to 30.5 percent in 2001 – 4.5 percentage points less than the U.S. rate."[4]

[4] Id.

Because the United States taxes the worldwide income of American businesses, these high rates affect the international competitive position of those businesses. For example, if an American corporation, a French corporation and a U.K. corporation compete for business in the U.K., the American corporation will generally have the highest tax burden of the three, which will be triggered if it repatriates the earnings to the U.S. as a dividend. This rate disparity has an adverse effect on American competitiveness internationally and it would exist even if the foreign tax credit provisions of the Code functioned properly. Moreover, because the subpart F provisions of the Code are so broad the adverse effect of the rate disparity is all too frequently felt before repatriation of a CFC's earnings.

For these reasons, the reduction of the U.S. federal corporate income tax rate would be the most effective means to increase American business competitiveness, both at home and abroad. It would reduce the adverse impact of continued U.S. taxation of foreign source income and produce the following additional benefits. First, it would promote U.S. exports in particular, and the international operations of American businesses in general, in a way that is beyond challenge before the WTO or elsewhere as a violation of the international agreements to which the United States is a party. Second, it would be simple. Unlike many of the changes in the taxation of foreign source income enacted since the mid-1980s, there would not be yet another maze of new rules that would puzzle both taxpayers and the Internal Revenue Service. Finally, the results of a tax rate reduction would be predictable. In contrast to many of the complex recent tax law changes, Congress and the Treasury could more readily determine the immediate and ongoing impact of a rate reduction on tax receipts. Likewise, U.S. companies would be better able to plan for their future needs (e.g., for capital investment and the hiring of new personnel).

Targeted Revisions to the Taxation of Foreign Source Income

Some in Congress and in the Administration have suggested that the U.S. move away from taxing the worldwide income of American companies, and instead adopt a territorial tax regime. We believe that such fundamental tax reform issues are beyond the scope of this hearing, and that immediate, practical solutions are what this Committee seeks. Therefore, assuming that Congress chooses to continue to tax foreign source income, there are numerous changes that could and should be made to the subpart F and

foreign tax credit provisions of the Code in a manner that will both enhance American competitiveness and simplify the operation of those provisions.

With respect to subpart F, Congress should reduce the number of instances where deferral is inappropriately denied, particularly in the case of active businesses. In the case of the foreign tax credit provisions, Congress should eliminate, or at least reduce substantially, situations that can result in double taxation (including situations where credits for foreign taxes actually paid cannot in fact be used). The four specific proposals discussed below are illustrative rather than comprehensive, but they are both critically important in their own right and demonstrate the manner in which the current foreign source income provisions of the Code inappropriately compromise American international competitiveness.

1. Subpart F: Working Capital for Active Businesses

Under subpart F, deferral generally is denied for passive investment income earned by a CFC and such income is taxed to the U.S. shareholders of the CFC on a current basis as if it had been distributed to those shareholders as a dividend. Such passive investment income generally is classified as "foreign base company income" and is not eligible for deferral. There is a so-called de minimis exception, which is applicable if the CFC's foreign base company income and insurance income (computed on a gross basis) is less than the *lesser* of five percent of gross income or $1 million.[5]

Notwithstanding this de minimis rule, the incremental investment income attributable to the working capital of a CFC engaged in an active business can still be subject to U.S. tax on a current basis. The dollar limitation contained in section 954(b)(3)(A)(ii) should be eliminated for working capital. A specific dollar threshold (such as the $1 million in current law) discriminates against successful CFCs which, given the nature of their active business (e.g., cyclical retailers), require relatively large amounts of working capital in the ordinary course of business. It is inappropriate as a matter of policy when, solely as a result of its size and the working capital needs of its active business, a CFC is treated as generating subpart F income. There is broad

[5] Section 954(b)(3)(A). Unless otherwise specifically indicated, all references are to sections of the Internal Revenue Code of 1986, as amended.

agreement within the private sector that the application of subpart F in such a case is inappropriate.[6]

For these reasons, section 954(b)(3)(A) should be amended to preserve deferral for working capital of a CFC attributable to active business operations. This could be accomplished in one of two ways. First, the current threshold could be returned to its original 1962 level (gross foreign base company income of the CFC cannot exceed 30 percent of its gross income with no dollar limitation). While such a change would reflect the operating needs of active businesses for working capital, it would also encompass other forms of foreign base company income. As an alternative, Congress could limit the change to investment income attributable to working capital by excluding such income from the computation of the de minimis rule (i.e., in applying section 954(b)(3)(A)(ii), investment income attributable to working capital maintained in connection with an active business would be disregarded). We believe a suitable definition of "working capital" could be developed and that such an exception could be readily applied to taxpayers and administered by the Internal Revenue Service.

2. Subpart F: Repeal of Foreign Base Company Sales and Services Income Rules or Same Country Exception

Under subpart F, certain sales and services income of a CFC is classified as foreign base company income and is thus not eligible for deferral even though the income is generated in the active conduct of a trade or business. Under section 954(d), foreign base company income generally includes *sales* income earned by a CFC located in a country that is neither the origin nor destination of property it either purchases from or sells to a related person. Under section 954(e), foreign base company income generally includes income earned by the CFC from *services* performed outside the country in which it is incorporated if the services are performed for or on behalf of a related party.

Many countries that have anti-deferral regimes comparable to subpart F have not included provisions such as those that deny deferral for foreign base company sales and services income. In our view, Congress should repeal the foreign base company sales and services income rules. As noted, the income encompassed by the foreign base company sales and services income rules is active business income of the type frequently not taxed

[6] International Tax Policy for the 21st Century, National Foreign Trade Council, Vol. 1 at p9.

on a current basis by other countries that have enacted anti-deferral regimes. Such income should not be subject to current U.S. tax.

If deferral continues to be denied in the case of these types of sales and services income, the "same country" exceptions (which permit deferral) should be revised to treat the member countries of the EU as a single country and comparable treatment should be provided with respect to China/Hong Kong. Such a change would merely reflect the current political reality of those regions. Thus, the subsidiaries of a U.S. corporation located within the EU or China/Hong Kong would no longer be characterized as having tainted income (i.e., income subject to an immediate U.S. tax) upon the receipt of certain payments from other subsidiaries located within these locales. The member countries of the EU and China/Hong Kong are not "tax havens" and there is no reason to defer action on this targeted modification to subpart F.

3. Foreign Tax Credit: Ordering Rules and Carryover Periods

Because U.S. corporations (and other U.S. based taxpayers) are subject to U.S. tax on their worldwide income, the income they earn from their international operations potentially can be taxed twice – once by the foreign country in which it is earned and a second time by the U.S. The foreign tax credit is intended to reduce the incidence of double taxation by permitting most foreign income taxes to be credited against the U.S. tax on foreign source income. These credits are generally allowable in the year they are "triggered" (e.g., by the payment of a dividend by a CFC to its U.S. Parent or by the imposition by a foreign country of withholding taxes on the U.S. Parent's receipt of foreign source income such as royalties paid by a CFC to the U.S. Parent).

Even if triggered, foreign tax credits may be used only to offset the U.S. tax on foreign source income. If, in any year, the full amount of otherwise creditable foreign taxes cannot be used, the resulting "excess" credits may be carried back to the two preceding taxable years and then forward to the five succeeding taxable years. If not used within those carryover periods, the foreign tax credits expire and can no longer be used to offset U.S. taxes on foreign source income. In prior years, Congress has enacted legislation that reduces the likelihood that foreign tax credits may be used promptly (e.g., requiring that various categories of foreign source income be placed in separate "baskets" and prohibiting the use of credits attributable to foreign source income assigned to one basket to reduce the U.S. tax on foreign source income assigned to a different basket).

Furthermore, there are certain additional rules (such as the interest allocation rules discussed below) that artificially reduce the portion of a taxpayer's income that is treated as foreign source income. Since foreign taxes may only be credited against the U.S. tax on foreign source income, such artificial reductions reduce the ability to use foreign tax credits.

These and other provisions of the Code operate to reduce the effectiveness of the foreign tax credit as a tool to prevent double taxation. This is unfortunate since it is generally acknowledged that the foreign tax credit is critical to American international competitiveness. While Congress should address the underlying causes for the ineffectiveness of the foreign tax credit, it can and should take two immediate steps: (1) revise the ordering rules for applying credits; and (2) extend the carryover periods.

The current ordering (or "stacking") rules contained in section 904(c) permit foreign tax credits triggered in one year to be used in a carryover year only *after* the foreign tax credits triggered in the current year have been fully utilized. This rule increases the likelihood that otherwise valid credits for foreign taxes actually paid on foreign source income that has been subject to U.S. tax will nevertheless not be used during the carryover period and will thus expire.

The proposed "International Tax Simplification for American Competitiveness Act", introduced in 1998 (H.R. 4173 and S. 2231) sought to remedy this problem directly. Specifically, section 206 of that proposed legislation would have amended section 904(c) to provide that, with respect to any taxable year, foreign tax credits would be applied in the following order: (1) credits from carryforwards to that taxable year; (2) credits triggered in that taxable year; and (3) credits from carrybacks to that taxable year. This sensible result would make it more likely that U.S. corporations could in fact fully use the credits they earn for foreign taxes actually paid. This would increase the likelihood that the foreign tax credit would effectively serve its intended purpose and reduce the incentive that American businesses now have to engage in transactions designed principally to enable them to use excess foreign tax credits before they expire.

4. <u>Foreign Tax Credit: Interest Allocations</u>

As discussed above, current law contains a number of provisions that artificially reduce the portion of a taxpayer's total income that is treated as foreign source income. One of the most notable of these provisions requires the apportionment of U.S. interest

expense between U.S. and foreign source income based on the asset values of members of the group (including the stock of CFCs and other foreign assets). Interest paid by a CFC is ignored. As a result, an excessive portion of domestic interest expense is apportioned to foreign source income. This reduces the portion of the group's income that is treated as foreign source income and means that U.S. tax may in fact be imposed on foreign source income that has already been subject to foreign tax at rates equal to or in excess of the 35 percent U.S. corporate tax rate.

Congress should address this problem by providing an election to allocate interest expense on a worldwide basis. Such a change is highly desirable. American companies should be able to include the interest expense of their CFCs, and thus achieve a truly worldwide or global apportionment.

Conclusion

When Congress began consideration of a legislative response to the decision of the World Trade Organization concerning foreign sales corporations and exterritorial income, we frequently saw the term "non-exporter" in the press. However, we feel that a better term for a company such as Wal-Mart with growing international operations is "wealth and jobs creator." As I explained earlier, our success internationally fuels economic growth, creates jobs in the United States and creates markets for U.S. products around the world.

Wal-Mart and IMRA appreciate this opportunity to present our views. We are prepared to assist the Committee in any manner as it continues to consider the important issue of the adverse effects of the current U.S. tax regime on the international competitive position of American businesses.

Prepared Testimony
By Pierre A. Chao, Managing Director
Credit Suisse First Boston

U.S. Senate Committee on Finance
"The Role of the Extraterritorial Income Exclusion Act in the International Competitiveness of U.S. Companies"
July 30, 2002

Mr. Chairman, Senator Grassley and distinguished members of the Committee:

My name is Pierre Chao and I am a Managing Director with the equity research division of Credit Suisse First Boston, a global financial institution. As part of my everyday job I am required to assess the impact of economic, financial, political, and technological events on corporations and their stock values. At CSFB we have analysts and economists that follow practically every sector of the economy, although my particular area of expertise is the aerospace/defense industry.

Thank you giving me this opportunity to discuss the real impact on U.S. industry of the proposed repeal of the Extraterritorial Income Exclusion/Foreign Sales Corporation (ETI/FSC) provisions of the U.S. tax code.

Allow me to begin by stating that I am approaching this issue with a belief that capitalism works, that open trade is beneficial to an economy, that trade and international competition should occur on a fair and level playing field, and that the United States should abide by the rulings of the WTO. That being said, we are all aware there are distortions in the international market place, some deliberate and some unintended. The irony of this current discussion is that the ETI/FSC rules were put into place to offset an existing distortion in the market place – the fact that countries whose tax laws are based on territoriality do not tax or significantly lower their taxes on exporters, thereby putting U.S. companies at a direct disadvantage when competing in third-party markets. A U.S. and a foreign company could be identical in every respect, with the exception of location, and the U.S. company would be forced to keep its prices higher in order to make up the tax hit or accept lower margins. I was constantly surprised that this very common sense element was often missing in the WTO debate.

Nonetheless, the WTO has made a ruling and the ETI/FSC must go away. The Congress has heard quite a bit of expert testimony over the last few years on this topic. Economists and tax specialists have discussed how economies and firms theoretically respond and adjust. I would like to bring us to the real world and the here-and-now. The repeal of the ETI/FSC will act as an instant tax on U.S. exporters – hitting industries such as agriculture, electrical equipment, aerospace/defense, manufacturing and certain parts of high technology particularly hard. Without relief, I believe the companies will have little ability to respond in the very near term, which will serve to increase their effective tax rates and lower earnings per share. All else being equal, a decline in earnings per share

will impact the stock prices/market capitalization of these exporters in a fairly rapid fashion. The mathematics are simple – same pretax income, higher effective tax rate based on removing the ETI/FSC exclusions, a lower earnings per share, using the same price-to-earnings multiple equals a lower stock price. Some quick calculations based on 2001 earnings reveal that, all else being equal, key exporters like Boeing and United Technologies could lose $3-3.5 billion of market capitalization; Caterpillar, Deere and Walt Disney could lose around $1 billion of market capitalization; Archer Daniels Midland and Dupont around a $0.5 billion of market cap; and Harley Davidson and Tyson Foods could lose a few hundred million dollars. Not to mention the estimate that the impact on General Electric's and Intel's market capitalization could be as high as $15-20 billion. That's quite a kick in the teeth to battered investors who have already suffered a stock market meltdown. This is a time when I believe we should be reassuring investors and trying to get them to invest in solid American firms, not giving them a reason to flee.

Naturally, management teams will have to respond. Their options are limited. Either raise prices to offset the impact of the increased tax (making them less competitive internationally), accept lower margins and earnings (thereby impacting their ability to attract capital) or lower costs to offset the increased tax rate. Lowering costs in this world often translates into laying people off, moving work to lower cost areas (which are often offshore) or fundamentally restructuring how a company operates its factory floor (also known as "lean" efforts, which again usually results in firing people and takes time). The fact that the ETI/FSC repeal disproportionately hits key, good-wage, high value-added U.S. exporting industries like aerospace, manufacturing and high technology is particularly disturbing. I would submit to you that finding a WTO-compliant replacement to the ETI/FSC exclusion is critical, worthy of taking the time and, in the end, a matter of fundamental fairness.

I would be more than happy to elaborate further during the questioning period.

RESPONSES TO QUESTIONS FROM SENATOR BAUCUS

Questions: Mr. Chao, you caution (perhaps even warn) about the adverse effects of repealing the ETI. You call it an "instant tax" on exporters that would be reflected in financial statements and, consequently, stock price. Can you walk us through the accounting here? Why is the elimination of the ETI regime for future years reflected in current financial statements? If we replaced the ETI with various tax cuts applicable to multinational companies, would that offset the adverse impact to these U.S. corporations?

Please note that my comments and responses are my own and do not necessarily reflect the opinion or position of Credit Suisse First Boston.

Question 1: I believe that if ETI is repealed without any offsetting changes in the tax laws then U.S. corporations will be faced with the prospect of a fairly immediate decline in profitability. Corporate managements will have only a few responses available to them, in my opinion. U.S. corporations can simply accept the lower profitability, which will ultimately impact stock prices, the ability to raise future capital and competiveness. The second option available would be to raise prices in order to offset the "tax" ETI repeal represents—this would serve to make U.S. companies less competitive versus foreign firms. The last option would be to reduce costs in order to offset the decline in profitability. This could be accomplished by trying to reduce salaries, cutting workforces, shrinking research and development, squeezing suppliers and/or trying to move the work to lower cost areas/countries.

Question 2: I believe the impact on the stock market would be fairly immediate if ETI was repealed without any offsetting changes to the tax laws. The stock market would perceive a reduction in profitability for exporters, factor in the lower earnings and reduce the market valuation of the firms. Over a longer time period, as managements are forced to offset the loss in profitability, U.S. jobs are put at risk in my opinion.

Question 3: If ETI were repealed without any offsetting changes to the tax laws, there is the potential for some aerospace/defense work to move offshore, particularly in the commercial aerospace arena. Pressures would exist to move some commercial aerospace work over time to lower cost countries that have been trying to build/expand their aerospace industries—China, South Korea, India, Czech Republic, Romania, Poland and Russia to name a few. It would be harder to move defense related work offshore given the export control laws, therefore the risk would be that U.S. defense contractors become less competitive in the international market place.

TESTIMONY OF KENNETH W. DAM
DEPUTY SECRETARY
UNITED STATES DEPARTMENT OF THE TREASURY
BEFORE THE SENATE COMMITTEE ON FINANCE
REGARDING THE WTO DECISION ON THE EXTRATERRITORIAL INCOME EXCLUSION PROVISIONS AND INTERNATIONAL COMPETITIVENESS

Introduction

Mr. Chairman, Senator Grassley, and distinguished Members of the Committee, I appreciate the opportunity to appear today at this hearing regarding the World Trade Organization (WTO) decision with respect to the extraterritorial income exclusion (ETI) provisions of U.S. tax law and the implications for international competitiveness. I commend the Committee for holding this hearing on this matter of vital importance to U.S. workers and U.S. businesses in today's global marketplace.

On January 29, 2002, the WTO Dispute Settlement Body adopted a final report finding that the ETI provisions are inconsistent with the United States' obligations under the WTO. That decision is the culmination of a challenge brought by the European Union in late 1997 against the foreign sales corporation (FSC) provisions then contained in the U.S. tax law. However, the origins of this dispute go back almost 30 years, predating the World Trade Organization itself. The United States has vigorously pursued this matter and defended its laws because of the importance of the provisions and principles at stake.

A WTO arbitration panel currently is considering the European Union's request for authority from the WTO to impose trade sanctions on $4.043 billion worth of U.S. exports. The arbitration panel is expected to issue its report on the appropriate level of trade sanctions in the next few weeks. Following the issuance of that report, the European Union will be in a position to receive authority to begin imposing trade sanctions on U.S. exports up to the level set by the arbitrators and the authority for such sanctions will continue until the United States rectifies the WTO violation.

This is an urgent matter that requires our immediate attention. The threat of substantial retaliatory sanctions against U.S. exports is not something that any of us takes lightly. Such sanctions, if imposed, would do real damage to U.S. businesses and American workers. And the imposition of such sanctions would have serious adverse consequences for the overall trade relationship between the United States and the European Union beyond those sectors directly targeted with sanctions, which would have a direct and detrimental effect on U.S. consumers. Of course the urgency is not just about the critical need to avert costly retaliation. The WTO has issued its final decision in this case, and we must comply with that decision. That is a matter of principle.

The President has spoken on this and his message is clear. The United States will honor its WTO obligations and will come into compliance with the recent WTO decision. To do so will require legislation to change our tax law. The Administration is committed to

working closely with the Congress in the development and enactment of the legislation necessary to bring the United States into compliance with WTO rules.

The analysis of the current WTO rules reflected in the decision in the FSC/ETI case makes it apparent that legislation attempting to replicate FSC or ETI benefits will not pass muster in the WTO. Nor can we satisfy our WTO obligations and comply with WTO rules through "tweaks" to the ETI provisions. The WTO Appellate Body made clear that a benefit tied to export activity, such as is provided through the ETI provisions, is not permitted. Therefore, it will not be fruitful to pursue again a replacement of the ETI provisions.

Addressing the WTO decision through the tax law will require real and meaningful changes to our current international tax laws. While the WTO decision is a bitter pill, we must look forward and take a fresh look at our tax laws and the extent to which they enhance or harm the position of the U.S. in the global marketplace. As we evaluate the changes we might consider, it is imperative that we make choices that will enhance – and not adversely affect - the competitive position of American workers and U.S.-based businesses in today's global marketplace.

In stating his commitment to compliance in this case, the President has said we must focus on enhancing America's competitiveness in the global marketplace because that is the key to protecting American jobs. At its core, this case raises fundamental questions regarding a level global playing field with respect to tax policy. The ETI provisions, like the FSC provisions that preceded them, represent an integral part of our larger system of international tax rules. These provisions were designed to help level the global playing field for U.S.-based businesses that are subject to those international tax rules. In modifying our tax laws to comply with this decision, we must not lose sight of that objective and what it means: the health of the US economy and the jobs of American workers.

Much can be done to rationalize our international tax rules through reforms both small and large. The need for reform of our international tax rules is something I know you recognize, Mr. Chairman. You have lead the way on a bipartisan basis with proposals to reform our international tax rules. The U.S. international tax rules can operate to impose a burden on U.S.-based companies that is disproportionate to the tax burden imposed by our trading partners on the foreign operations of their companies. The U.S. rules for the taxation of foreign-source income are unique in their breadth of reach and degree of complexity. The recent activity involving so-called corporate inversion transactions is evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy. Foreign acquisition of U.S. multinationals that arises out of distortions created by our international tax system raises similar concerns. We must address these tax disadvantages to reduce the tilt away from American workers and U.S.-based companies. And as we consider appropriate reform of our system of international tax rules, we should not underestimate the benefits to be gained from reducing the complexity of the current rules.

The bottom line is clear and simple. Our economy is truly global. U.S.-based companies must be able to compete in today's global marketplace. Our system of international tax rules should not disadvantage them in that competition. If we allow our international tax rules to act as an impediment to successful competition, the cost will be measured in lost opportunities and lost jobs here at home.

While we work toward the needed changes to our international tax rules, we must continue a dialogue with the European Union. We must take every step needed to ensure that this dispute does not further escalate to the detriment of the global trading environment. It is essential that we achieve a resolution of this matter that is clear, fair and final – a resolution that protects America's interests and satisfies our obligations under the WTO.

As I said in opening, resolving this case is an urgent matter that requires our immediate attention. We must work toward enactment of legislation that will bring us into compliance with the international WTO rules and protect the interests of American workers and businesses. On this there can be no delay – we must make real progress now.

However, this case highlights significant issues requiring further consideration as the discussions regarding WTO matters continue in the new round. As I said in my opening statement in the WTO appellate proceeding in this case in Geneva last November, "few things are as central to a country's sovereignty as how it raises revenue." The WTO Appellate Body in its report in the FSC case stated that the WTO rules do not "compel Members to choose a particular kind of tax system." That is a critically important point.

Compliance with the WTO decision in this case will require that we make meaningful changes to our tax law. We have an obligation to U.S. workers and businesses not simply to eliminate the ETI provisions. Our commitment to the American worker requires that we protect the competitive position of our businesses. We must couple the changes needed to address the WTO decision with needed reforms of our tax rules that will help level the playing field for U.S.-based businesses that must compete in today's global marketplace. The reforms that are needed address basic inequities in our international tax rules, rules that are out of step with those of our major trading partners. Such reform to the U.S. international tax system is not a matter in which there is any role for the WTO to play.

This case has been about the application of WTO rules to a particular aspect of the U.S. income tax system. However, there is a much more fundamental question regarding the treatment of taxes under the WTO rules that demands our careful consideration. The WTO rules on prohibited export subsidies make a distinction between direct taxes, such as income taxes, and indirect taxes, such as value added taxes. Under the WTO agreements, direct taxes are not permitted to be border adjustable. Therefore, the U.S. income tax is not rebatable on export under these rules. In contrast, indirect taxes are

permitted to be border adjustable under the WTO rules. Accordingly, the European value added taxes may be, and are, rebated at the border consistent with WTO rules.

This disparity in treatment between direct and indirect taxes dates back formally to a 1960 GATT working party and its informal origins date back even farther. Notwithstanding this long history, there is no compelling rationale for disparate treatment of direct and indirect taxes. Reconsideration of this distinction in the treatment of direct and indirect taxes under the WTO rules will be part of the discussion of WTO matters in the new round. These negotiations, however, are not a strategy for addressing the compliance obligation we face in this case today.

I would like to turn now to a brief history of the WTO case and our tax provisions that have been the subject of this protracted litigation. I will conclude with a discussion of the international competitiveness issues that must be a central focus in formulating the tax law changes needed to satisfy our WTO obligations and protect the interests of U.S. businesses and workers.

Overview of the History of the WTO Case

The FSC provisions were enacted in 1984. They provided an exemption from U.S. tax for a portion of the income earned from export transactions. This partial exemption from tax was intended to provide U.S. exporters with tax treatment that was more comparable to the treatment provided to exporters under the tax systems common in other countries.

The FSC provisions were enacted to resolve a General Agreement on Tariffs and Trade (GATT) dispute involving a prior U.S. tax regime – the domestic international sales corporation (DISC) provisions enacted in 1971. Following a challenge to the DISC provisions brought by the European Union and a counter-challenge to several European tax regimes brought by the United States, a GATT panel in 1976 ruled against all the contested tax measures. This decision led to a stalemate that was resolved with a GATT Council Understanding adopted in 1981 (the "1981 Understanding"). Pursuant to this 1981 Understanding regarding the treatment of tax measures under the trade agreements, the United States repealed the DISC provisions and enacted the FSC provisions.

The European Union formally challenged the FSC provisions in the WTO in November 1997. Consultations to resolve the matter were unsuccessful, and the EU challenge was referred to a WTO dispute resolution panel. In October 1999, the WTO panel issued a report finding that the FSC provisions constituted a violation of WTO rules. The United States appealed the panel report; the European Union also appealed the report. In February 2000, the WTO Appellate Body issued its report substantially upholding the findings of the panel.

Although the United States argued forcefully that the FSC provisions were blessed by the 1981 Understanding, the WTO panel disagreed, concluding that the 1981 Understanding had no continuing relevance in the interpretation of current WTO rules. The panel's analysis focused mainly on the application of the WTO Agreement on Subsidies and

Countervailing Measures. The panel found that the FSC provisions constituted a prohibited export subsidy under the Subsidies Agreement.

In response to the WTO decision against the FSC provisions, the FSC Repeal and Extraterritorial Income Exclusion Act was enacted on November 15, 2000. The legislation repealed the FSC provisions and adopted in their place the ETI provisions. The legislation was intended to bring the United States into compliance with WTO rules by addressing the analysis reflected in the WTO decision. At the same time, the legislation also was intended to ensure that U.S. businesses not be foreclosed from opportunities in the global marketplace because of differences in the U.S. tax laws as compared to the laws of other countries.

Immediately following the enactment of the ETI Act, the European Union brought a challenge in the WTO. In August 2001, a WTO panel issued a report finding that the ETI provisions also violate WTO rules. The panel report contained sweeping language and conclusory statements that had broad implications beyond the case at hand. Because of the importance of the issues involved and the troubling implications of the panel's analysis, the United States appealed the panel report. The WTO Appellate Body generally affirmed the panel's findings, although it modified and narrowed the panel's analysis in some respects. The Dispute Settlement Body adopted the report as modified by the Appellate Body on January 29, 2002.

The Appellate Body report makes four main findings with respect to the ETI provisions: (1) the ETI provisions constitute a prohibited export subsidy under the WTO Subsidies Agreement; (2) the ETI provisions constitute a prohibited export subsidy under the WTO Agriculture Agreement; (3) the limitation on foreign content contained in the ETI provisions violate the national treatment provisions of Article III:4 of GATT; and (4) the transition rules contained in the ETI Act violate the WTO's prior recommendation that the FSC subsidy be withdrawn with effect from November 1, 2000.

When it challenged the ETI Act in November 2000, the European Union simultaneously requested authority from the WTO to impose trade sanctions on $4.043 billion worth of U.S. exports. The United States responded by initiating a WTO arbitration proceeding on the grounds that the amount of trade sanctions requested by the European Union was excessive under WTO standards. This arbitration was suspended pending the outcome of the European Union's challenge to the WTO-consistency of the ETI Act, and resumed on January 29th with the Dispute Settlement Body's adoption of its final report. As I noted at the outset, the arbitration panel is expected to issue its report on the appropriate level of trade sanctions in the next few weeks and, following the issuance of that report, the European Union will be in a position to be authorized to begin imposing trade sanctions on U.S. exports up to the level set by the arbitrators.

Competitiveness and U.S. Tax Policy

The U.S. international tax rules have developed in a patchwork fashion, beginning during the 1950s and 1960s. They are founded on policies and principles developed during a

time when America's foreign direct investment was preeminent abroad, and competition from imports to the United States was scant. Today, we have a truly global economy, in terms of both trade and investment. The value of goods traded to and from the United States increased more than three times faster than GDP between 1960 and 2000, rising to more than 20 percent of GDP. The flow of cross-border investment, both inflows and outflows, rose from a scant 1.1 percent of GDP in 1960 to 15.9 percent of GDP in 2000.

Multinational corporations are a vital part of the United States economy. The ability of U.S. multinational corporations to compete successfully abroad leads directly to their employment of American workers at home. They employ over 20 million people in the United States, or about one in every six American workers. Approximately one fourth of the output produced by U.S. workers and U.S.-owned companies is produced by U.S. non-bank multinationals, either at home or abroad. Multinationals in the manufacturing sector produce over half of all U.S. gross manufactured product.

U.S. multinationals also participate substantially in international trade. Their merchandise exports account for about two-thirds of overall U.S. merchandise exports. Their merchandise imports account for about 40 percent of all U.S. merchandise imports. On balance, the operations of these companies showed a net trade surplus of $64 billion in 1999.

Multinational companies compete abroad to increase their sales in foreign markets, which increases their worldwide earnings. Much of their foreign activities are aimed at providing services that cannot be exported and selling goods that are costly to export due to transportation costs, tariffs, and local content requirements. About one third of the gross product of foreign affiliates of U.S. multinationals is produced by affiliates in the service sector, including distribution, marketing, and servicing U.S. exports. Foreign investment is also undertaken to obtain access to natural resources abroad.

Among the most important assets of U.S. multinationals is their technical and scientific expertise. Their foreign investments broaden the opportunities to benefit from such expertise and thus encourage them to spend more on research and development. Spending on research and development allows the United States to maintain its competitive advantage in business and be unrivaled as the world leader in scientific and technological know-how. In 1999, non-financial U.S. multinationals performed $142 billion of research and development. Nearly 90 percent of this activity was located in the United States. It accounted for more than two thirds of all research and development conducted by companies in the United States.

At one time, the strength of America's economy was thought to be tied to its abundant natural resources. Today, America's strength is its ability to innovate: to create new technologies and to react faster and smarter to the commercialization of these technologies. America's preeminent resource today is its knowledge base.

A feature of a knowledge-driven economy is that unlike physical capital, technological know-how has the potential to be applied across the world without reducing the

productive capacity of the United States. For example, computer software designed to enhance the efficiency of a manufacturing process may require substantial upfront investment, but once completed it can be employed around the world by its developer without diminishing the benefits of the know-how within the United States. Foreign direct investment by companies in a knowledge-driven economy provides opportunities to export this know-how at low cost and provides incentives to undertake greater domestic investment in developing these sources of competitive advantage.

There are many reasons to believe that the principles that guided U.S. international tax policy in the past should be reconsidered in today's highly competitive, knowledge-driven economy. In this regard, it is significant that the U.S. tax system differs in fundamental ways from those of our major trading partners. In order to ensure that U.S. workers achieve higher living standards, we must ensure the U.S. tax rules do not hinder the ability of the U.S. businesses that employ them to compete on a global scale. If U.S. workers and businesses are to succeed in the global economy, the U.S. tax system must not generate a bias against their ability to compete effectively with foreign-based companies.

To understand the effect of U.S. tax policy on the competitiveness of U.S. business, we must consider how U.S. businesses compete in today's global marketplace. A U.S. business operating at home and abroad must compete in several ways for capital and customers. Competition may be among:

- U.S.-managed firms that produce within the United States;
- U.S.-managed firms that produce abroad;
- Foreign-managed firms that produce within the United States;
- Foreign-managed firms that produce abroad within the foreign country in which they are headquartered; and
- Foreign-managed firms that produce abroad within a foreign country different from the one in which they are headquartered.

These entities may be simultaneously competing for sales within the United States, within a foreign country against local foreign production (either U.S., local, or other foreign managed), or within a foreign country against non-local production. Globalization requires that U.S. companies be competitive both in foreign markets and at home.

Other elements of competition among firms exist at the investor level: U.S.-managed firms may have foreign investors and foreign-managed firms may have U.S. investors. Portfolio investment accounts for approximately two-thirds of U.S. investment abroad and a similar fraction of foreign investment in the United States. Firms compete in global capital markets as well as global consumer markets.

In a world without taxes, competition among these different firms and different markets would be determined by production costs. In a world with taxes, however, where countries make different determinations with respect to tax rates and tax bases, these

competitive decisions inevitably are affected by taxes. Assuming other countries make sovereign decisions on how to establish their own tax systems and tax rates, it simply is not possible for the United States to establish a tax system that restores the same competitive decisions that would have existed in a world without taxes.

The United States can, for example, attempt to equalize the taxation of income earned by U.S. companies from their U.S. exports to that of U.S. companies producing abroad for the same foreign market. However, in equalizing this tax burden, it may be the case that the U.S. tax results in neither type of U.S. company being competitive against a foreign-based multinational producing for sale in this foreign market.

The manner in which balance is achieved among these competitive concerns changes over time as circumstances change. For example, as foreign multinationals have increased in their worldwide position, the likelihood of a U.S. multinational company competing against a foreign multinational in a foreign market has increased relative to the likelihood of U.S. export sales competing against sales from a U.S. multinational producing abroad. The desire to restore competitive decisions to those that would occur in the absence of taxation therefore may place greater weight today on U.S. taxes not impeding the competitive position of U.S. multinationals vis-à-vis foreign multinationals in the global marketplace. Similarly, while at one time U.S. foreign production may have been thought to be largely substitutable with U.S. domestic production for export, today it is understood that foreign production may provide the opportunity for the export of firm-specific know-how and domestic exports may be enhanced by the establishment of foreign production facilities through supply linkages and service arrangements. Ensuring the ability of U.S. multinationals to compete in foreign markets thus provides direct opportunities at home for American workers.

Given the significance today of competitiveness concerns, it is important to understand the major features of the U.S. tax system and how they differ from those of our major trading partners. The primary features of the U.S. tax system considered here are: (i) the taxation of worldwide income; (ii) the current taxation of certain types of active foreign-source income; (iii) the limitations placed on the use of foreign tax credits; and (iv) the unintegrated taxation of corporate income at both the entity level and the individual level.

U.S. Worldwide Tax System

The United States, like about half of the OECD countries, including the United Kingdom and Japan, operates a worldwide system of income taxation. Under this worldwide approach, U.S. citizens and residents, including U.S. corporations, are taxed on all their income, regardless of where it is earned. Income earned from foreign sources potentially is subject to taxation both by the country where the income is earned, the country of source, and by the United States, the country of residence. To provide relief from this potential double taxation, the United States allows taxpayers a foreign tax credit that reduces the U.S. tax on foreign-source income by the amount of foreign income and withholding taxes paid on such income.

The U.S. worldwide system of taxation is in contrast to the territorial tax systems operated by the other half of the OECD countries, including Canada, Germany, France, and the Netherlands. Under these territorial tax systems, domestic residents and corporations generally are subject to tax only on their income from domestic sources. A domestic business is not subject to domestic taxation on the active income earned abroad by a foreign branch or on dividends paid from active income earned by a foreign subsidiary. A domestic corporation generally is subject to tax on other investment-type income, such as royalties, rent, interest, and portfolio dividends, without regard to where such income is earned; because this passive income is taxed on a worldwide basis, relief from double taxation generally is provided through either a foreign tax credit or a deduction allowed for foreign taxes imposed on such income. This type of territorial tax system sometimes is referred to as a "dividend exemption" system because active foreign business income repatriated in the form of a dividend is exempt from taxation. By contrast, a pure territorial system would provide an exemption for all income received from foreign sources, including investment-type income. Such pure territorial systems have existed only in a few developing countries.

Differences between a worldwide tax system and a territorial system can affect the ability of U.S.-based multinationals to compete for sales in foreign markets against foreign-based multinationals. The key difference between the two systems is which tax rate – source country or home country – applies to foreign-source income. Under a worldwide tax system, repatriated foreign income is taxed at the higher of the source country rate or the residence country rate. In contrast, foreign income under a territorial tax system is subject to tax at the source country rate. The effect of this difference depends on how the tax rate in the country where the income is earned compares to the tax rate in the company's home country. The effect on U.S.-based businesses depends upon their mix of foreign-source income, but the imposition of residual U.S. tax on income earned abroad can impose a cost for U.S. businesses that is not imposed on their foreign competitors. Differences between these systems also can affect decisions about whether and when to repatriate earnings, which in turn affect investment decisions in the United States.

It is important to note that both worldwide and territorial systems involve the taxation of income. The complexities present in taxing income generally are heightened in determining the taxation of income from multinational activities, where in addition to measuring the income one must determine its source (foreign or domestic). This complexity affects both tax administrators and taxpayers. Indeed, the U.S. international tax rules have been identified as one of the largest sources of complexity facing U.S. corporate taxpayers.

Given the complexity of the task of taxing multinational income under a worldwide or territorial system on top of the general complexity of the income tax system, some consideration might be given to alternative tax bases other than income. Other OECD countries typically rely on taxes on goods and services, such as under a value added tax, for a substantial share of tax revenues. In the European OECD countries, for example,

these taxes raise nearly five times the amount of revenue as does the U.S. corporate income tax as a share of GDP.

Comparison with Other Worldwide Tax Systems

As described above, about half of the OECD countries employ a worldwide tax system as does the United States. However, the details of our system are such that U.S. multinationals may be disadvantaged when competing abroad against multinational companies established in other countries using a worldwide tax system. This is because the United States employs a worldwide tax system that, unlike other worldwide systems, taxes active forms of business income earned abroad before it has been repatriated and more strictly limits the use of the foreign tax credits that prevent double taxation of income earned abroad.

Limitations on Deferral

Under the U.S. international tax rules, income earned abroad by a foreign subsidiary generally is subject to U.S. tax at the U.S. parent corporation level only when such income is distributed by the foreign subsidiary to the U.S. parent in the form of a dividend. An exception to this general rule is provided with the rules of subpart F of the Code, under which a U.S. parent is subject to current U.S. tax on certain income of its foreign subsidiaries, without regard to whether that income is actually distributed to the U.S. parent. The focus of the subpart F rules is on passive, investment-type income that is earned abroad through a foreign subsidiary. However, the reach of the subpart F rules extends well beyond passive income to encompass some forms of income from active foreign business operations. No other country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity. The effect of these rules is to force U.S.-based companies either to structure their operations in a manner that is less than optimal from a business perspective or to incur current U.S. tax in addition to the local tax. The foreign-based companies against which our companies must compete do not face this same tradeoff.

Several categories of active business income are covered by the subpart F rules. Under subpart F, a U.S. parent company is subject to current U.S. tax on income earned by a foreign subsidiary from certain sales transactions. Accordingly, a U.S. company that uses a centralized foreign distribution company to handle sales of its products in foreign markets is subject to current U.S. tax on the income earned abroad by that foreign distribution subsidiary. In contrast, a local competitor making sales in that market is subject only to the tax imposed by that country. Moreover, a foreign competitor that similarly uses a centralized distribution company to make sales into the same markets also generally will be subject only to the tax imposed by the local country. This rule has the effect of imposing current U.S. tax on income from active marketing operations abroad. U.S. companies that centralize their foreign distribution facilities therefore face a tax penalty not imposed on their foreign competitors. This increases the cost of selling goods that are produced in the United States.

The subpart F rules also impose current U.S. taxation on income from certain services transactions performed abroad. In addition, a U.S. company with a foreign subsidiary engaged in shipping activities or in certain oil-related activities, such as transportation of oil from the source to the consumer, will be subject to current U.S. tax on the income earned abroad from such activities. In contrast, a foreign competitor engaged in the same activities generally will not be subject to current home-country tax on its income from these activities. These rules operate to subject U.S.-based companies to an additional tax cost on some classes of income arising from active business operations structured and located in a particular country for business reasons wholly unrelated to any tax considerations.

Limitations on Foreign Tax Credits

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

The foreign tax credit may be used only to offset U.S. tax on foreign-source income and not to offset U.S. tax on U.S.-source income. The rules for determining and applying this limitation are detailed and complex and can have the effect of subjecting U.S.-based companies to double taxation on their income earned abroad. The current U.S. foreign tax credit regime also requires that the rules be applied separately to separate categories or "baskets" of income. Foreign taxes paid with respect to income in a particular category may be used only to offset the U.S. tax on income from that same category. Computations of foreign and domestic source income, allocable expenses, and foreign taxes paid must be made separately for each of these separate foreign tax credit baskets, further adding to the complexity of the system. Moreover, the U.S. foreign tax credit regime requires the allocation of U.S. interest expense against foreign-source income in a manner that reduces the foreign tax credit limitation by understating foreign income. The practical effect of these interest allocation rules can be the denial of a deduction for interest expense incurred in the United States, which increases the cost of investment and expansion here at home.

Other countries do not have restrictions and limitations on foreign tax credits that are nearly as extensive as our rules. These rules can have the effect of denying U.S.-based companies the full ability to credit foreign taxes paid on income earned abroad against the U.S. tax liability with respect to that income. The result is that U.S.-based companies are subject to just the double taxation that the foreign tax credit is intended to eliminate.

U.S. Corporate Taxation

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

One aspect of the U.S. tax system is that the income from an equity-financed investment in the corporate sector is taxed twice. Equity income, or profit, is taxed first under the corporate income tax. Profit is taxed again under the individual income tax when received by the shareholder as a dividend or as a capital gain on the appreciation of corporate shares. In contrast, most other OECD countries offer some form of integration, under which corporate tax payments are either partially or fully taken into consideration when assessing shareholder taxes on this income, eliminating or reducing the double tax on corporate profits.

The non-integration of corporate and individual tax payments on corporate income applies equally to domestically earned income or foreign-source income of a U.S. company. This double tax increases the "hurdle" rate, or the minimum rate of return required on a prospective investment. In order to yield a given after-tax return to an individual investor, the pre-tax return must be sufficiently high to offset both the corporate level and individual level taxes paid on this return. Whether competing at home against foreign imports or competing abroad through exports from the United States or through foreign production, the double tax makes it more difficult for the U.S. company to compete successfully against a foreign competitor.

As noted above, most OECD countries offer some form of tax relief for corporate profits. This integration typically is provided by reducing personal income tax payments on corporate distributions rather than by reducing corporate level tax payments. International comparisons of corporate tax burdens, however, sometimes fail to account for differences in integration across countries and consider only corporate level tax payments. To be meaningful, comparisons between the total tax burden faced on corporate investments by U.S. companies and those of foreign multinational companies must take into account the total tax burden on corporate profits at both the corporate and individual levels.

Closing Thoughts

The U.S. economy is an integral part of the global marketplace, and the activities of U.S. businesses in the global marketplace are a critical part of America's economic success. Accordingly, we must ensure that U.S. tax rules do not adversely impact the ability of American workers and U.S. businesses to compete successfully around the world. Relative to the tax systems of our major trading partners, the U.S. international tax rules can impose significantly heavier burdens on domestically based companies. As we make the changes to our tax law that are needed to comply with WTO rules, we must keep our focus on the objectives served by the FSC and ETI provisions and look to removing biases against the ability of U.S. businesses to compete in today's global economy. Such

reforms will allow the United States to retain its world economic leadership to the benefit of American workers.

The Administration is committed to working with Congress to satisfy the twin objectives of meeting our WTO obligations and ensuring that we protect the competitive position of American workers and businesses.

PREPARED STATEMENT OF DAN KOSTENBAUDER

My name is Dan Kostenbauder, General Tax Counsel at Hewlett-Packard Company in Palo Alto, California. HP was founded in 1939. With our recent merger with Compaq Computer Corporation, the new HP is a leading technology solutions provider for consumers and businesses with market leadership in fault-tolerant servers, UNIX® servers, Linux servers, Windows® servers, storage solutions, management software, imaging and printing and PCs. Furthermore, 65,000 professionals worldwide lead our IT services team. Our $4 billion annual R&D investment fuels the invention of products, solutions and new technologies, so that we can better serve customers and enter new markets. HP invents, engineers and delivers technology solutions that drive business value, create social value and improve the lives of our customers.

I am appearing today on behalf of the AeA, formerly the American Electronics Association. Advancing the business of technology, AeA is the nation's largest high-tech trade association. AeA represents more than 3,500 member companies that span the high-technology spectrum, from software, semiconductors and computers to Internet technology, advanced electronics and telecommunications systems and services. With 18 regional U.S. councils and offices in Brussels and Beijing, AeA offers a unique global policy grassroots capability and a wide portfolio of valuable business services and products for the high-tech industry. AeA has been the accepted voice of the U.S. technology community since 1943.

Summary of Testimony

Repeal of the Extraterritorial Income Exclusion regime ("ETI") is a possible response to the World Trade Organization ("WTO") Appellate Body decision that ETI is a prohibited export incentive. If the ETI is repealed, then it should be replaced with tax legislation that clearly will comply with WTO rules. Such legislation should be designed to help those sectors of the U.S. economy that currently benefit from the ETI and to improve the competitiveness of U.S. based companies. If the timeframe for such legislation is too short to permit a complete review and reform of the international provisions of the U.S. tax system, AeA believes that a number of improvements can be made to today's rules that will be consistent with future efforts toward more comprehensive reform. AeA believes that reforms in the Subpart F and foreign tax credit areas would be good tax policy and very straightforward to adopt.

In particular, the AeA suggests that the following provisions should be among those that should be adopted upon repeal of the ETI:

1. Repeal the foreign base company sales income and the foreign base company services income rules under Subpart F,
2. Remove active rents and royalties from the passive income rules under Subpart F,
3. Increase the foreign tax credit carryforward period to 10 years, and
4. Repeal the limitation on use of foreign tax credits to offset the corporate alternative minimum tax.

Benefits of Current ETI Regime Should Be Preserved to the Extent Possible

The WTO decision that the ETI regime enacted by Congress in 2000 is a prohibited export subsidy violating U.S. international treaty obligations could lead to significant sanctions against the United States. There are other sources of trade friction between the United States and many of our trading partners that should be resolved in a manner that enhances international trade. The "compliance work plan" announced by Ambassador Zoellick and EU Commissioner Lamy, under which the Administration and Congress will work together to develop a proposal that will allow the US to comply with the Appellate Panel ruling, is a good step forward.

AeA is pleased to contribute its ideas at this hearing, which is an important step in the process of developing an alternative to the ETI. We hope the process is both credible and rapid enough to forestall retaliation by the EU, or at least to minimize the possibility of sanctions and the attendant trade friction that would result.

As part of this process, AeA believes that the ETI regime should be replaced with legislation that helps those sectors of the economy that currently benefit from the ETI and that helps to improve the international competitiveness of U.S. based companies.

Since it would be imprudent to enact provisions that once again test the limits of what constitutes an export subsidy, Congress should exercise its judgment to support sectors of the economy enjoying benefits of ETI in a way that does not have a direct reliance upon exports.

The AeA recommends that the foreign base company sales income and foreign base company services income rules of Subpart F be repealed in their entirety.

In general, U.S. tax is imposed under Subpart F not only on a foreign subsidiary's passive income (interest, dividends, etc.), but also on income earned from certain active business transactions with related persons. For example, U.S. tax is imposed on the income of a foreign subsidiary from purchasing goods from legal entities within the multinational group and reselling them outside its country of incorporation.

By imposing U.S. tax on intercompany payments between foreign subsidiaries, Subpart F of the Internal Revenue Code puts U.S. multinationals at a competitive disadvantage in the global marketplace by imposing current U.S. tax on ordinary foreign business transactions that otherwise would not be subject to current U.S. taxation.

The Subpart F base company rules have been justified as measures that counteract efforts by U.S. multinationals to shift foreign profits to tax havens by making payments to related companies located in tax havens. The 1962 legislative history to Subpart F reveals that the related person provisions were targeted at transfer pricing abuses. Since 1962, however, the ability of the IRS and foreign tax authorities to combat transfer-pricing abuses has improved dramatically. The IRS has issued increasingly detailed transfer pricing regulations to provide guidance, and Congress has enacted stern penalties

for non-compliance. As a result, the profits of the various members of a U.S.-based multinational group are much more likely today to be properly allocated based on real economic factors (such as the functions performed, investments made, and risks borne).

Subpart F generally does not apply to transactions within a single "country" under the rationale that, in such cases, artificial profit shifting between tax jurisdictions does not occur. For example, the provisions applicable to intercompany payments (the "foreign personal holding company income" rules) exclude dividends and interest received by a controlled foreign corporation ("CFC") from a related person that is a corporation organized under the laws of the same country in which the CFC was created and that has a substantial part of its assets used in a trade or business located in that same foreign country.

Additionally, in the early 1960's, foreign subsidiaries of U.S. multinationals typically operated only in their country of incorporation, in part because each country presented a unique market. With the rise of globalization, the falling of trade barriers (e.g., the economic integration of the EU countries), and improvements in technology, foreign subsidiaries can now more efficiently and effectively conduct business on a regional or even global basis. For example, many multinational groups now seek to centralize functions in regional hubs or service centers. However, Subpart F imposes a tax cost on foreign subsidiaries that operate outside their country of incorporation, and as a result, they are penalized for acting in the most economically efficient manner (e.g., by operating on a regional basis). Accordingly, U.S. multinationals are forced to either pay the extra tax cost or to needlessly duplicate functions in multiple foreign countries. The Subpart F related person provisions create unnecessary complexity, which leads to excessive taxpayer compliance costs, increased IRS audit costs, and additional burdens on the courts.

The Subpart F base company rules do not automatically generate revenue for the U.S. Treasury. In cases where Subpart F income is generated due to activities in high tax countries, foreign tax credits can eliminate any residual U.S. tax liability.

As companies continue to adopt integrated business models dictated by the global marketplace, the foreign base company provisions act as a hindrance to U.S. competitiveness.

An interesting proposal that was considered, but rejected, in 1962 when Subpart F was enacted would have treated the European Economic Community (now the European Union) as a single country for purposes of the Subpart F related persons provisions. According to the legislative history, the basis for this decision was the fact that, although the European countries had formed a common market, they did not yet have a unified tax system. Recent proposals introduced to simplify Subpart F include provisions relating to the treatment of the EU as one country. For example, in H.R. 2018 (106th Congress), the Secretary of the Treasury would have been tasked with analyzing the impact of treating the EU as one country for purposes of applying the same country exceptions under Subpart F.

This treatment makes even more sense today than it did in 1962. Greater political and economic integration among EU countries has been achieved over the last forty years, including adoption of the euro as a common currency by most member countries. Furthermore, the EU has been working to achieve tax harmonization. For the past three years, the EU members have been negotiating a "code of conduct" with respect to tax matters, in order to eliminate harmful tax competition among member states. More recently, the EU Commission has begun investigating whether certain member state tax regimes constitute unlawful state aids.

There are several ways that repeal of the base company rules would encourage U.S. exports. First, if the base company rules apply to purchases from the U.S. that are exported to foreign customers, then an export transaction probably bears more U.S. tax as a result of the Subpart F base company rules.

Second, if the foreign subsidiaries of U.S. multinational companies are healthy and competitive, the U.S. parent company almost always prospers as well. Since other countries have not duplicated the U.S. foreign base company rules (unlike the passive income rules), foreign subsidiaries of U.S. companies face greater complexity and higher taxes than the foreign companies in whose home markets they are trying to compete. Since such foreign subsidiaries of U.S. companies are the conduit into foreign markets for most U.S. exports, the healthier they are the greater are the prospects for U.S. exports.

Exclude Active Software Royalties from Passive Income

An important policy goal of ETI replacement legislation should be to provide benefits to those U.S.-based taxpayers that previously qualified for FSC/ETI benefits. Since software rents and royalties expressly qualify for ETI benefits today, any reform of Subpart F should include relief for active business income from rents and royalties.

The software industry is unique in that it delivers its products and services to customers via delivery methods that, depending on the facts of the transaction, produce either rents, royalties, sale of goods income or services income. In all cases, the vendor company is engaged in essentially the same business activity of developing, marketing and supporting its products. The reason a software company may have rent and royalty income therefore is due to its choice of delivery methods, and does not imply that the company is not engaged in an active trade or business.

Accordingly, to achieve parity with other industries which deliver their products only by means of sales of goods, any Subpart F reform should amend section 954(c)(2)(A) both to eliminate the current complete prohibition on deferral for related party rents and royalties and to rationalize the active trade or business test. These reforms would place software companies on a tax parity with other U.S. companies, and would allow Congress to meet the policy goal of matching the beneficiaries of the proposed legislation as closely as possible with the groups that historically benefited from FSC/ETI.

Two primary concerns have been expressed concerning whether this proposal would be appropriate -- that rents and royalties are somehow by their very nature indicia of passive activity, and that even if some reform is appropriate, the scope of qualifying rents and royalties should be appropriately limited.

With respect to the concern that all rents and royalties are inherently passive, it is important to emphasize that the classification of income as active or passive based merely on whether it is characterized as a sale of goods, rents or royalties is not necessarily appropriate, at least in the software context. It would be inconsistent and unfair from a policy perspective to treat transactions that arise from the same business activity differently, based solely on their nominal classification.

Also, it should be possible to create an active trade or business test, which appropriately distinguishes between rents and royalties derived in the conduct of an active business, and income from more passive, investment oriented activities. This test almost certainly should refer to activities conducted by other members of the group to characterize a revenue stream as active or passive, as is currently provided for in certain other contexts. Perhaps the most straightforward approach would be to limit the scope of any reform to those industries that historically have derived rents and royalties through active business operations, and retain current law for other income such as real property rents. This approach would be consistent with other statutory provisions reflecting the Congressional desire to equalize the treatment of computer software royalties and other forms of active business income. One possible means to narrowly limit the scope of the proposal is to apply the proposal only to rents and royalties, which currently qualify for FSC/ETI benefits. Another possible approach is to define a qualified recipient as an entity engaged in an active software business based on some appropriate measure, such as the presence in the affiliated group of substantial development, marketing, and/or other business activities.

Increase Foreign Tax Credit Carryforward period from 5 years to 10 years

Reform of the foreign tax credit ("FTC") carryover rules is needed to provide for an effective operation of U.S. tax laws intended to protect against double taxation. The AeA further recommends that the ordering rules be amended such that credits would be used first from carryforwards to such taxable year, second from the current year, and third from carrybacks.

U.S. taxpayers may claim FTC's against U.S. tax in order to avoid double taxation of income. The amount of FTC's that may be claimed in a year is subject to a limitation, so that the credit is allowed only to offset U.S. tax on foreign source income. To the extent the amount of creditable taxes of a given taxable year exceeds the limitation, the excess may be carried back two years and forward five years.

Problems of double taxation often arise because the foreign tax treatment of items of income and expense may differ from the U.S. tax treatment. For example, the same income may arise in different taxable years for foreign and U.S. tax purposes. As a

result, the foreign taxes may be imposed in a year during which little or no foreign income may arise under U.S. tax principles. The rules for FTC carryovers seek to address this problem by allowing the FTC's to be carried over from years in which foreign taxes are imposed to years in which the foreign source income arises under U.S. tax principles.

Extending the period of the FTC carryforwards would allow companies to offset their U.S. tax liabilities in later years when they are profitable without facing the pressure of expiring FTC carryovers. This modification would allow U.S. taxpayers that had accrued or paid foreign taxes additional time to utilize their FTC carryovers.

In addition, with the enactment of transfer pricing legislation in many foreign jurisdictions, U.S. multinational corporations are required to recognize income and pay foreign taxes in foreign jurisdictions even when they have losses on a consolidated basis. The vagaries of the economy and other business cycles are additional factors that sometimes prevent utilization of FTC's before their expiration.

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

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

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

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

Testimony of
F. Lynn McPheeters
Vice President & CFO
Caterpillar Inc.

Before the
United States Senate Finance Committee
July 30, 2002

Good morning Mr. Chairman, Senator Grassley and distinguished members of the Committee. I am Lynn McPheeters, Vice President & CFO for Caterpillar. Thank you for this opportunity to discuss the future of the Extraterritorial Income regime and its impact on the international competitiveness of U.S. based exporters like Caterpillar.

Let me briefly give you a few facts about Caterpillar. For more than 75 years, Caterpillar has been helping build the world's infrastructure and, in partnership with Cat dealers, is driving positive and sustainable change on every continent. With 2001 sales and revenues of nearly $21 billion, and 72,000 employees worldwide, Caterpillar is the world's leading manufacturer of construction and mining equipment, diesel and natural gas engines and industrial gas turbines. We also provide financing, insurance, and logistics services to a global customer base.

The models before you represent Caterpillar products manufactured in the U.S. that have helped build the world's infrastructure during our 75 + year history. I'll talk more about the significance of the models later in my comments.

Caterpillar has long maintained a strong commitment to free trade principles. And I applaud your leadership, Mr. Chairman -- and the strong support by members of the Committee -- to pass a TPA bill. However, I'm concerned that the loss of ETI – without a suitable replacement – could undermine the ability of U.S. exporters to compete in a global trade environment. The consequences of such actions could have a detrimental impact on capital and job growth in the U.S.

Repeal of the ETI provisions of the U.S. tax code would immediately impose a more than a **<u>$5 billion tax increase</u>** on the nation's exporters -- making it difficult for U.S. based exporters to remain competitive versus their foreign counterparts. This additional cost would be factored into investment analysis models most firms use when determining where to invest their shareholder capital. For exporters, an obvious alternative to investing in the U.S. is to produce closer to where the product is being sold. If returns from investments in the U.S. decline, U.S. based exporters will have a disincentive to invest here -- ultimately leading to a loss of high-dollar-value export-related jobs in the U.S.

Caterpillar's business model is somewhat unique because we are one of a handful of Fortune 100 companies that successfully compete globally from primarily a U.S. manufacturing base. Over 60 percent of our global manufacturing assets are in the U.S. To maintain this base, it is important to continue to competitively access international markets from here. Of the $21 billion in 2001 sales I mentioned earlier, over $5 billion was attributed to U.S. exports – directly supporting 16,500 high-dollar-value U.S. Caterpillar jobs and an additional 33,000 U.S. suppliers jobs. By 2010, we estimate that approximately 75% of our $30 billion in sales will be outside the United States. As exports increase, so do the number high-paying U.S. jobs needed to support them.

The models you have before you help emphasize the importance of Caterpillar's exports to our ability to create jobs in the U.S. – a trend we plan to continue. Each model has a tag that shows the percentage of U.S. production exported to countries around the world. With our continued growth, we have the potential to create a large number of additional export-related jobs for American workers in the future. However, our ability to increase export-related employment is primarily dependent on our ability to compete in the global marketplace. This includes ensuring that U.S. tax laws help us remain internationally competitive and incent U.S. exporters, like Cat, to make capital investments and create jobs in the U.S.

By way of background, in 1971 Congress passed the Domestic International Sales Corporations (DISC) legislation to help partially level the playing field for U.S. businesses. In the last thirty-one years global competition has increased substantially. As a result, the impact of U.S. tax rules – like ETI – on international competitiveness of U.S. based exporters is much more significant today. The fundamental policy considerations Congress used to develop the DISC, and later FSC and ETI, remain important, and we believe lawmakers recognize that. But now we have a series of challenges to our tax code by the European Union, requiring Congress to consider changes to our laws.

There is an important consideration to note as Congress considers alternatives to ETI. Even with ETI, many of our foreign competitors enjoy an advantage over U.S.-based multi-nationals because their governments use border adjustable tax regimes that do not tax income earned outside of their borders. A repeal of ETI -- without a suitable replacement -- would only increase the competitive disadvantage U.S. companies face internationally.

I believe the ideal outcome will consist of a WTO compliant solution that keeps U.S. exporters competitive and contains elements of both tax law changes and negotiations with the EU. We believe the U.S. has the responsibility to comply with its WTO obligations. But it's important for Congress and the Administration to take the time to develop the right overall tax policy to avoid making the creation of capital and jobs more attractive in foreign countries than in the U.S.

Mr. Chairman, on behalf of Caterpillar, I appreciate the opportunity to offer comments on this important issue. Thank you.

Testimony of

Dwight "Dyke" Messinger
President and Chief Executive Officer
Power Curbers, Inc.
Salisbury, North Carolina

Before the
Committee on Finance
United States Senate

On
The Extraterritorial Income Regime

July 30, 2002

Chairman Baucus, Ranking Member Grassley, and members of the committee, thank you for the opportunity to appear before you today to present the views of Power Curbers, Inc., and the National Association of Manufacturers (NAM) on ways to promote the competitiveness of U.S. companies while respecting our international obligations under the World Trade Organization (WTO) agreement. I am Dyke Messinger, president and chief executive officer of Power Curbers.

The NAM, the nation's largest industrial trade association, represents 14,000 member companies (including 10,000 small - and mid-sized companies) and 350 member associations serving manufacturers and employees in every industrial sector and all 50 states. Headquartered in Washington, D.C., the NAM has 10 additional offices across the country.

Power Curbers manufactures and sells concrete paving equipment. Our machines are used in more than 80 countries to, among other things, build curbs, gutters and sidewalks — and even the railbeds for the Eurotunnel project. Founded in 1953, the company grossed $24 million in sales in 2001. Power Curbers, a family-owned company, employs 130 workers at its facilities in Salisbury, North Carolina, Cedar Falls, Iowa and White House, Tennessee.

The current extraterritorial income regime (ETI) — as well as its predecessors, the domestic international sales corporation (DISC) and the foreign sales corporation (FSC) — have been integral factors in increasing export activity by U.S. manufacturers. According to the IRS, of the roughly 4,300 FSCs in existence in 1996, 89 percent of them exported manufactured products. Congress first created the DISC in 1971 to level the playing field for U.S. companies — large and small — selling their products overseas. These three types of tax incentives created over the past three decades were designed to neutralize some of the tax advantages enjoyed by our foreign competitors located in countries with territorial tax systems, which generally exempt income earned outside the country from income tax and exports from value-added (VAT) and other consumption taxes.

Traditionally, much of the attention in this area has been focused on FSCs used by large companies. FSC benefits also are important to small - and mid-sized manufacturers that export. In fact, exporting goods overseas is more than a sideline for many of these smaller companies; it's a simple necessity of staying in business. Smaller companies often turn to export tax incentives to effectively compete in the global marketplace. According to an NAM survey in 2000, small - and mid-sized manufacturers saved, on average, about $124,000 annually by using a FSC.

It is critically important to continue to encourage export activity by these small companies. Of all the exporting manufacturers in America, 93 percent are small - and mid-sized manufacturers. These firms, which individually employ anywhere from 10 to 2,000 employees, together employ roughly 9.5 million people. Small - and mid-sized manufacturers that export add jobs 20 percent faster than firms that remain solely domestic, and are 9 percent less likely to go out of business.

For a company like Power Curbers, selling products in the international market means more than reaching a few additional customers. International sales contribute to the growth and health of Power Curbers, ensuring our survival. International sales account for 20 percent of Power Curbers' revenue, and these sales are responsible for 12 percent of profits.

In the past, Power Curbers used a foreign sales corporation (FSC) and we currently use the extraterritorial income regime. The benefits provided by FSC/ETI justify the additional risk and effort needed to go into overseas markets, price our products competitively from the outset, and compete. For example, the tax systems in some European countries heavily favor local suppliers; FSC/ETI helps level the playing field. You can't just pull away incentives that allow small and medium manufacturers to actively pursue overseas markets.

Moreover, the loss of tax incentives like those provided by FSC/ETI would have a tremendous impact on the company, affecting revenues and employment. There are many hidden costs in doing business internationally. In markets where margins are already thin, we would lose sales due to an uneven playing field. If these sales slumped, Power Curbers likely would have to lay off 5 to 10 percent of its workforce.

Given the imminent release of the WTO arbitration panel's sanctions report, we are pleased that the European Union recognizes the difficulty of the situation and has agreed to delay imposing any sanctions until at least 2003. However, five months is not enough time. It is clear that the international tax issues involved are complex and a considerable amount of time will be required to develop and implement an appropriate legislative response.

The simplest — and wrong — answer would be to eliminate the ETI and subsequently increase taxes on U.S. industry by almost $5 billion annually. This increase would largely affect manufacturers, who are the largest contributors to U.S. economic growth and the largest beneficiaries of the FSC/ETI rules. Small - and mid-sized manufacturers would acutely feel the burden, adding to the mounting problems of rising energy, insurance and health-care costs that limit the appeal of American exports. These adverse factors are compounded by the inability to

pass increases on to consumers, due to the competitive nature of the global market. Thus, if ETI is repealed, it is critically important that any cost savings are used to benefit U.S. exporters.

Another inappropriate solution would be to ignore the ruling of the WTO. Refusal to comply with the WTO findings would subject U.S. industry to potentially $4 billion in annual retaliatory sanctions and have significant negative repercussions for U.S.-European trade relations.

Perhaps the most obvious way to comply with the WTO rulings and maintain international competitiveness would be to completely redesign the U.S. tax system, for example, by changing it to a territorial system. However, the sheer magnitude of rewriting the tax code and today's political climate limit the feasibility of this solution.

Ever since the ETI first came under attack, there has been an ongoing effort in the business community and on Capitol Hill to come up with a fair and equitable solution. As you well know, this is proving to be a difficult task.

No consensus has been found yet on an appropriate solution. Current proposals vary considerably, ranging from substituting other changes in the international tax area for FSC/ETI to a legislative framework and timeline to achieve compliance with the WTO rulings.

As a small, U.S.-based manufacturer, I am concerned that some of the proposed solutions are targeted to multinational corporations with subsidiaries, operations and employees outside of the United States. These changes will not benefit small exporters, like Power Curbers, with operations only in the United States and thus will not serve as an adequate substitute for FSC/ETI.

In crafting a proposal to address the FSC/ETI issue, it is imperative that the United States strive to maintain approximately the current level of benefits for all exporters and continue to work toward achieving a level playing field and a competitive environment for U.S. companies. At this point, it appears likely that the long-term solution will have to involve a combination of negotiations and legislation.

On the negotiations front, I support efforts to reopen this issue in the Doha trade round and negotiate to change the WTO rules so they provide similar treatment for indirect and direct taxes. On the more problematic issue of legislative action, the options to help small exporters are more difficult to identify in light of the WTO prohibition on tax benefits tied to exports.

From the legislative perspective, one approach would be to look at broad-based business tax relief and simplification of the tax code to ease our tax burden and make us more competitive overseas. Specific changes could include permanent income tax rate cuts, enhanced capital cost recovery, reduced capital gains tax rates, permanent repeal of the death tax and payroll tax relief. This type of approach, however, would significantly dilute the current benefits and fail to provide any type of export incentive.

I, along with other members of the National Association of Manufacturers, am grateful to Chairman Baucus and the Finance Committee for holding this hearing on ETI and international competitiveness. We look forward to working with you and other members of Congress and the Administration to resolve this issue in a fair and expeditious manner that satisfies the World Trade Organization, does not result in a significant tax increase on U.S. companies, avoids sanctions on U.S. products and encourages export activity by American manufacturers of all sizes.

Thank you for working to provide the tools for American manufacturers, large and small, to compete effectively with their foreign counterparts.

Statement of
Robert B. Zoellick
U.S. Trade Representative
before the
Committee on Finance
of the
U.S. Senate
July 30, 2002

Chairman Baucus, Senator Grassley, and Members of the Committee:

First and foremost, I want to thank you, Chairman Baucus, Senator Grassley, and other conferees on the Trade Promotion Authority legislative package for completing your work last week and for producing a strong conference report. I appreciate your leadership, persistence, cooperation, and support. You have broken through a logjam that held back America's trade leadership for eight years.

With the successful vote in the House of Representatives late last week, the President has urged the Senate to complete action this week before its August recess. A great deal rests on Senate passage this week.

As this Committee knows, time is of the essence. As President Bush has stressed, TPA sends an important signal to the American people that the Executive and Legislative branches are working together to strengthen the American economy and open new markets for our workers, farmers, and consumers. Overseas, the four Andean countries have lost their trade benefits under the Andean Trade Preference Act (ATPA) since May 16, 2002; the economic costs for these four fragile democracies have been great - - and equally important, the political signal of U.S. interest in and support for them needs this boost at a time of stress in the hemisphere. With new Presidents being inaugurated in Bolivia and Colombia on August 6 and 7, respectively, Senate passage this week would be auspicious and greatly encouraging.

African countries are eager to receive the political and economic support of the African Growth and Opportunity Act enhancements (AGOA II). And 116 developing economies have been without the special trade access afforded by the Generalized System of Preferences since that law expired on September 30, 2001.

We also want to use rapidly the new TPA authority to take the offense on America's trade negotiating agenda. Just last week, the Administration – with the advice and support of Chairman Baucus and Senator Grassley – launched a far-reaching proposal in the global Doha WTO negotiations to liberalize the world agricultural trade. With TPA, our proposals will be propelled with added force.

Thank you again for your special leadership, and I hope we can work together this week to finish the job.

I also want to thank you, Mr. Chairman, as well as Senator Grassley and other Members of the Finance Committee, for addressing the FSC/ETI issue.

Since Deputy Secretary of the Treasury Dam will speak to the tax policy issues, I would be pleased to comment on the trade aspects of this problem. In particular, I will discuss the reasons why a legislative solution is necessary to ensure that the United States complies with its international obligations, so as to avoid economically damaging trade retaliation. Such sanctions, if imposed, would harm American workers, farmers, and businesses.

Over the course of some 30 years, a number of Congresses and Administrations have devised and revised U.S. tax laws – such as the Domestic International Sales Corporation (DISC) provisions, Foreign Sales Corporation (FSC) provisions, and the provisions of the Extra-Territorial Income Exclusion (ETI) Act – to try to enhance the international competitiveness of the United States. When other countries challenged the consistency of these policies with international trade rules, various Administrations defended them vigorously.

The most recent chapters in this account began in October, 1999, when a WTO panel found against the FSC provisions, a position sustained on appeal in February, 2000. After the United States sought to comply with the WTO ruling in November, 2000, by making various technical amendments through the ETI, a WTO panel determined in August, 2001, that the ETI changes were insufficient to come into compliance. To highlight the significance we placed on this matter, Deputy Secretary Dam led the U.S. legal defense efforts on appeal. Nevertheless, on January 14 of this year, the WTO Appellate Body again ruled against the United States.

Notwithstanding the best efforts of different Administrations, the GATT – and now the WTO – has found consistently that the FSC/ETI tax exemption is a prohibited export subsidy. Now we must look to alternative ways of enhancing U.S. competitiveness other than through the FSC-type tax regime.

On May 2 of this year, President Bush announced his commitment to "work with our Congress to fully comply with the WTO decision on our tax on foreign sales corporations." We now have the need – and the opportunity – to strengthen U.S. competitiveness by making appropriate changes to the U.S. tax system. I defer to my Treasury colleagues on the nature of such changes. However, I have noted that there seems to be a growing group of experts – including Eric Engen of AEI, William Gale of the Brookings Institution, Stephen Entin of the Institute for Research on the Economics of Taxation, William Reinsch of the National Foreign Trade Council, and former Chairman of the Ways & Means Committee Bill Archer – who believe that changes to the U.S. tax system and laws on international tax policy could be useful, and that the current rules in this area diminish – rather than enhance – U.S. competitiveness.

The status of the FSC/ETI case with the WTO is as follows. In finding that the ETI Act – the successor to the FSC – continues to provide a prohibited export subsidy, the WTO Appellate Body made the following principal findings:

(1) The Act confers a subsidy by exempting from taxation income that would be taxed under otherwise applicable U.S. tax rules.

(2) This subsidy is export contingent insofar as U.S.-produced goods are concerned, because the subsidy is provided only if those goods are exported.

(3) This export subsidy is not protected as a measure to avoid double taxation of foreign-source income because, among other things, the Act systematically results in a tax exemption for domestic-source income.

Although the Appellate Body's findings were disappointing, they were in line with the conclusions of previous GATT and WTO panels. The upshot is that it has become clear that simply altering the FSC/ETI regime through a new mechanism for delivering the same benefits will not be found compliant with WTO rules. Instead, we need real legislative reform.

With the issuance and subsequent adoption by the WTO of the Appellate Body report, the WTO arbitration proceeding to determine the amount of retaliation to which the EU is entitled has resumed. Under a procedural agreement the United States reached with the EU in September, 2000, this arbitration was suspended pending the outcome of the EU's challenge to the ETI Act. In the arbitration, we have challenged the EU's claimed amount of $4 billion, and have argued instead that the EU is entitled to no more than $1.1 billion in retaliation. We expect a decision from the arbitrators in coming weeks.

However, even if we prevail in the arbitration, $1.1 billion is still a sizable retaliation figure. Any retaliation of that magnitude against U.S. exports would be extremely damaging to American workers, farmers, and businesses.

Pascal Lamy, the European Commissioner for Trade, has stated publically that his focus is on U.S. compliance with the WTO ruling, and that he would prefer to avoid retaliation if possible: "The name of the game is not retaliation; the name of the game is compliance." He also has told me that he understands that making meaningful revisions to the U.S. tax system is a complex process that takes some time. Accordingly, the EU has been willing to forego retaliation against U.S. exports if the United States demonstrates serious progress toward compliance, including pointing to a path to completion.

In addition, Commissioner Lamy has emphasized that the EU will not link the FSC dispute to other disputes, so that the EU will not exercise its FSC retaliation rights in order to influence the resolution of other differences.

We have been able to manage this dispute and hold off EU retaliation by explaining the Administration's intention to come into compliance and by pointing out the challenges of Congressional consideration of these tax policy topics. To continue to manage the dispute constructively, we need to be able to point to serious progress by the Congress, working in conjunction with the Executive branch. Therefore, if the United States is to avoid large trade retaliation by the EU, it is important that Congress take legislative action to bring the United States into compliance.

Fortunately, we have been able to show some progress. We appreciate that you, Mr. Chairman, and Senator Grassley, have been willing to meet informally with Ways & Means Committee Chairman Thomas and Ranking Member Rangel, along with the Administration, to address this problem. I know that you, Mr. Chairman, have taken the lead in previous bipartisan efforts to reform our international tax rules. Committee Chairman Thomas and Ranking Member Rangel have written to Secretary O'Neill and me on May 21 to express their support for a legislative solution. They explained,

> "we will work to pass legislation that maintains U.S. competitiveness and follows WTO rules now and as they may exist in the future. Therefore, we are committed to pursuing legislative options that meet these dual goals."

Like you and like them, I support the need for a reform of our international tax rules that increases U.S. competitiveness.

In addition, the Ways & Means Committee has held several rounds of hearings to explore the history of the problem, the current situation, and possible solutions. There was a consensus among those testifying that simply altering the FSC/ETI regime in a manner that maintains the same distribution of benefits will neither meet the requirements of the WTO ruling nor serve America's competitive interests. Chairman Thomas has introduced the American Competitiveness and Corporate Responsibility Act of 2002 (H.R. 5095), and has expressed his desire to move a bill forward.

I would urge the Senate to move equally expeditiously to address this problem through legislation.

The EU, of course, understands that the U.S. Constitution requires legislation to be passed by both the House and the Senate before it can be presented to the President for signature to become law. Nevertheless, the European Commission is likely to turn to retaliation if the Congress is perceived as making little or no progress regarding implementing legislation.

In coming weeks and months, I expect that the European Commission is likely to publish draft retaliation lists for public comment. I expect the EC will then prepare a final list, even as it considers the prospects for Congressional action.

I am aware of the preference of some to hold off on implementing legislation and to seek a solution to this matter in the new global trade negotiations that we launched in Doha last November. While I appreciate the apparent appeal of deferring the problem through negotiations, I need to advise you that a strategy based on this approach will not avoid trade retaliation.

To begin with, there is a problem of timing. We just began the Doha Development Agenda, and it is not even scheduled to be completed until 2005. And that is assuming that everything goes as planned.

In the meantime, we are faced with a WTO finding that the United States is in violation of the current rules. We cannot justify non-compliance on the grounds that we are attempting to negotiate a change in the rules by which we lost. If the shoe were on the other foot, we would not accept such an approach.

As a practical matter, the EU is highly likely to retaliate if we take this course.

Thus, the United States will have to come into compliance with our obligations well before the global trade negotiations are due to conclude.

For the longer-term, Congress has stated an interest in pressing in the Doha negotiations to change the current GATT/WTO rules concerning taxes, and particularly addressing the way in which those rules treat indirect taxes differently from direct taxes, such as income taxes. Congress has also sent a very strong signal about not renegotiating this area of WTO rules, which concern topics such as subsidies that underpin U.S. laws against unfair trading practices. Since a push on the tax items would be part of larger negotiations, we will need to consider together the possible tradeoffs and changes that others might seek from the United States in return.

Finally, I would note that Congress included the objective of changing WTO rules on direct and indirect taxes in setting negotiating goals for the Tokyo and Uruguay Rounds, but there was no consensus in support of the U.S. proposals in those rounds.

My colleagues in the Administration with responsibility for tax policy are the appropriate ones to offer counsel on what should replace the DISC/FSC/ETI. However, as a trade official, I can say that it is critically important that the United States, as the world's largest exporter, support the credibility of the multilateral trading system by following the rules of that system. To do so, we need to revise our tax system to come into compliance with our WTO obligations *and* simultaneously make America more prosperous by reforming our own international tax policies.

In conclusion, I greatly appreciate the Finance Committee's willingness to face this issue, difficult though it is. I would be pleased to continue to work together with you to bring the United States into compliance with its international obligations and to ensure that our tax system enhances the international competitiveness of U.S. businesses. Thank you.

Prepared Statement of James H. Zrust,

Mr. Chairman, on behalf of the more than 170,000 employees of The Boeing Company as well as the nearly 26,000 supplier companies and their employees in all 50 states, I want to thank you for the opportunity to present our views on the potential impact on U.S. aerospace workers and suppliers if the Extraterritorial Income Exclusion Act of 2000 ("ETI") is repealed without an equivalent replacement. We applaud your tireless efforts to address, on behalf of U.S. exporters, the World Trade Organization's decision on ETI.

This Committee has long worked to ensure that our tax system does not unfairly penalize U.S. businesses, especially vis-à-vis foreign competitors. Consistent with that position, we do not believe that an appropriate response to the WTO's decision would be to simply repeal ETI. The effect of such an act would be a tax increase on American exporters. More importantly for Boeing, this could result in the potential loss or relocation of 9,600 high-paying, high tech jobs. For our suppliers, this could mean the loss of 23,000 jobs. Repealing ETI without a suitable replacement would have an adverse impact on the international competitiveness of domestic exporters, threatening thousands of American jobs.

It would be especially devastating to the U.S. aerospace industry, an industry that employs nearly 800,000 highly skilled workers. It would likely cause companies to lose substantial portions of their export business activities and result in the elimination or transfer of these U.S.-based jobs overseas.

Today ETI helps level the playing field for U.S. companies competing against foreign firms, which are often heavily subsidized by their governments and enjoy tax rebates on their exports. For example, Boeing competes against a heavily subsidized European aerospace industry. According to a 1990 Commerce Department study, if Airbus had to pay commercial rates for its net government financial support--which it does not---the total funds committed would have been valued at $26 billion. Today that number is more than $30 billion. Most of these funding advances have never been repaid, nor is it expected that they ever will be repaid. Moreover the entire European aerospace industry is the recipient of billions of dollars in "indirect" subsidies in the form of government R&D contracts where the work performed is often merely for commercial applications, not for "breakthrough" technologies.

Boeing seeks a three-pronged approach as a way of remaining competitive. First, the Congress, the Administration, and U.S. industry should work together to develop an alternative to the ETI regime that provides comparable benefits. Moreover, the revenues associated with ETI should not be diverted to other industries or priorities.

Second, the Congress and the Administration should make one of their top trade priorities the negotiation of a delay in the imposition of sanctions by the European Union and a process for resolving this dispute. Included in those negotiations should be an agreement by the Europeans that any legislative proposal will not be challenged again and that the inequity in the current WTO rules regarding direct and indirect tax systems will be eliminated. We thank the committee for its leadership in addressing this inequity in the recently passed Trade Promotion Authority bill.

Third, in crafting an alternative, it is critical to avoid incentives for companies to move abroad. Companies that have chosen to stay in the United States and produce jobs here at home should not be penalized if and when ETI is repealed. The National Foreign Trade Council has developed alternatives that would assist U.S. manufacturers, which our trade experts believe are WTO-consistent.

Mr. Chairman, the United States government has spent thousands of hours through years of negotiations to resolve disputes with Europe over bananas and beef—cases that pale in comparison to the value of ETI. The ETI dispute is the largest trade dispute ever to come before the WTO. We believe the U.S. government should be equally—if not more—vigilant in seeking to negotiate an acceptable approach to resolve this issue.

Members of this committee are acutely aware that the airline and aerospace industries have been hit particularly hard by the events of September 11 of last year. These events have had a chilling effect on the average citizen of this country and, in particular, the traveling public. My purpose today is to make clear to this committee and to the Congress the potential for further setbacks to this high-technology industry if the circumstances of exporters of U.S. produced aerospace products are not taken into full consideration.

In addition, I want to highlight the potential negative impact on this country's trade balance if ETI is not replaced with legislation that provides comparable benefits. Mr. Chairman, in 2001, the aerospace industry was the largest positive *net* contributor to the U.S. trade balance, producing an industry trade surplus of almost $27 billion. This positive contribution is a testament to the creativity, ingenuity, and efficiencies developed over time by the dedicated men and women who go to work every day to try to maintain our competitive edge.

A recent U.S. government report indicates a one-month trade deficit of some $37 billion. This number will increase substantially if U.S. aerospace exporters lose ETI benefits. Without tax benefits similar to those under ETI available to the U.S. industry—benefits born out of a necessity to help "level the playing field" with European VAT rebates which provide a large price advantage for EU exporters—our balance of trade will suffer even more dramatically.

I believe that my comments on the extent to which U.S. aerospace workers would be adversely affected if an equivalent tax provision were not enacted into law are reflective of most aerospace companies in the United States. For Boeing, some seventy percent of all our commercial aircraft are exported to foreign airlines. We rely heavily on a "rules-based" trading system in order to ensure that an effective global trading system is maintained and economies around the world continue to grow. The maintenance of an effective rules-based trading system is one reason why Boeing takes very seriously the need for the U.S. government to ultimately comply with the WTO's decision. The question now before this body is *how* to shape compliance.

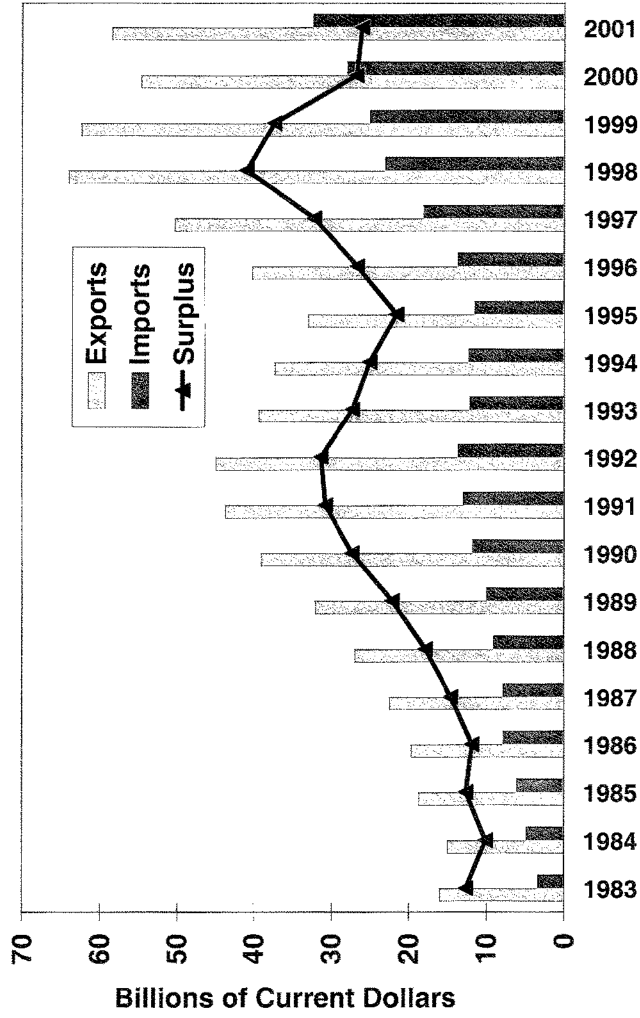
The Boeing Company, our suppliers and workers who assemble the aircraft take great pride in the fact that we are a "pure exporter." Rather than establish foreign subsidiaries to produce and distribute our aircraft for us, we have relied on ETI and its predecessors in making investment decisions. Those decisions have allowed us to strengthen our production capabilities and employment in the U.S. since Boeing was founded more than eighty-five years ago. Our approach has maximized the creation of high technology and higher-paying jobs *within* the United States. We are convinced that this approach is responsible for strengthening the industrial base of our country. We should hardly be punished for taking this approach.

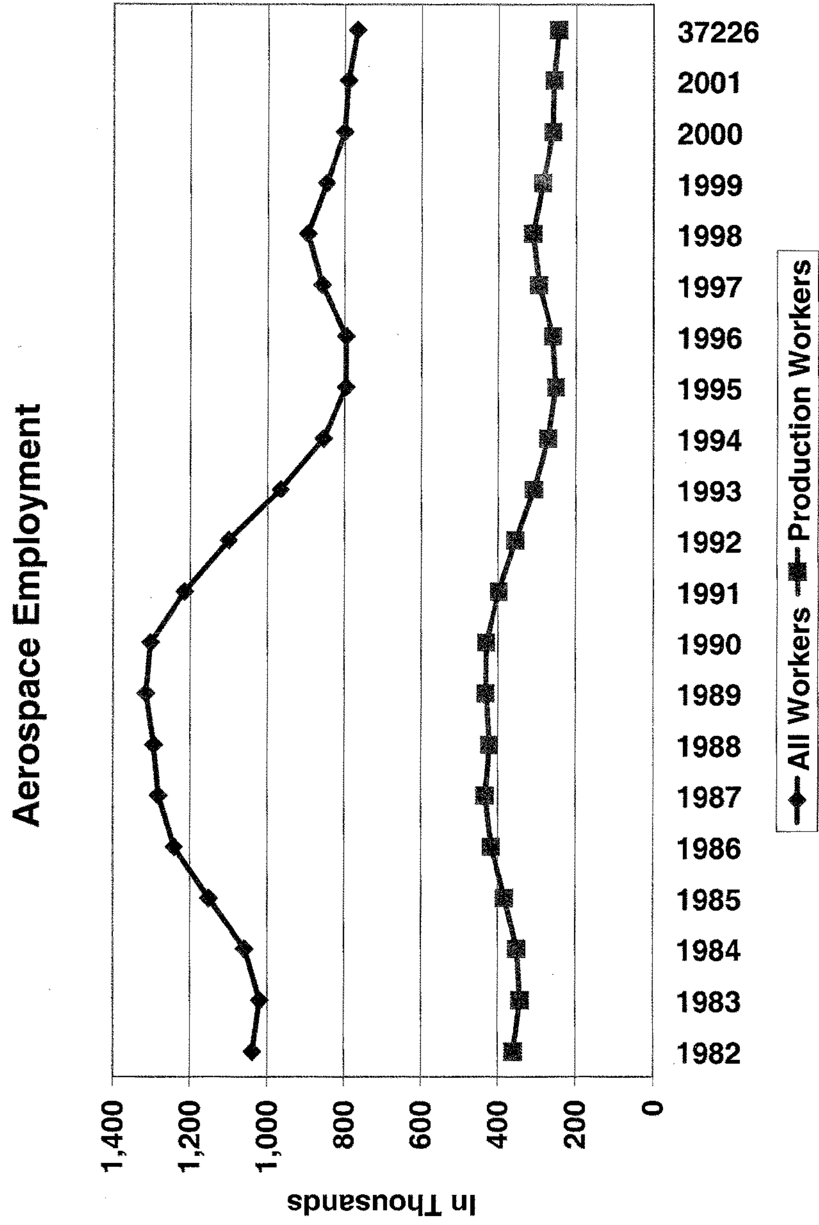
Boeing has major operations in 26 states and employees working in every state of the U.S. Our supply chain stretches throughout all 50 states of the union. We are the largest employer in the states of Washington and Kansas. We are also the largest *manufacturing* employer in California and Missouri. For decades, Boeing has made substantial investments in the training and educating of people, the development of technology, and creation of highly advanced manufacturing facilities. Using a conservative multiplier effect of 2.4, the work of Boeing today generates nearly one-half million jobs in this country, many of which are with small and medium size businesses. In short, the Boeing Team has been and, hopefully, will continue to be an important engine of economic growth and technology in the United States.

However, any repeal of the ETI Act—without an equivalent replacement for the aerospace industry and other pure exporters who are not interested in exporting jobs abroad—will be particularly detrimental to the industry's ability in the future to provide these benefits to the industry and to the country. The loss of a tax provision that allows U.S. exporters to compete fairly with European exporters may well translate into a reduction in R&D investments, higher capital costs, and lost market share over time. And, the effect of that will be a reduction in our workforce and supplier base. I submit to you that this is a scenario that neither Boeing, nor our suppliers, nor the Congress wants to see unfold.

Mr. Chairman, we look forward to working with you to resolve these very difficult issues facing Boeing and other exporters who choose to retain jobs at home in the United States.

graph




Aerospace Employment
In Thousands
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1987
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1989
1990
1991
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2000
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37226
All Workers
Production Workers

August 21, 2002

Honorable Max Baucus
Chairman
United States Senate
Committee on Finance
Washington, DC

Dear Mr. Chairman:

Thank you again for the opportunity to testify before your committee on the role that ETI plays in keeping American companies competitive in a global marketplace and especially its role in terms of The Boeing Company.

We are pleased to provide the following responses to the additional questions posed by Senator Hatch.

In response to which states would be hardest hit by a blanket ETI repeal, for Boeing clearly this will have the largest negative effect on the jobs of our commercial aircraft employees. This is estimated to be in the range of 9,600 positions. The hardest hit states would be Washington and Kansas, followed by Texas, Oklahoma and Oregon. When you factor in the impact on our supplier base, we would anticipate additional impact to be felt in nearly 23,000 jobs primarily in the states of Texas, California, Connecticut, Ohio, Arizona and North Carolina.

In answer to your second question, an estimate on the stock price impact on Boeing with a repeal of ETI, our potential stock price impact would be in the $3 to $4 range per share, approximately $3 to $3.5 billion of market cap. We would agree with Pierre Chao's analysis that for other similarly situated exporters there would be a significant reduction in earnings per share based on their market capitalization factor.

Lastly, when I testified I mentioned the first prong in keeping exporters competitive would be for the Congress, the Administration, and U.S. industry to work together to develop an alternative to the ETI regime that provides comparable benefits. We applaud your call for a bipartisan, bicameral working group with participation from the Administration and the business community and look forward to working with you to achieve that goal.

Elaborating on what an alternative regime might look like, we would suggest a good beginning would be to review the National Foreign Trade Council's

recommendations regarding alternatives that would assist U.S. manufacturers, while meeting our WTO obligations. From a Boeing perspective the "Footnote 59" approach would provide a suitable replacement. This alternative would be consistent with WTO rules and be more suitable to exporters who do not have substantial operations offshore. This proposal would aim to avoid the double taxation of foreign source income by excluding from US tax all "foreign source income" earned by US taxpayers in export transactions. As the WTO Appellate Body indicated in its ruling on ETI, Footnote 59 of the Agreement on Subsidies and Countervailing Measures permits adoption of a measure to avoid such double taxation.

We would be pleased to provide you with additional information about how Footnote 59 approach works and its consistency with WTO rules.

We believe that the Congress and the Administration should make one of their top trade priorities the negotiation of a delay in the imposition of sanctions by the European Union and a process for resolving this dispute. Included in those negotiations should be an agreement by the Europeans that any legislative proposal will not be challenged again and that the inequity in the current WTO rules regarding direct and indirect tax systems will be eliminated. We thank the committee for its leadership in addressing this inequity in the recently enacted Trade Promotion Authority statute.

And as always, we are willing to work with you and the committee to ensure any final legislation adopted by the committee advances the global competitiveness of U.S. production and helps preserve and create well-paying US jobs.

Sincerely,

James H. Zrust
Vice President Tax

cc: Senator Orrin Hatch

Senator Charles Grassley

COMMUNICATIONS

STATEMENT OF THE COALITION OF SERVICE INDUSTRIES

The European Commission ("Commission") filed a World Trade Organization ("WTO") challenge against the Foreign Sales Corporation ("FSC") regime in 1997. The United States replaced the FSC with the extraterritorial income (or "ETI") regime) in 2000, after the WTO Appellate Body ruled that the FSC was a prohibited export subsidy. On January 14, 2002, the WTO Appellate Body issued a final report finding that the ETI regime also violates WTO agreements to which the United States is a party. The July 30, 2002, hearing was held to explore the role of the Extraterritorial Income Exclusion Act in the international competitiveness of U.S. companies.

CSI welcomes the opportunity to submit its comments for the record of the July 30, 2002, hearing. CSI's members represent a broad range of service sectors, including financial services, transportation services, accounting, legal, and other professional services as well as telecommunications, energy, and information technology. CSI members entered into cross-border leasing transactions that utilized the foreign sales corporation ("FSC") or the ETI tax rules.

I. Introduction

Since the late 1980's, U.S. companies have acted as lessors (the "FSC Lessors") in multi-year contracts of U.S.-manufactured goods, including aircraft, rolling stock and other equipment, the leasing terms for which factored in FSC tax benefits. Examples include long-term leases of U.S.-manufactured aircraft to foreign airlines and, for use on international routes, major U.S. airlines, and leases of locomotives manufactured in the United States to Canadian railroads (collectively, the "Lessees"). In setting the economics of rents and other payments to be made by the Lessees, FSC Lessors assumed (among other things) that U.S. tax benefits under the FSC and, after September 30, 2000, ETI regimes would be available for the duration of their leases and related transactions. Total repeal (including all grandfathering) of FSC and ETI benefits would have a material adverse effect on FSC Lessors. FSC Lessors understand the need to accommodate the WTO by discontinuing such export-related tax benefits for new transactions going forward. Nevertheless, the further step of eliminating transitional rules that

grandfathered financing transactions that closed up to a decade or more ago would be inequitable and contrary to historical U.S. tax policy. Moreover, while FSC Lessors would be harmed economically, the Lessees would continue to reap the benefits of lower financing costs afforded by the FSC and ETI benefits.

Taxpayers should be able to proceed on the assumption that the transition rules for leasing transactions involving a FSC will be continued. Similarly, if the Congress determines that ETI should be replaced, equivalent transition relief should be extended to leasing transactions that qualified under ETI. The taxpayers in these ETI transactions priced their leases in reliance on the assessment of the Congress – as reflected in the legislative history – that the law in effect when the transactions were closed complied with the WTO obligations of the United States.[1] A similar analysis applies to taxpayers who entered into long-term FSC leases containing lessee options which, while not binding on the lessor, were also priced in reliance on FSC benefits should the options be exercised by the lessee and accepted by the lessor – these FSC leases and options are today eligible for tax benefits under the ETI regime. Similar to the applicable legislative history, the Administration's "Appellant Submission" to the WTO argued that the ETI regime was drafted to comply with the applicable WTO agreements.[2] The Congress should seek to ensure the provision of transition relief that will fairly treat taxpayers who have detrimentally relied on the U.S. government's assessment regarding the validity of current law.

The Congress should make clear that the Administration would be expected to negotiate with the Commission and insist on the Commission's acceptance of prospective effective dates and reasonable transition rules in any legislative response to the WTO FSC-ETI dispute. This is particularly appropriate in view of the fact the United States is in the position of considering amendments to its tax law because of a ruling handed down by an international body– not because U.S. lawmakers determined that a policy change was in order. Indeed, as the Administration observed in its Appellant Submission to the WTO, "in requiring a sovereign country to subject its taxpayers to such a shift, the WTO rules cannot have been intended to further require that the country deny its taxpayers the right to an orderly shift through transition relief consistent with it's practice."[3]

II. Example of a Long-Term FSC/ETI Lease

In a typical aircraft lease, the FSC Lessor borrows 80-87% of the funds to purchase an aircraft, and contributes equity for the remaining 13-20%. In other cases, the FSC Lessor

[1] For example, the "Reasons For Change" in the Report of the House Committee on Ways and Means, H.R. Rep. No. 106-845, 106th Cong., 2d. Sess., includes the following statement: "The Committee strongly believes that the substantial modification to the U.S. tax law provided in this bill is WTO compliant." *See also* S. Rep. No. 106-416, 106th Cong., 2d Sess. page 5, regarding the statement that the ETI "legislation addresses both the broader issue of U.S. taxation of income derived from foreign sales, *i.e.*, "extraterritorial income," as well as complying with the WTO rulings."

[2] *See United States—Tax Treatment for "Foreign Sales Corporations,* Appellant Submission of the United States, (November 1, 2002) paragraph. 67.

[3] *United States—Tax Treatment for "Foreign Sales Corporations,* Appellant Submission of the United States, (November 1, 2002) paragraph. 262.

is capitalized solely with equity. The aircraft is then leased to the airline/lessee for a term of roughly 12-24 years. At the end of the term, the lessee typically may either exercise a fixed or capped purchase option[4], renew the lease for a specified term at pre-determined rents, arrange for a replacement lessee to enter into a follow-on lease, or return the equipment to the lease, all with predetermined contractual and economic terms and conditions.

A. U.S. Tax Treatment

As in all other long-term leveraged leases, the FSC Lessor will record rentals as taxable income, offset by depreciation deductions, interest expense on any debt, and amortization of capitalized expenses. The FSC and ETI regimes provide for a lower effective tax rate in years where the Total Taxable Income ("TTI") is positive. Due to the patterns of rent, depreciation and debt amortization (and resulting interest expense), TTI is generally greater in the latter portion of the lease term. The lower FSC/ETI tax rates also apply to taxable income from the sale or disposition of the leased asset – obviously occurring at or near the end the initial lease term, or any follow-on term(s). The tax benefits thus accrue directly to the lessor, and are passed on to the lessee through the pricing of rents for the property.

Therefore, the majority of the tax benefits have yet to be realized on most FSC/ETI leases, because larger FSC/ETI tax "benefits" are realized late in the lease term and the largest such benefit is realized at time of disposition of the asset. Yet, lessees of the equipment begin to realize the benefits on day one. This economic reality is reflected in the financial accounting for these contracts.

B. GAAP Accounting Treatment

As in all other long-term leveraged leases, the FSC Lessor determines the overall return on its investment by calculating the total after-tax cash flows generated by the lease. In accordance with GAAP rules (FAS 13), this total after-tax income is allocated for accounting purposes in proportion to the FSC Lessor's outstanding investment over time at a constant rate of return. Therefore, for financial accounting purposes, income from the lease is at its greatest in the early years, when the FSC Lessor's outstanding investment is the largest.

As a result, while FSC Lessors are still waiting to realize the majority of their FSC/ETI tax benefits, GAAP accounting has required much of the income associated with these benefits to be recorded in the early years of the leases. A total repeal (without transitional rules grandfathering treatment for existing transactions) would require a reversal of that portion of income recorded to-date attributable to the future FSC/ETI tax benefits – *i.e.*, income would have to be restated and reduced to reflect the lost FSC-ETI benefits.

[4] Some purchase options are exercisable prior to the end of the lease term – referred to as Early Buyout Options.

See the Attachment for an illustrative example.

III. The FSC Transition Rules Honor Binding Contracts Entered into by FSCs or Related Parties before the Enactment of ETI.

The United States' repeal of the FSC was required to "have effect from October 1, 2000. Many affected leases are long-term in nature, some with terms as long as 20 years. The repeal of the FSC transition rules would wreck the economics of an existing lease that was priced by taking into account the FSC benefit to the lessor or its affiliate (resulting in lower rentals).

The repeal of the FSC provisions was a fundamental change in tax policy, and – as such – should not apply on a mandatory basis to contracts that were entered into before the date of enactment. Any other treatment could result in an unwarranted retroactive tax increase and be totally inconsistent with past Congressional practice.

A. Transition Rules Included in the ETI Act Preserved the Benefits of the FSC Regime for Leasing Transactions.

In considering the transition from the FSC rules to the ETI regime, the Congress recognized the need for a general transition rule that took account of existing leasing contracts. For FSCs that were in existence on September 30, 2000, and at all times thereafter, the amendments made by the ETI Act did not apply to any transaction in the ordinary course of trade or business involving the FSC that occurred—

a) Before January 1, 2002, or

b) After December 31, 2001, pursuant to a binding contract that—
    1) Is between the FSC (or any related person) and any person that is not a related person, and
    2) Is in effect on September 30, 2000, and at all times thereafter.

For purposes of this general transition rule, a binding contract included a purchase option, renewal option, or replacement option that was included in such contract and which was enforceable against the seller or lessor. Thus, transition relief was provided to preserve the benefits of the current FSC regime for: The remaining term of existing leases; The term of a new lease entered into pursuant to a renewal option; The term of a replacement lease entered into pursuant to a replacement option; The sale of property pursuant to a purchase option; and other lease options that would have been eligible for FSC benefits.

B. Transition Rules Preserved the Economic and Business Rationale of the FSC Regime for Leasing Transactions for All Contracting Parties.

Transition rules included in the ETI Act effectively retained the FSC benefits for most leasing transactions that were entered into prior to the enactment of the ETI statute, in recognition that these were multi-year contracts entered into in reliance on existing law.

They averted the material adverse effect of a total repeal (without grandfathering) on FSC Lessors that would have occurred while leaving lessees unharmed economically.

1. FSC/ETI Leases Disadvantaged vs. FSC/ETI Sales

For a U.S.-manufactured asset that was exported via a sale under the FSC or ETI regimes, the manufacturer would have realized 100% of the FSC/ETI tax benefits in the year of the sale. For an identical asset that was exported via a lease, the FSC Lessor would expect the FSC/ETI benefits to accrue over the life of the transaction. Therefore, if FSC/ETI benefits are not grandfathered, the manufacturer would be unaffected, retaining all of its original FSC/ETI benefit from the completed sale, while the ***FSC*** Lessor would lose all FSC/ETI benefits going forward, effectively being "punished" for providing long-term financing to the Lessee.

2. FSC Lessors are "Stuck" in the Transaction -- Lessees Retain Benefit

No Early "Opt-Out". A change in U.S. tax law, such as the repeal (without grandfathering) of the FSC and ETI regimes, would not trigger an "early-out" for the FSC Lessor –it is extremely rare to find "opt-outs" in the lease contracts for adverse events such as the denial of FSC/ETI benefits going forward, nor could there be. As with substantially all long-term U.S. leases, the FSC Lessor assumes all of the change-in-law risk with regard to U.S. tax law. As a result of such a repeal, (i) the FSC Lessor would suffer a significant decrease in its return while (ii) the Lessee (e.g., a European airline) would continue to reap the economic advantage of the FSC/ETI benefits through lower, fixed rentals and ultimate purchase price.

Why No Early "Opt-Out"? In long-term leases (including FSC/ETI leases), Lessees generally do not accept "opt-out" provisions for the Lessor due to changes in U.S. tax law. This is because an early termination would come at a substantial cost to the Lessee. The lower rents available to the Lessee are possible due to the time-value nature of the tax deferral to the Lessor, *i.e.*, large depreciation and interest expense deductions (and therefore tax losses) early in the lease, followed by taxable income later in the lease. If a transaction is prematurely truncated, the Lessee would have to make a sizable termination payment in order to give the Lessor its originally anticipated return.

Lessees, particularly foreign companies, will not assume economic risks that turn on a change in U.S. tax law, about which they are not experts, and which is completely outside of their control. Alternatively, U.S. Lessors base their investment decisions on the assumption, among other things, that U.S. tax law at the inception of a lease will be applicable for the duration of that lease and any follow-on transactions. Apart from rate changes, tax law changes affecting leases have historically been applicable only to transactions closed after the effective date (the FSC Repeal Act being a case in point).

3. FSC Lessor Needs FSC/ETI Benefits to Realize Market Return

The original FSC leases were generally done in a competitive market with FSC Lessors getting a "market return" after taking into account the additional economic benefits from the FSC/ETI regimes. The FSC/ETI benefits were effectively passed on to the Lessee in the form of lower rents. Therefore, the repeal (without grandfathering) of the FSC and ETI regimes would result in a substantially below-market return for the FSC Lessor. Meanwhile, because the rents during the initial term, renewal term(s) and/or replacement term, as well as the purchase option price, are all fixed, the Lessee is guaranteed to retain the original FSC/ETI-advantaged economics for the entire transaction.

In order for FSC Lessors to realize the expected benefits of the FSC and ETI regimes, the transitional grandfathering rules must cover all of the FSC Lessors' taxable income generated by the leased asset. This includes, in addition to the initial lease to the Lessee, rents from renewals, replacement leases or other follow-on leases and proceeds from any disposition, including (but not limited to) an early termination of a lease or sale to the Lessee or unrelated third party.

4. Total Repeal of ETI/FSC Would Require Accounting Write-Down

What Happens? Pursuant to GAAP accounting rules, the FSC Lessor records accounting income from the inception of the lease based on its overall expected return. The loss of FSC/ETI benefits would result in a higher effective tax rate during the latter portion of the lease, decreasing the total after-tax income and the resulting return to the FSC Lessor. In such event, GAAP accounting rules would require a one-time write-down at enactment of the new legislation, to reduce profits by reversing the higher earnings booked to-date attributable to the expected FSC/ETI benefits. In addition, on-going earnings would be significantly adversely affected.

How Will It Look? In today's business environment where investors and regulators are hypersensitive to accounting adjustments, and the mere appearance of impropriety, a FSC Lessor's substantial write-down of a FSC/ETI lease portfolio would wrongfully appear as if the original accounting was "aggressive" or improper. This would affect a broad base of FSC Lessors (*e.g.*, manufacturer-owned finance units, banks, independent finance companies, insurance companies and investment houses).

In fact, FSC Lessors apply the same accounting treatment, per FAS 13, to all leveraged leases, including FSC/ETI leases. As is true for a myriad of transactions where taxes have an impact on the return as reported under GAAP, Lessors book accounting income from leases under the assumption that the originally existing tax laws will remain in

effect for the duration of those transactions. Other than changes in tax rates, this has proven to be the case.

IV. The WTO's View of the Transition Rules is Simply Unacceptable.

The United States must weigh the WTO Appellate Body's ruling – that "a Member's obligation to withdraw prohibited export subsidies…cannot be affected by contractual obligations which private parties may have assumed *inter se* in reliance on laws conferring prohibited export subsidies," (¶ 230 of the AB Report) – against the fundamental unfairness inherent in significant tax law changes that have an adverse economic impact on taxpayers who relied on their government's assessment of current law to their detriment.

As the Administration pointed out in its Appellant Submission to the WTO, "without such transition rules, taxpayers lose confidence that the tax treatment they expect will in fact prevail. The absence of such certainty affects the ability of taxpayers to plan for their businesses, either in the long term or even in the short term. Failure to maintain a consistent practice of transition relief would result in significant and inefficient transaction costs as taxpayers are required to factor in the risk of tax changes into their transactional planning."[5]

U.S. practice in the development of tax law changes is to accommodate contracts that relied on the law as it existed when the contract was made. Thus, while it probably will be necessary to seek the Commission's agreement to continue the FSC transition rules and provide similar rules for ETI transactions, we believe the Administration should strive to respect congressional precedents and the contractual obligations of the parties who entered into leasing transactions. Any other treatment would result in an unwarranted retroactive tax increase and be totally inconsistent with past Congressional practice.

A. No More "FSC/ETI Advantage" – WTO Should be Indifferent

The WTO's trade equity concerns should be unaffected by whether the FSC/ETI regimes for existing leases are grandfathered in a manner consistent with past Congressional practice. The "FSC/ETI advantage" was all reflected in the original pricing at the closing of the lease, through lower rents to the Lessee. In fact, even with FSC/ETI benefits, the FSC Lessor must get "market" rents and sale proceeds at the end of the initial lease in order to ultimately realize its originally anticipated market return. Therefore, the continued availability of FSC/ETI benefits will not provide any competitive advantage to the FSC Lessor. The only effect of a total repeal (without grandfathering) is a substantial decrease in the FSC Lessors' returns -- while the Lessees, through predetermined, fixed

[5] *United States—Tax Treatment for "Foreign Sales Corporations,* Appellant Submission of the United States, (November 1, 2002) paragraph. 265.

rents and purchase option prices, continue to reap the benefits of the FSC and ETI regimes.

B. In the Interests of Fairness and Equity, The United States Should Not Abandon It's Long-standing Practice of Promulgating Transition Rules When Repealing Significant Tax Legislation.

The United States rarely enacts retroactive tax provisions. Generally, retroactivity is reserved for situations where affected transactions are viewed as "abusive" *and* some significant Congressional action has already occurred by the effective date.

The FSC transition rules were enacted because the ETI Act effected a fundamental change in the treatment of foreign sales transactions. The United States generally provides transition rules when taxpayers can demonstrate that they had already taken steps in reliance on existing law on or before the date on which a proposed change is effective. There are numerous precedents for providing transition rules on the basis of a binding contract, even if subject to a condition if the condition is not within the control of the affected taxpayer. Note that even tax treaties typically have one-year transition provisions under which you can continue to apply the old treaty if you choose.

There is also ample precedent for providing specific grandfather rules for leasing transactions, mainly in the context of legislation affecting capital cost recovery provisions. For example, the effective date of the 1984 Tax-exempt Leasing rules[6] was for property "placed in service" after the relevant date, thus excluding property already under lease. Also under a provision in the 1984 legislation that applied the effective date to property *leased* after the relevant date, a lease was "not treated as entered into or renewed...merely by reason of the exercise of the lessee of a written option" that was enforceable against the lessor on the effective date and at all times thereafter.

V. Conclusion

As noted above, U.S. financing companies and other parties to leasing transactions fully acknowledge that the WTO decision found fault with the FSC transition rules, and the WTO maintained that these transition rules should be withdrawn. Nevertheless, we believe the United States should protect U.S. taxpayers who relied on U.S. law and regulations from retroactive changes in this area after the tax benefits have already been irrevocably factored into the economics of leases. We urge the Congress and the Administration to include appropriate transition rules in any legislation that moves forward to otherwise repeal the ETI statute. We also pledge to work vigorously with this Committee and the Administration to help obtain the Commission's support for continuing these transition rules as part of any final resolution of the FSC/ETI matter.

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[6] See page 76 of the *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, prepared by the staff of the Joint Committee on Taxation (December 31, 1984).

Attachment

THE CASE FOR PRESERVING TRANSITIONAL RULES FOR FSC AND ETI LEASING TRANSACTIONS

EXAMPLE OF A LONG-TERM FSC/ETI LEASE
Hypothetical Example - Impact of Repeal on Tax/GAAP Treatment for Lessors

Assumptions:

Transaction Type	Commission FSC Leveraged Lease
Asset Type	Aircraft
Orig. Equipment Cost	$100,000,000
Closing Date	January 1, 1996
Total Term	24 Years
Repeal FSC/ETI Transition Effective	January 1, 2003
End of Lease - Sales Proceeds year 2020	$20,000,000

Year	Tax Year	Realized FSC Tax Benefit	Recognized GAAP Earnings FAS 13 (a)
1	1996	$0	$1,254,000
2	1997	$0	$1,078,000
3	1998	$0	$809,000
4	1999	$0	$626,000
5	2000	$0	$505,000
6	2001	$0	$370,000
7	2002	$0	$144,000
			Repeal
8	2003	$114,000	$1,000
9	2004	$349,000	$0
10	2005	$349,000	$0
11-23	2006-2019	$5,809,000	$2,884,000
24	2020	$1,050,000	$0
Totals		$7,671,000	$7,671,000

Net Impact of Repeal on Tax/GAAP
Tax Impact of Repeal: $7,671,000 lost future cash benefit = 100%

GAAP Earnings Impact: $4,786,000 2002 Cumulative Adjustment Hit (Tax Year 2002)
$2,885,000 2003-2020 lost future earnings

Footnotes:
(a) For illustration purposes, GAAP earnings reflect benefit in connection with FSC only.

STATEMENT OF THE EQUIPMENT LEASING ASSOCIATION TO THE SENATE FINANCE COMMITTEE

FOR THE RECORD OF ITS JULY 30, 2002 HEARING ON EXTRATERRITORIAL INCOME LAWS AND U.S. COMPETITIVENESS

The Equipment Leasing Association (ELA) is submitting this statement for the record to express our views on the need for Congress to retain the FSC leasing transition rules in any FSC/ETI legislation enacted by Congress, and to protect lease transactions done pursuant to the Extraterritorial Income Act. ELA has over 800 member companies throughout the United States who provide financing for all types of businesses in all types of markets. Large ticket leasing includes the financing of transportation equipment such as aircraft, rail cars and vessels. Middle market lessors finance high-tech equipment including mainframe computers and PC networks, as well as medical equipment such as MRIs (magnetic resonance imaging) and CT (computed tomography) systems. Lessors in the small ticket arena provide financing for equipment essential to virtually all businesses such as phone systems, pagers, copiers, scanners and fax machines.

It is the position of ELA that leasing transactions negotiated and closed during the time that the FSC or ETI tax regimes were U.S. law must be grandfathered as part of any final resolution to the FSC/ETI matter. It is imperative that the FSC leasing transition rules contained in the FSC/ETI Act be retained and that similar transition rules be provided for leasing transactions done pursuant to the ETI regime.

For more than a decade, numerous ELA member companies have helped to advance and facilitate Congressional intent by serving as financing conduits for long-term contracts of U.S. manufactured goods. Examples of FSC/ETI transactions done by ELA members include long-term leases of U.S. manufactured aircraft to foreign airlines and U.S. manufactured rolling stock and locomotives to foreign railroads. In determining the economics of these long-term contracts, including the lessee's lease payments, FSC/ETI lessors relied upon the specific statutory tax incentives contained in the FSC or ETI regime.

Our position that existing FSC and ETI lease transactions must be grandfathered is consistent with the approach taken by Congress in considering the original transition from the FSC rules to the ETI regime, wherein Congress provided a general transition rule taking into account existing lease contracts. Pursuant to the general transition rule adopted by Congress, a binding contract included a purchase option, renewal option, or replacement option that was included in such contract and which was enforceable against the seller or lessor. Thus, transition relief was provided to preserve the benefits of the current FSC regime for: the remaining term of existing leases; the term of a new lease entered into pursuant to a renewal option; the term of a replacement lease entered into pursuant to a replacement option; the sale of property pursuant to a purchase option; and other lease options that would have been eligible for FSC benefits. The failure to maintain these transition rules in future legislation would be a gross inequity which

will have grievous consequences for the U.S. leasing companies which relied on specific statutory tax incentives in pricing these long term contracts.

Ironically, should Congress fail to provide lessors with transition relief for transactions done pursuant to the FSC and ETI regimes, FSC/ETI lessees, many of which are EU based, will continue to reap the benefits of the lower lease financing rates resulting from the FSC and ETI regimes, while U.S. leasing companies would be denied the market returns they negotiated under the same tax regimes. (Further, it should be noted that for a U.S. manufactured asset that was exported via a sale under the FSC or ETI regimes, the manufacturer realized 100% of the statutory tax incentives in the year of sale.)

What we are seeking is not unprecedented. In fact, it is common practice for Congress to provide transition rules in situations where taxpayers can show that they relied on existing law when entering into a binding contract on or before the date on which a proposed change may become effective. In the case of multi-year contracts, we are aware of no instances where Congress has not provided adequate grandfathering. Further, the grandfathering of multi-year FSC leasing contracts by Congress in the ETI statute provided lessors with comfort that ETI contracts would receive similar transition treatment if the U.S. were to repeal the ETI regime.

In addition to denying FSC/ETI lessors the market returns they negotiated, should Congress fail to grandfather such transactions, FSC/ETI lessors face accounting consequences as well. Because FSC/ETI lessors realize the majority of their tax benefits in the later years of the contract, under GAAP (SFAS 13), they will be required to reduce and restate income to reflect the lost FSC/ETI benefits. In today's environment where corporate accounting standards and practices are undergoing a rigorous review and every accounting adjustment is intensely scrutinized, leasing companies which complied with U.S. law and acted in good faith in facilitating Congressional intent with regard to the exporting of U.S. manufactured goods, may be unfairly criticized.

As Congress moves forward with its efforts to reform the international tax code and to replace the FSC/ETI regime with a WTO compliant tax regime, it must give strong consideration to the precedent it will set and the uncertainty that it will create in business planning if U.S. taxpayers can not rely on existing U.S. law when entering into transactions. Thus, as the process advances, we strongly urge Congress to protect and defend U.S. taxpayers who entered into binding contracts and priced those transactions based on existing U.S. law.

STATEMENT BY THE NATIONAL GRAIN TRADE COUNCIL

SUBMITTED FOR THE HEARING RECORD
COMMITTEE ON FINANCE
JULY 30, 2002
THE ROLE OF THE EXTRATERRITORIAL INCOME EXCLUSION ACT IN THE INTERNATIONAL COMPETITIVENESS OF U.S. COMPANIES

The National Grain Trade Council (NGTC) is a national trade association whose regular, policy-making members are grain exchanges, boards of trade, and national grain marketing organizations. The Council's associate members represent a broad cross-section of the grain industry and related businesses. These associate members include individual grain companies, milling and processing companies, transportation companies, futures commission merchants, and banks. We appreciate the opportunity to offer the following comments for the record in the hearing on the role of the Extraterritorial Income Exclusion Act in the international competitiveness of U.S. companies.

U.S. agriculture has a major stake in the effort to address the World Trade Organization's ("WTO") adverse rulings with respect to the Foreign Sales Corporation ("FSC") and its successor, the Extraterritorial Income tax law ("ETI"). The tax benefit provided by FSC/ETI, which the WTO has found to be an illegal export subsidy, was intended to offset in a small way the significant competitive advantage that most European and other countries provide their exporters through a refund of accumulated Value Added Taxes ("VAT") when domestically produced goods are sold outside their borders.

U.S. agriculture, all along in this dispute, has faced significant exposure as both agricultural cooperatives and corporations have established FSCs as a necessity in order to competitively export U.S. agricultural products overseas. There are four primary reasons why U.S. agriculture must be concerned.

First, the elimination of the FSC/ETI tax benefit will hit agriculture disproportionately hard relative to other industries because agriculture is a low-margin, highly price-sensitive business. Even a small tax benefit helps maintain a U.S. presence in foreign markets to offer U.S. commodities competitively against foreign-based companies that benefit from a refund of accumulated VAT. The FSC/ETI tax benefit is already built into the pricing structure of U.S. agricultural exports, and there is a legitimate concern that any change to FSC/ETI, by making U.S. companies less competitive, could cause farm exports to back up into the home market. Second, regardless of the motives behind its original action, the European Commission ("EC") specifically targeted U.S. agricultural exports in its original amended complaint.

Third, U.S. agriculture has turned to the WTO in a number of recent trade disputes, including European beef and banana import restrictions, and it is important to global agricultural trade to support the WTO by addressing its FSC/ETI rulings.

Fourth, and perhaps most important, there is little question that if the U.S. does not successfully resolve this challenge, the EC will retaliate first against U.S. agricultural exports.

Statement of Principles

For all these reasons, the U.S. must act quickly and responsibly to address the WTO's adverse rulings in the FSC/ETI dispute. To provide guidance in achieving this objective and to ensure that U.S. agriculture is able to continue to compete in the international marketplace, the National Grain Trade Council believes that the Congress and the Administration should adhere to the following guidelines.

First, Congress should encourage the U.S. Trade Representative to consider re-negotiating the Agreement on Subsidies and Countervailing Measures as this is the only way to address the long-term disparity resulting from the WTO's different treatment of subsidies related to direct versus indirect taxes. VAT represents a significant portion of the tax revenues raised by countries employing VAT regimes and therefore, consideration should be given to the manner in which VAT systems are designed to allow for recovery of VAT on goods exported from those countries. There is no reason to justify the different treatment of border adjustments among these different tax systems.

We further recommend that any replacement legislation:

a. should be consistent with U.S. international obligations.

b. should be designed to maintain or improve the international competitiveness of U.S. companies and any revenue raised by the elimination of the current FSC/ETI tax benefit should be used solely toward this goal.

c. should provide tax benefits that are, to the extent possible, equivalent with the tax benefit now being provided by the FSC/ETI tax law in order to help create and retain agricultural jobs in the United States.

d. should not discriminate among industries but should support the international competitiveness of all industries in the global market.

Title III of The American Competitiveness Act of 2002 proposed by the House Committee on Ways and Means addresses changes to the treatment of controlled foreign corporations and the determination of foreign tax credits in an attempt to offer benefits in lieu of the FSC/ETI tax benefit. While it may be appropriate to enact such changes for the purpose of simplification of certain rules, these changes do not provide export incentives to the taxpayers who export American agricultural products.

STATEMENT OF SMITHFIELD FOODS, INC., SMITHFIELD, VA

[SUBMITTED BY V. TRACY TURNER, CORPORATE TAX DIRECTOR]

REPEAL OF EXTRATERRITORIAL INCOME EXCLUSION (ETI) WOULD RAISE TAXES AND DAMAGE THE COMPETITIVENESS OF EXPORTERS

Background: The ETI, and its predecessors the Foreign Sales Corporation (FSC) and the Domestic International Sales Corporation (DISC), were enacted to help offset the competitive disadvantages faced by U.S. exporters compared to exporters from other countries with more favorable systems of taxation. Also, at the time that DISC was enacted, Congress was concerned that companies were moving their operations overseas. Although Congress recognized that there were many business reasons why certain products needed to be manufactured close to their markets, they wanted to encourage production of goods in the United States when possible, given the demands of the marketplace. The DISC, the FSC and the ETI all addressed this dual Congressional concern: maintaining the competitiveness of U.S. exporters and encouraging production of goods in the United States.

The American Competitiveness Act (ACA) Repeals the ETI: The ACA would repeal the ETI. Chairman Thomas has proposed repeal of the ETI in response to a World Trade Organization (WTO) ruling that the ETI regime is an illegal export subsidy. However, repeal of ETI without an adequate replacement will significantly harm U.S. exporters.

Chairman Thomas has proposed that money raised from the repeal of the ETI be used to pay for other international tax reforms that will aid the competitiveness of U.S. multinationals. The problem with the proposals in the ACA is that the reforms provide little or no benefit to U.S. exporters that do not have significant foreign operations. Chairman Thomas has commented that if these U.S. exporters just did some restructuring they would be able to take advantage of some of the provisions in the legislation.

Companies with primarily U.S. based operations would have to move manufacturing and sales operations that currently take place in the United States to offshore locations to garner tax savings from the legislation to make up for the loss of ETI benefits. We would be surprised if Congress and the Administration supported legislation to repeal a provision that benefits taxpayers that keep jobs in the United States in favor of a provision that encourages taxpayers to move those jobs overseas. This is exactly the type of business that Congress tried to target in 1971 when they wrote the DISC rules. They wanted to discourage this group of exporters from moving their manufacturing operations overseas to take advantage of tax and other cost savings.

Impact on Smithfield: Smithfield exports 180 thousand tons of food products annually, which impacts over 10,000 full time employees. We raise the majority of the hogs used to produce our pork products in the United States as apart of our vertical integration strategy. Smithfield's vertical integration business model simply does not lend itself to complicated restructuring as a way to achieve international tax efficiency. Our business model and the agribusiness industry fit the classic profile of the taxpayer that the DISC,

FSC and ETI regimes were enacted to help.[1] If the ETI is repealed without an adequate substitute, many U.S. based exporters will lose an important incentive to keep jobs, assets, and production in the United States.

Meeting our WTO Obligations: Smithfield supports the Administration and Chairman Thomas in their commitment to honor our WTO obligations and come into compliance with the WTO decision on FSC and ETI by modifying our tax laws. However, we strongly disagree with Chairman Thomas in his conclusion that the best way to accomplish this is by repealing the ETI and using the money raised by repeal to pay for international tax reform that provides no benefit to many U.S. exporters.

In recent testimony before the House Ways and Means Committee, Council of Economic Advisors Chairman Glenn Hubbard said that the Administration's position on this issue was to "work with Congress to enhance if possible, *but certainly not diminish*, the competitiveness of our tax rules." Chairman Thomas' proposal would diminish the competitiveness of Smithfield and many other U.S. exporters, especially those in the agricultural sector of our economy.

Smithfield believes that a GATT legal measure can be developed to replace the ETI that will not hurt the competitiveness of U.S. exporters. GATT rules permit Member nations to adopt measures to avoid double taxation of foreign source income, even if the measure might otherwise be viewed as a prohibited export subsidy. Although the ETI was not found to meet the requirements of a measure to avoid double taxation of foreign source income, a measure can be developed that meets traditional criteria of a mechanism to avoid double taxation used by developed nations around the world. Smithfield believes that this type of measure would be able to address the valid specific concerns raised by the Appellate Body in its report on the ETI.[2]

Specifically, we believe that a rule can be developed that would appropriately source income from cross-border distribution activities as arising in the country where the distribution activities occur. The amount of income associated with the distribution activities would be based on arm's length principles (e.g. the income derived would be comparable to profit margins on sales by unrelated distributors). Income that is considered to be foreign source distribution income could then be exempt from U.S. taxation under standard principles for the avoidance of double taxation. Although the

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[1] For example, Russia's recent ban on chicken imports hurt Smithfield. This trade restriction put an overabundance of chicken in the U.S. market and created strong downward pricing pressure on all sources of U.S. protein – including pork and beef. Agribusinesses are frequently the target of trade sanctions. The ETI helps to relieve the pressure associated with such trade disputes.

[2] Some of the issues raised by the Appellate Body reflect a lack of understanding of certain general principles of international taxation that are utilized by many developed countries and WTO member nations. We do not think it would be appropriate to address these issues in designing an ETI replacement.

theory behind this rule is similar to the theory for justifying the ETI as a measure to avoid double taxation, the measure would be quite different.[3]

Relief Requested: Efforts to repeal the ETI and use the revenue from its repeal to pay for tax incentives that do not benefit companies that manufacture and export from the United States without substantial foreign operations should be opposed. A GATT legal remedy for ETI should be fashioned that would continue to benefit U.S. exporters and keep jobs in the United States. Smithfield would be pleased to work with the Administration and Congress to design a GATT legal remedy to ETI that does not diminish the competitiveness of U.S. exporters.

[3] The Appellate Body recognized that the principles set out in the text might meet a measure for the avoidance of double taxation, but found that the U.S. did not meet its burden of proving that to be the case with respect to the ETI. One of their major criticisms was that the ETI was too narrowly crafted so that it would not have applied to many categories of distribution income. This measure would be drafted more broadly. Also, the Appellate Body was concerned with specific formulas for determining the amount of income that was foreign source under ETI. This measure would require the Treasury Department to draft regulations with respect to allocating that income that comport with arm's length principles.