WTO'S EXTRATERRITORIAL INCOME DECISION

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

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WTO'S EXTRATERRITORIAL INCOME DECISION

WEDNESDAY, FEBRUARY 27, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 10:45 a.m., in room 1100 Longworth House Office Building, Hon. Bill Thomas (Chairman of the Committee) presiding.

[The advisory and revised advisory announcing the hearing follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
February 19, 2002
No. FC–16

CONTACT: (202) 225–1721

Thomas Announces a Hearing on WTO's Extraterritorial Income Decision

Congressman Bill Thomas (R–CA), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on the World Trade Organization's (WTO's) decision that the United States' Extraterritorial Income Exclusion Act (ETI) is a prohibited export subsidy. **The hearing will take place on Wednesday, February 27, 2002, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

Oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

On January 14, 2002, the WTO Appellate Panel issued its report finding the United States' ETI rules to be a prohibited export subsidy. This marks the fourth time in the past two and one-half years that the United States has lost this issue, twice in the Foreign Sales Corporation (FSC) case and now twice in the ETI case. There is no opportunity for the United States to appeal this latest determination.

On January 29, 2002, a WTO Arbitration Panel began proceedings to determine the amount of retaliatory trade sanctions that the European Union (EU) can impose against U.S. exports to the EU. The EU has requested $4.043 billion in sanctions. The United States has asserted that the proper measure of sanctions is no more than $956 million. The Arbitration Panel will issue its determination by the end of April 2002.

In announcing the hearing, Chairman Thomas stated: "Although the most recent decision comes as no surprise, it illustrates the need to fundamentally reform our tax system so that U.S. workers, farmers and businesses are not disadvantaged in international trade. This will be the first of several hearings to consider the WTO Appellate Panel decision and to examine ways to maintain the international competitiveness of the United States."

FOCUS OF THE HEARING:

The hearing is expected to (1) outline the history of the FSC–ETI dispute, (2) analyze the January 14, 2002, WTO Appellate Panel Decision, and (3) discuss the potential trade ramifications of the decision.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to "*hearingclerks.waysandmeans@mail.house.gov*," along with a fax copy to (202) 225–2610 by the close of business, Wednesday, March 13, 2002. Those filing written statements who wish to have their statements distributed to

the press and interested public at the hearing should deliver their 300 copies to the full Committee in room 1102 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse unopened and unsearchable deliveries to all House Office Buildings. Failure to do so may result in the witness being denied the opportunity to testify in person.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to *hearingclerks.waysandmeans@mail.house.gov,* along with a fax copy to (202) 225–2610, in Word Perfect or MS Word format and MUST NOT exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Any statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

* * * NOTICE—CHANGE IN TIME * * *

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
February 26, 2002
No. FC–16 Revised

CONTACT: (202) 225–1721

Change in Time for Committee Hearing on WTO's Extraterritorial Income Decision

Congressman Bill Thomas (R–CA), Chairman of the Committee on Ways and Means, today announced that the Committee hearing on the World Trade Organization's decision that the United States' Extraterritorial Income Exclusion Act is a prohibited export subsidy, scheduled for Wednesday, February 27, 2002, at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building, **will now be held at 10:30 a.m.**

All other details for the hearing remain the same. (See Committee Advisory No. FC–16, dated February 19, 2002.)

Chairman THOMAS. If our guests will find their seats, please. Good morning. As the world's largest importer and the world's largest exporter, an orderly international trading system is crucial to the economic success of the United States. Given our global leadership, it is important that America complies with the established rules of engagement that the World Trade Organization (WTO) referees. It is in our interest that others follow the rules and therefore, it is imperative that we follow the rules as well.

To that end, we must carefully and thoroughly address the problems created at the intersection of our Tax Code, and our international trade obligations. On January 14 of this year, the WTO issued an appellate ruling that the U.S. Tax Code provides an export subsidy. This decision marks the fourth time that the WTO has ruled this way, twice in the foreign sales corporation (FSC) case and now twice in the extraterritorial income (ETI) case. Four times the WTO has sent the United States this same clear message. Our tax system, as it is currently constituted, violates international trade rules. In the opinion of the Chairman of this Committee, the time has come for us to listen.

Our corporate tax structure is in need of major restructuring, not another attempt at a short-term fix. More fundamental reform is required. In an economy struggling to recover, the United States cannot afford to dismiss the Europeans' proposed 4 billion, 3 billion, 2 billion, 1 billion, pick-a-number retaliation as an empty threat. Many people said the Europeans would never challenge us on this portion of the Code because they would be damaged as well. It has even been called a nuclear weapon. Well, it has been triggered. It is not an empty threat.

U.S. Trade Representative (USTR) Robert Zoellick is forcefully challenging the European Union's (EUs) assessment of harm, but if we do nothing, trade sanctions against our country remain a distinct possibility. The European Union has graciously indicated that it will be reasonably patient and that it does recognize the difficulty of changing our corporate Tax Code. The Congress and I believe this Administration must also demonstrate its commitment to address the problem. It is not an easy task. It will require collaboration from all Members of this Committee, Republican and Democrat. We must build a consensus on a new approach that will meet our international obligations while maintaining the competitiveness of American businesses and workers in the global marketplace.

It will be impossible to recreate a system which duplicates the current winners. But we must act in good faith. And we must begin this difficult process now. Today's hearing, where we will discuss the history of the foreign sales corporation dispute, the January 14 appellate body decision and the threat of retaliation, marks the beginning of this process. Yet no discussion of history, no attempt to justify the correctness of the U.S. position can be a beginning, a beginning begins with the realization that the previous attempts have failed.

One chapter has been closed. We need to open a new one. Following the full Committee hearing, the Subcommittee on Select Revenue will hold a series of hearings to examine options in reforming America's corporate tax structure. To give you an idea of how difficult that will be, we have a second panel today in which there are some suggested options, and my assumption is there will be an examination of the viability of some of those options. This is never pleasant. It is always difficult. The United States believes that we should set our own course, but we are a partner among partners and we have to start with the recognition that we have to change. And with that, does the gentleman from New York wish to make any opening remarks.

[The opening statement of Chairman Thomas follows:]

Opening Statement of the Hon. Bill Thomas, a Representative in Congress from the State of California, and Chairman, Committee on Ways and Means

Good morning. As the world's largest importer and exporter, an orderly international trading system is crucial to the economic success of the United States. Given our global leadership, it is important that America complies with the established rules of engagement that the World Trade Organization (WTO) referees. It is in our interest that others follow the rules and therefore it is imperative that we follow the rules as well.

To that end, we must carefully and thoroughly address the problems created at the intersection of our tax code and our international trade obligations.

On January 14th of this year, the WTO issued an appellate ruling that the U.S. tax code prohibits an export subsidy.

This decision marks the fourth time that the WTO has ruled this way, twice in the Foreign Sales Corporation (FSC) case and now twice in the Extraterritorial Income (ETI) case.

Four times the WTO has sent the United States this same clear message—our tax system as it is currently constituted violates international trade rules. In the opinion of the Chairman of this committee, the time has come for us to listen. Our corporate tax structure is in need of major restructuring, not another attempt at a short-term fix. More fundamental reform is required.

In an economy struggling to recover, the United States cannot afford to dismiss the European's proposed $4 billion, $3 billion, $2 billion, $1 billion, pick a number—retaliation as an empty threat. Many people said the Europeans would never challenge us on this portion of the code because they would be damaged as well. It has even been called a nuclear weapon. Well, it's been triggered. It is not an empty threat. The United States Trade Representative Robert Zoellick is forcefully challenging the EU's assessment of harm, but if we do nothing trade sanctions against our country still remain a distinct possibility.

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A beginning begins with the realization that previous attempts have failed. One chapter has been closed and we need to open a new one. Following this full committee hearing, the Subcommittee on Select Revenue will hold a series of hearings to examine options in reforming America's corporate tax structure.

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we are a partner among partners and we have to start with the recognition that we have to change.

I now recognize the ranking member from New York for his opening statement.

Mr. RANGEL. Thank you, Mr. Chairman. This Congress, and more particularly this Committee, has taken a lot of pride in the bipartisanship in which we have handled trade and issues before the World Trade Organization. This dispute has gone on for decades, but we as a Committee have stood solidly behind this and previous Administrations in letting the World Trade Organization understand our unanimity of thought in trying to get a fair and flat playing field. Now it appears as though we may have reached an impasse. And I would hope that this Administration would come to this Committee with strong recommendations as to how we could maintain the integrity of our tax system, and at the same time, fulfill our international obligations.

I am fearful, however, that this crisis that we face with the WTO may be used as a political vehicle to bring back the days when rhetorically we talked about pulling up the Tax Code by its roots and getting on buses going into communities and saying that we are going to simplify the system. That is a very, very political road, and I would hate to see our European friends think that our division in thought as to what the Tax Code should or should not be would give them an opportunity to go into these sanctions that they are threatening us with.

I do hope we can continue the spirit of bipartisanship on this issue that historically we found ourselves. But having heard the Secretary of Treasury talk about proposals to repeal the corporate tax, knowing the rhetoric about substituting consumption taxes for our tax system, realizing the lack of progressivity on some of these things, the Chairman said it would be difficult. I say these are very explosive political issues. I don't want the crisis that we face as a nation and certainly the responsibilities that we have as a—as the tax writing Committee for the entire Congress—to allow our political preferences to interfere with obligations to attempt to resolve this problem. The Administration—the Administration can avoid a train wreck on this. The Administration should be giving us guidelines on this.

If you let us get started on this before the election, you can bet your life you are going to have a political problem. If, on the other hand, you give us direction as to what we can do legislatively, well, you do the best you can diplomatically, I think we can maintain our tradition and move forward as a bipartisan Committee. Thank you, Mr. Chairman.

[The opening statements of Mr. Crane and Mr. Ramstad follow:]

Opening Statement of the Hon. Phillip M. Crane, a Representative in Congress from the State of Illinois

Mr. Chairman, I want to thank you for holding this very important hearing. As you know, I have been a longtime advocate for the repeal of the corporate income tax. Corporations don't pay taxes, instead, they pass along this cost of doing business to consumers through higher prices. The ruling by the WTO that makes illegal the FSC/ETI is the perfect hook for us to finally repeal this insidious tax scheme.

Unfortunately, there are those that will advocate for a new iteration of the FSC. I believe that this would be a major mistake. We have already made three attempts to write an export subsidy law that is WTO compliant and each time we have failed. Clearly, the WTO discriminates against our tax system, which is income based, as opposed to favoring those tax systems that are consumption based. It's not secret that the Europeans provide similar subsidies to their domestic corporations. Yet, there can be no successful challenge to those schemes because of the underlying assumption that a consumption based system is de facto WTO compliant.

That leaves us in the position to advocate for either a total repeal of the corporate tax or, in the alternative, fundamentally reforming the system with a territorial or border-adjustable VAT tax. If we are unable to repeal the corporate tax, then I'll support a territorial system. But I still believe the repeal of the corporate tax is the best alternative. No corporate tax means that foreign corporations will race to set up shop in the United States. That means more jobs for American workers, less people on welfare, and more tax revenues for the Treasury. I challenge anyone to argue with those outcomes.

Opening Statement of the Hon. Jim Ramstad, a Representative in Congress from the State of Minnesota

Mr. Chairman, thank you for holding this important hearing on the WTO's decision that the United States' Extraterritorial Income Exclusion Act (ETI) rules amount to an illegal export subsidy.

The ETI structure, and its predecessors the Foreign Sales Corporation (FSC) and the Domestic International Sales Corporation (DISC), were attempts to level the tax playing field for American companies doing business overseas.

Our international competitors have territorial tax systems and many allow Value-Added Tax (VAT) rebates for their companies' exports. This structure is acceptable to the WTO, while the U.S. system of worldwide taxation, which taxes the income of American businesses regardless of where they are doing business, combined with an ETI-like structure is unacceptable to the WTO.

While our U.S. trade team deals with the fallout from the WTO decision, we must begin to examine whether the foundations of our worldwide tax system are sustainable if American businesses are to remain competitive in our global economy. We already have too many examples of former U.S. companies that now are headquartered overseas because of our burdensome international tax system. The WTO's most recent decision and the resulting sanctions facing our businesses is another wake-up call for reform.

I look forward to hearing from our witnesses today about possible short-term and long-term solutions to the massive trade challenge we are now facing following the WTO's ruling.

Thank you, Mr. Chairman.

Chairman THOMAS. Thank you very much, Mr. Rangel. And to hear the first word from the Administration on this issue, the two departments that are clearly focused on this issue is Barbara Angus, the International Tax Counsel, Office of Tax Policy, U.S. Department of the Treasury; and Peter Davidson, the General Counsel of the U.S. Trade Representative. I want to thank you both for appearing. Your written testimony will be made a part of the record and you may address us as any way you see fit during the time you have available. The microphones need to be turned on and they are very uni-directional, so you need to be right in front of it so we can hear you. So with that, Ms. Angus.

STATEMENT OF BARBARA ANGUS, INTERNATIONAL TAX COUNSEL, U.S. DEPARTMENT OF THE TREASURY

Ms. ANGUS. Mr. Chairman, Congressman Rangel and distinguished Members of the Committee. I appreciate the opportunity to

appear today at this hearing on the World Trade Organization's recent decision regarding the extraterritorial income exclusion provisions of the U.S. tax law.

On January 29, the WTO dispute settlement body adopted a final report finding that the ETI provisions of the U.S. tax law are inconsistent with U.S. obligations under the WTO. We are all disappointed with this outcome.

This decision is the culmination of a challenge brought by the European Union in late 1997 against the FSC provisions then contained in the U.S. tax law. However the origins of this dispute go back almost 30 years, predating the WTO itself. The United States has consistently and vigorously pursued this matter and defended its laws through 3 decades because of the importance of the provisions and principles at stake. At its core, this case raises fundamental questions regarding a level 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 playing field for U.S.-based businesses that are subject to those international tax rules. As we contemplate our next steps and address this decision, we should not lose sight of that objective.

The Congress has demonstrated its commitment to the U.S. businesses, both large and small, that operate in the global marketplace and to the U.S. workers that produce the output that is sold in markets around the world. The Congress took decisive action on a bipartisan basis under significant time pressure in passing legislation in November, 2000, to respond to the first WTO decision in this dispute by repealing the FSC provisions and enacting the ETI provisions. That legislation represented a good faith effort to bring the United States into compliance with its WTO obligations, while at the same time protecting the level playing field for U.S. businesses.

To be facing this same issue again so soon is certainly a disappointment. Nevertheless, we must look forward and pursue all options to resolve this matter so that American workers and the businesses that employ them will not be disadvantaged. We have a serious problem, and we need to develop a serious solution. Mr. Chairman, the Administration looks forward to working closely with the Congress to find a solution that will protect America's interest and honor our obligations in the WTO. Given the focus of this hearing, our written testimony today focuses on the particular provisions of our tax law at issue, the history of the dispute in the WTO over these provisions and the findings and analysis of the WTO dispute settlement body. I would be happy to answer any questions. Thank you very much.

Chairman THOMAS. Thank you, Ms. Angus. Mr. Davidson.

[The prepared statement of Ms. Angus follows:]

Statement of Barbara Angus, International Tax Counsel, U.S. Department of the Treasury

Mr. Chairman, Congressman Rangel, and distinguished Members of the Committee, we appreciate the opportunity to appear today at this hearing on the World Trade Organization's recent decision regarding the extraterritorial income exclusion (ETI) provisions of the U.S. tax law.

On January 29th, the WTO Dispute Settlement Body adopted a final report finding that the ETI provisions of the U.S. tax law are inconsistent with the United States' obligations under the WTO. We all are very disappointed with this outcome. This 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 WTO itself. The United States has vigorously pursued this matter and defended its laws because of the importance of the provisions and principles at stake.

At its core, this case raises fundamental questions regarding a level playing field with respect to tax policy. Few things are as central to a country's sovereignty as the right to choose its own tax system. 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 playing field for U.S.-based businesses that are subject to those international tax rules. As we contemplate our next steps, we should not lose sight of that.

The Congress has demonstrated its commitment to the U.S. businesses, both large and small, that operate in the global marketplace and to the U.S. workers that produce the output that is sold in markets around the world. The Congress took decisive action, under significant time pressure, in passing legislation in November 2000 to respond to the first WTO decision in this dispute by repealing the FSC provisions and enacting the ETI provisions. That legislation represented a good faith effort to bring the United States into compliance with its WTO obligations while protecting the level playing field for U.S. businesses.

To be facing the same issue again so soon certainly is a disappointment. Nevertheless, we must look forward and pursue all options to resolve this matter so that American workers and the businesses that employ them will not be disadvantaged.

Mr. Chairman, the Administration looks forward to working closely with the Congress, on a bipartisan basis, to find a solution that will protect America's interests and honor our obligations in the WTO.

Our testimony today will focus on the particular provisions of our tax law at issue, the history of the dispute in the WTO over these provisions, and the findings and analysis of the WTO Dispute Settlement Body with respect to these provisions.

The Foreign Sales Corporation Provisions

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.

A FSC that elected to be subject to these provisions generally was a foreign subsidiary of a U.S. manufacturer. The U.S. manufacturer sold its products to the FSC for resale abroad or paid the FSC a commission in connection with its sales of products abroad. In order to qualify for these provisions, the FSC was required to be managed outside the United States and was required to conduct certain economic processes outside the United States with respect to these export transactions. These economic processes related to the solicitation, negotiation, and making of contracts with respect to such transactions.

The sales or commission income of the FSC on these transactions was determined under specified pricing rules. The exemption from tax applied to a portion of the FSC's income from sales and leases of export property and from related services. The FSC was subject to current U.S. tax on the remainder of its income from these transactions.

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 WTO Decision Regarding the FSC Provisions

The European Union formally challenged the FSC provisions in the WTO in November 1997, thirteen years after their enactment. Consultations to resolve the matter were unsuccessful, and the EU challenge was referred to a WTO dispute resolu-

tion 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 believed that the FSC provisions were blessed by the 1981 Understanding, the WTO panel completely dismissed this argument, 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.

Under the Subsidies Agreement, a subsidy exists if (1) government revenue otherwise due is foregone and (2) a benefit is thereby conferred. The Subsidies Agreement prohibits subsidies that are contingent, in law or in fact, on export performance. Looking first at the subsidy issue, the panel concluded that three specific aspects of the FSC provisions, taken together, resulted in an exception from taxation for income that otherwise would be subject to U.S. tax; the panel therefore concluded that the FSC provisions resulted in foregone government revenue through which a benefit was conferred. The panel then concluded that this subsidy provided by the FSC provisions was export-contingent, and therefore prohibited, because the tax treatment under the FSC provisions depended upon the exportation of U.S. goods. The panel further found that the FSC provisions constituted an export subsidy in violation of the WTO Agreement on Agriculture. The panel declined to rule on the European Union's additional arguments that the pricing rules and "domestic content" rules contained in the FSC provisions constituted separate violations of the WTO rules. The panel recommended that the subsidy provided by the FSC provisions be withdrawn with effect from October 1, 2000 (which date was later extended to November 1, 2000, under a procedural agreement between the parties).

The Extraterritorial Income Exclusion Provisions

In response to the WTO decision against the FSC provisions, the FSC Repeal and Extraterritorial Income Exclusion Act was enacted on November 15, 2000. This legislation had been voted out of this Committee with a vote of 34 to 1, and was passed by the House with a vote of 316 to 72. 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. The new regime addressed the subsidy issue by establishing a new general rule of taxation under which extraterritorial income is excluded from gross income; the new regime addressed the export-contingency issue by applying to income from all foreign sales and leases of property, without regard to where the property is manufactured. At the same time, the legislation also was intended to ensure that U.S. businesses not be foreclosed from opportunities abroad because of differences in the U.S. tax laws as compared to the laws of other countries.

The ETI provisions provide an exclusion from U.S. tax for certain extraterritorial income. This exclusion applies to a portion of the taxpayer's income from foreign sales and leases and certain related services. The ETI provisions apply to foreign sales and leases of property manufactured in the United States and also to foreign sales and leases of property manufactured outside the United States. In the case of property manufactured outside the United States, the manufacturer either must be subject to the taxing jurisdiction of the United States or must elect to subject itself to such jurisdiction. Thus, the income from transactions to which the ETI provisions apply is subject to consistent U.S. tax treatment.

Unlike the FSC provisions, the ETI provisions do not require the filing of an election or the formation of a special entity to which sales are made or commissions are paid. Also unlike the FSC provisions, the ETI provisions apply to both corporations and individuals in the same manner.

The exclusion provided under the ETI provisions generally is available only if certain economic processes are conducted outside the United States. As under the FSC provisions, these economic processes relate to the solicitation, negotiation, and making of contracts. A portion of the income from foreign transactions covered by the ETI provisions is exempt from U.S. tax. Because this exclusion is an alternative approach to addressing potential double taxation, foreign tax credits are not allowed with respect to the excluded income.

The WTO Decision Regarding the ETI Provisions

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. However, significantly, the Appellate Body modified and narrowed the panel's analysis. 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.

Prohibited Export Subsidy Under the Subsidies Agreement

The analysis of the prohibited export subsidy under the Subsidies Agreement involved three separate issues.

First, the Appellate Body found that the ETI provisions constitute a subsidy under Article 1.1(a)(ii) of the Subsidies Agreement. The Appellate Body compared the ETI exclusion to the tax rules that otherwise would have applied to income from this type of transaction. Based on that analysis, the Appellate Body found that the ETI exclusion constitutes the "foregoing of revenue which is 'otherwise due'," that it confers a benefit, and that it is therefore a subsidy.

Second, the Appellate Body found that the ETI provisions are export contingent because of the provisions' application only to income from transactions involving property that is sold, leased, or rented for direct use, consumption, or disposition outside the United States. As did the lower panel, the Appellate Body bifurcated the ETI provisions, separating the application to transactions involving property produced within the United States from the application to transactions involving property produced abroad. For property produced within the United States, the foreign use requirement could be met only by exporting the property. Based on this bifurcation, the Appellate Body found that the ETI provisions are export contingent with respect to domestically produced products. This conclusion was not affected by the fact that the ETI provisions apply in circumstances that are plainly not export contingent (i.e., with respect to property produced outside the United States and sold for use outside the United States).

Third, the Appellate Body rejected the U.S. argument that the ETI provisions constitute a permitted measure for avoidance of double taxation. The United States believed that the ETI provisions fell within the fifth sentence of footnote 59 of the Subsidies Agreement which effectively permits a country to "tak[e] measures to avoid the double taxation of foreign-source income," even if the measures constitute export subsidies. The Appellate Body found that footnote 59 applies only to "foreign-source income" and that, to be considered "foreign-source income," the income must have sufficient links to another country that the income could be taxed by that other country. The Appellate Body further viewed the ETI provisions as potentially applying to income that would not fall within the reach of this rule as so interpreted. Therefore, the Appellate Body found that the ETI provisions do not constitute a measure to avoid double taxation under footnote 59.

Export Subsidy Under the Agriculture Agreement

Because the Appellate Body held that the ETI provisions constitute a prohibited export subsidy under the Subsidies Agreement, it followed that the ETI provisions also violate the export subsidy provisions of the WTO Agriculture Agreement.

National Treatment Under GATT Article III:4

The Appellate Body affirmed the panel's finding that the 50 percent limitation on foreign articles and direct labor costs contained in the ETI provisions violates GATT Article III:4. The Appellate Body dismissed the U.S. factual point that taxpayers may meet this requirement without using any U.S. content whatsoever. The Appellate Body found that this limitation in the ETI provisions represents an encouragement of domestic manufacturers to use domestic over imported components, thereby

providing less favorable treatment to imported products than to like domestic products.

Withdrawal of FSC Benefits

The Appellate Body also rejected the transition rules included in the ETI Act, finding no basis for permitting the continuance of the application of the FSC provisions beyond the November 1, 2000 date specified for withdrawal of the subsidy found to have been provided by the FSC provisions. The Appellate Body rejected the U.S. position that efficient and fair administration of the tax laws frequently requires tax legislation to include transition rules and binding contract relief for taxpayers that acted in reliance on the prior law provisions.

Current Arbitration Proceeding

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. The parties are filing written submissions and will meet with the arbitration panel, which will issue its report on the appropriate level of trade sanctions on April 29th. Following adoption of that report, the European Union will be authorized to begin imposing trade sanctions on U.S. exports up to the level set by the arbitrators.

STATEMENT OF PETER DAVIDSON, GENERAL COUNSEL, OFFICE OF THE UNITED STATES TRADE REPRESENTATIVE

Mr. DAVIDSON. Thank you, Mr. Chairman, Representative Rangel, and Members of the Committee. It is a pleasure to be here today. I do apologize in advance for my voice. I am working on a little cold here, so I will try to speak as loudly as I can or put it in my mouth here. But I do appreciate the opportunity to be here to talk about this issue, a dispute between the United States and the EU on the FSC and then the ETI case. As my detailed statement does go into somewhat more length on the historical record, I will try to be brief here in my remarks about where we are going to be going and be happy to answer any questions.

Ambassador Zoellick has said on a number of occasions in the past year, noting the seriousness of the dispute with its potentially large financial implications for U.S. companies, as the Chairman noted last May, he likened the issue to a trade nuclear bomb which, if not treated with the utmost care, could cause enormous damage to the U.S.-EU relationship, and perhaps the trading system more generally.

Mr. Chairman, I agree with you we cannot treat the threat of retaliation as an empty threat. Ambassador Zoellick stated in his joint press conference with Trade Commissioner Lamy of the EU last month that the United States intends to seek to resolve this dispute in a spirit of good faith, and that we intend to respect our WTO obligations.

Mr. Chairman, as you noted, you can forcefully challenge the amount at issue. And the arbitration phase will also work cooperatively to show the progress necessary to prevent retaliation. I hope we can work through our differences with the EU in a way that will result in a true level playing field with respect to taxation, but it will be a difficult road and one that will require patience on all

sides. The solution will be found in an appreciation of the need to move the global trading system forward to advance the U.S.-EU trading relationship overall, and at the same time, to find a solution to this dispute within which all parties can prosper.

I understand that the primary purpose of today's hearing is to review the history of this important case, and therefore I hope my comments will provide the Committee with a bit of context, both historical and WTO procedural, to help establish a framework for future discussions.

As we approach April 15, I am also reminded to provide another caveat that I am very far from a tax expert on any of these issues, and so I will defer most of those questions to the Treasury. But I will try to clarify some of the highlights if I can.

Barbara Angus just went through the history of the dispute. It is a long history. As the Chairman noted, it is history. And so I will not go through that about each of those stages at this point. A detailed account is in my written testimony. But to summarize, essentially since 1997, the FSC, and later the ETI, with both twice judged by the WTO, found to be an illegal export subsidy under WTO rules. The latest chapter began with the WTO panel finding against the ETI Act in August of 2001. After consulting extensively with Congress and the private sector last November, we proceeded to appeal the latest panel result challenging all of the panels' ultimate findings with respect to the ETI Act.

We chose to appeal even though we are not optimistic of achieving a reversal of all the panels' findings, we thought we could perhaps obtain greater clarity from the appellate body. The appellate bodies' report was formally adopted on January 29. At that point, the arbitration proceeding which had been suspended by mutual agreement with the EU in November of 2000 for purposes of determining the level of countermeasures to which the EU is entitled, resumed.

A WTO arbitration proceeding normally takes no more than 60 days. In this case, the arbitrators have informed us that they expect to take until April 29 to finish their work and issue their determination on the authorized maximum level of countermeasures. The EU and United States have, in recent days, submitted to the arbitrators our respective arguments on the appropriate maximum level for authorized countermeasures in this case. The EU is expected, and has argued, should be allowed to adopt countermeasures with a value of up to $4.043 billion. The EU essentially claims that this amount is reasonable because it estimates the actual effects of the ETI to be far greater than this amount.

In contrast, the United States holds that the EU should only be entitled to countermeasures totaling from $1 billion to $1.1 billion, depending on the base year chosen. This represents appropriately, in our view, the proportion of the FSC ETI subsidy that applies to the EU based on the EU's share of total nongoods production worldwide. If the arbitrators find that the EU is entitled to countermeasures in some amount, the EU would be in the same position to ask for WTO authority to impose countermeasures sometime in May.

However, there is no deadline by which the EU must request this nor is there any deadline by which the EU must impose counter-

measures once the authority is received. The European Commission (EC) in the fall of 2000 notified the WTO that it would seek authorization, when appropriate, to increase tariffs on U.S. exports to be selected from a very broad potential list. To date, we are unaware of any further-refined list of potential targets by the Commission.

Throughout the WTO dispute settlement process, we have maintained our contacts with EU counterparts with a view toward managing the dispute in a manner that does not disrupt the general progress being made in international trade liberalization. Ambassador Zoellick and Commissioner Lamy have met numerous times and with other counterparts in the European Commission Member States.

Mr. Chairman, I hope that this thumbnail sketch of our origin and current status of the dispute will prove useful in forming the Committee's future consideration of these issues. Given our understanding of the Committee's objectives for this hearing, I have refrained from going too far into thinking on how to move the topic forward in the coming weeks and months, but we look forward to working closely with Congress, the private sector, and in particular, this Committee, in developing ideas on how to respond to the WTO ruling and other aspects of this important issue. Thank you. And I would be happy to take any questions that the Committee would have.

[The prepared statement of Mr. Davidson follows:]

Statement of Peter Davidson, General Counsel, Office of the United States Trade Representative

Mr. Chairman, Representative Rangel, and Members of the Committee:

I would like to thank you for the opportunity to testify before the Committee today on the dispute between the United States and the European Union (EU) in the World Trade Organization, first over the Foreign Sales Corporation (FSC) rules of the U.S. tax code, and most recently over the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (ETI Act).

Ambassador Zoellick has on a number of occasions in the past year noted the seriousness of this dispute and its potentially large financial implications for U.S. companies. In Strasbourg, France, last May, Ambassador Zoellick likened the issue to a trade "nuclear bomb," which, if not treated with the utmost care, could cause enormous damage to the U.S.-EU relationship and perhaps the trading system more generally. There has certainly been no lack of expressions of concern coming in recent months to USTR from the private sector, other agencies, and of course the Congress emphasizing the need to find a way through the dispute that avoids EU retaliation.

As Ambassador Zoellick stated in his joint press conference with EU Trade Commissioner Lamy last month, the United States intends to seek to resolve this dispute in a spirit of good faith. He also said that we intend to respect our WTO obligations and seek to come into compliance with the WTO ruling.

I am hopeful that we will work through our differences with the EU in a way that will result in a true level playing field with respect to taxation. But it will be a difficult road, and one that will require patience on all sides. The solution will be found in an appreciation of the need to move the global trading system forward, to advance the U.S.-EU trading relationship overall, and at the same time, to find a solution to this dispute within which all parties can prosper.

All this being said, I understand that the primary purpose of today's hearing is to review the history of this important case. Therefore I hope my comments will provide the Committee with a bit of context, both historical and WTO/procedural, to help establish a framework for future discussions. The approach of April 15th reminds me that I need to underscore to you my lack of credentials as an expert on tax questions. However, I will do my best to make clear a rather complicated story.

History

The U.S.-EU disagreement over FSC/ETI in fact has been simmering for a long time. Indeed, the case began with a challenge in 1972 under the General Agreement on Tariffs and Trade (GATT) by the then European Economic Community (EC) to the Domestic International Sales Corporation (DISC) provisions of U.S. tax law, forerunner to the FSC. The EC's challenge alleged that the DISC rules constituted an export subsidy that was prohibited under the GATT. In its defense, the United States contended that the DISC in essence operated no differently from methods of exempting foreign-source income used by the tax regimes of EC Member States Belgium, France and the Netherlands. In the U.S. view, the DISC simply "looked different" from European approaches because it operated within the U.S. worldwide (or residence-based) system of income taxation as opposed to European-style territorial tax systems. The United States proceeded to bring its own GATT disputes against the three EC Member States.

In 1976, a GATT dispute settlement panel ruled against the DISC *and* the three European tax regimes, finding that each allowed exports to be taxed more favorably than comparable domestic transactions. In 1981, the panel's findings were adopted by the GATT Contracting Parties, together with an Understanding which essentially overturned the legal conclusions of the panel with respect to the European systems. In 1984, the United States enacted the FSC legislation, claiming in the GATT that the new U.S. tax rules conformed to the principles elaborated in the 1981 Understanding. Though the EC and Canada promptly requested GATT dispute settlement consultations on the new FSC, and joint consultations were held with these trading partners in 1985, neither Canada nor the EC thereafter chose to pursue the matter further in the GATT.

Ten years later, in 1995, the WTO came into existence, along with a new Subsidies Agreement. In 1997, the EC, now the EU, requested WTO dispute settlement consultations with respect to the FSC. In 1998, a WTO dispute settlement panel was established to consider the EU's complaint. In developing the U.S. defense in the case, USTR worked closely with the Treasury Department and private sector representatives of FSC users. The U.S. brief covered a range of technical areas, but the key U.S. arguments were:

- The FSC exempted income attributable to foreign economic activities, as expressly permitted by the 1981 Understanding; and
- In substance, if not form, the FSC was no different from the territorial exemption method used by many European countries. Like the DISC, it simply "looked different" due to the different nature of the U.S. tax system.

In 1999, the WTO panel issued its report, finding the FSC to be a prohibited export subsidy under both the WTO Subsidies and Agriculture Agreements. Essentially, the panel found that the FSC was an export-specific exemption from otherwise applicable U.S. tax rules. The panel also found that because the 1981 Understanding did not form part of the WTO rules on subsidies, there was no exception for tax measures that exempted income attributable to foreign economic activities. As a result, the panel did not make findings as to whether the FSC actually did exempt foreign-source, as opposed to domestic-source, income. Also on grounds of judicial economy, the panel did not address the EU's challenges to the FSC administrative pricing rules, which were alleged to be inconsistent with the arm's length principle; and to the FSC definition of "export property," which was alleged to violate the WTO prohibition against subsidies contingent upon the use of domestic over imported goods. The panel said that the United States should withdraw the FSC subsidy effective October 1, 2000.

The United States appealed the panel decision, but in February 2000, the WTO Appellate Body affirmed the panel's findings, although it modified its reasoning somewhat. Through the summer of 2000, Congress and the former Administration worked on replacement legislation. The parameters for this legislation were: (1) no significant revenue consequences; (2) no significant diminution of existing FSC benefits; and (3) WTO-consistency.

During this time the former Administration also attempted to engage the EU in discussions on what could go into the replacement legislation that would alleviate EU WTO concerns. Former Deputy Secretary of the Treasury Eizenstat visited Brussels in May 2000 and met with EU Trade Commissioner Pascal Lamy. Unfortunately, the European Commission declined to enter into substantive discussions of what the new legislation should look like, claiming that the EU was not in a position to advise the United States on how to write its tax laws and insisting that compliance with WTO rules was the only criterion that mattered to the EU.

After an intense several months of consultations between Congress, the Administration and the private sector, Congress in November 2000 enacted the FSC Repeal

and Extraterritorial Income Exclusion Act of 2000 (ETI Act). The EU promptly challenged the ETI Act as an inadequate response to the earlier panel findings. At the same time, it requested authority from the WTO to withdraw WTO concessions to the United States (i.e., impose countermeasures) in the amount of over $4 billion, in line with the EU's calculation of the amount of the subsidy provided by the FSC rules. However, under a procedural agreement the Administration had negotiated with the EU in September 2000, a WTO arbitration proceeding to determine the amount of countermeasures to which the EU actually was entitled was suspended pending the outcome of the EU's challenge to the WTO-consistency of the ETI Act.

In August 2001, the WTO panel issued its report, finding against the ETI Act. Specifically, the panel found that:

- The ETI Act's exclusion from taxation of certain extraterritorial income constitutes a prohibited export subsidy under the Subsidies Agreement.
- The tax exclusion is not protected as a measure to avoid double taxation of foreign-source income within the meaning of footnote 59 to the Subsidies Agreement.
- The tax exclusion constitutes an export subsidy in violation of U.S. obligations under the Agreement on Agriculture.
- The ETI Act's 50 percent rule regarding certain foreign value violates the national treatment provisions of Article III:4 of GATT 1994.
- The ETI Act's transition rules resulted in a failure to withdraw the FSC subsidies by the recommended date.
- On grounds of judicial economy, the panel did not address the EU's claims that the 50 percent rule rendered the tax exclusion a prohibited import substitution subsidy under the Subsidies Agreement.

Where We Are Today

After consulting extensively with the Congress and the private sector, on October 15, 2001, we filed a notice of appeal, challenging all of the panel's ultimate findings with respect to the ETI Act. We decided to appeal because, even though we were not optimistic about achieving a reversal of all of the panel's findings, we thought we could perhaps obtain greater clarity from the Appellate Body, which would be of assistance in making any further modifications to U.S. tax law. On November 1, we filed our appellant submission. As you will recall, the Appellate Body on January 14 of this year rejected our appeal on all counts. The Appellate Body's report was formally adopted on January 29, at which point the arbitration proceeding for purposes of determining the level of countermeasures to which the EU is entitled, which we had been suspended by mutual agreement with the EU in November of 2000, resumed. One would normally expect a WTO arbitration proceeding to take no more than 60 days. In this case, the arbitrators have informed us that they expect to take until April 29 to finish their work and issue their determination on the authorized maximum level of countermeasures.

The EU and the United States have in recent days submitted to the arbitrators our respective arguments on the appropriate maximum level for authorized countermeasures in this case. The EU, as expected, argued that they should be allowed to adopt countermeasures with a value up to $4.043 billion. The EU essentially claims that this amount is reasonable because it estimates the actual effects of the ETI to be far greater than this amount. In contrast, the United States holds that the EU should only be entitled to countermeasures totaling from 1.0 billion to 1.1 billion, depending on the base year chosen. Our reasoning is that WTO principles require that countermeasures be proportionate to the trade impact on the complaining WTO Member of a WTO-inconsistent measure adopted by the defending Member. To measure the trade impact of the ETI Act on the EU, we used the amount of the subsidy as a proxy for the actual trade impact, and assigned to the EU a portion of this amount based on the EU's share of total non-U.S. goods production worldwide.

If the arbitrators find that the EU is entitled to countermeasures in some amount, the EU would be in position to ask for WTO authority to impose countermeasures sometime in May. However, there is no deadline by which the EU must request authority to impose countermeasures, nor is there any deadline by which the EU must impose countermeasures once the authority is received. If the European Commission decides to utilize whatever authority it receives from the WTO to impose countermeasures, we expect it would then move to seek approval from the EU Council of Ministers, representing the EU Member States, to impose increased tariffs on selected imports from the United States. How long such a process would take is not clear at present. The Commission in the fall of 2000 notified the WTO Dispute Settlement Body that it would intend to seek authorization, when appropriate, to increase tariffs on U.S. exports to be selected from a very broad potential list. To date,

we are unaware of any further-refined lists of potential targets produced by the Commission.

I should add that, throughout the WTO dispute settlement process, we have maintained our contacts with our EU counterparts with a view toward managing the dispute in a manner that does not disrupt the general progress being made in international trade liberalization.

Future Work

Mr. Chairman, I hope this thumbnail sketch of the origin and current status of the FSC/ETI dispute will prove useful in informing the Committee's future consideration. Given our understanding of the Committee's objectives for this hearing, I have refrained from going into too much detail today with respect to our thinking on how to move this topic forward in coming weeks and months. We at USTR look forward to working with the Congress and the private sector to develop further our ideas on how to respond to the WTO ruling and other aspects of this important issue.

Thank you and I will be happy to answer any questions you may have.

Chairman THOMAS. Thank you very much both of you.

As I said in my opening statement, reinforced by my colleague, the Ranking Member, working a solution to this will be difficult, one, because it is hard, and two, because anyone who wants to—may or may not be true—but anyone who wants to can twist this in terms of a partisan reason for trying to change the Tax Code. I guess the first question that I need to ask to reinforce where we ultimately need to go is, do you believe there is any response that will have a lasting result short of changing the Tax Code?

Ms. Angus, can we do something other than changing the Tax Code to respond to this. It probably is a yes or no question.

Ms. ANGUS. In terms of the issue of tax changes, given the WTO's analysis of the WTO rules, we do think that significant change in the system would be necessary and that legislation that simply replicates the FSC or ETI provisions would be unlikely to pass muster.

Chairman THOMAS. Or is anywhere in the ball park of replicating or looks anything like it? Do you agree with that?

Ms. ANGUS. We need to look at this much more fundamentally and examine the whole range of possible ways to address the decision while ensuring that we continue to help maintain that level playingfield for U.S.-based businesses.

Chairman THOMAS. In your oral testimony, you used the term "disappointed" twice—we were disappointed. Well, all of us were disappointed that the Europeans didn't continue to honor the gentleman's agreement. Were you surprised?

Ms. ANGUS. I certainly was disappointed.

Chairman THOMAS. The point is that there is a legal argument to be made, but some of us who are not attorneys or legal or constitutional scholars have lived this. We were on the Committee when we marched through the alphabet with the Domestic International Sales Corp. (DISC), FSC, and up the hill on ETI. Has the Administration, or at least that portion of the Administration which this Committee has to work closely with in dealing with our laws, come to the conclusion, and I believe you said it, but I just want to underscore it, that we can't continue down the same similar trail and expect the Europeans to honor what, at one time, had been a gentleman's agreement, not to probe?

Ms. ANGUS. Again, in light of the decision of both appellate bodies and their fairly compelling statements rejecting that gentleman's agreement, taking the position that it had no continuing relevance under the WTO rules, we are faced with a situation with the appellate body's analysis of those rules, that legislation that takes a similar approach is not likely to pass muster at all.

Chairman THOMAS. I don't need to get more out of an attorney than that. I would appreciate more, but I will accept that. Not likely. I think that is an understatement. Can we get away with doing nothing?

Mr. DAVIDSON. Mr. Chairman——

Chairman THOMAS. And what are the consequences of doing nothing?

Mr. DAVIDSON. I think doing nothing and this comes from the conversations that Ambassador Zoellick has had with Commissioner Lamy and that we have had with a number of Member States and other Europeans. I think the comments you made in your opening remarks that retaliation is not an empty threat is accurate. I think that the United States taking a position that we need to do nothing to comply with the appellate body's decision would invite retaliation.

And I applaud the Committee for taking the step of having the hearing today and talking about the positive steps that we are going to make because Commissioner Lamy has made it clear, both in private and in public, most explicitly in the press conference, in meetings that he had with Ambassador Zoellick last month, that the EU will be looking for solid steps of progress in terms of what the Administration and Congress are going to do working together to move forward on this issue. And if we are doing that and it appears to the Europeans that we are taking our obligations seriously, that he believes it is possible to hold off retaliation. It is yet to be seen what level of retaliation will be authorized. Whatever level is authorized, it will be one of the largest, if not the largest amount in the history of the—short history of the WTO. So I think it is something that needs to be taken very seriously.

Chairman THOMAS. Well, if we agree that we can't stay where we are, which is the now and we have to go somewhere which is the then, between now and then, we will be looking to diplomatic initiatives to get people to understand that getting between now and then is difficult. It just so happens that I had a very interesting conversation with Mr. Superchi in the World Economic Forum up in New York and I found it ironic as he was talking about taking over the leadership of the WTO and some of the sensitive issues that they were going to have to face, he immediately presented to me two dates around which he needed to work, August and September, involving the parliamentary elections in France and the ministerial or the executive elections in Germany.

The Europeans have been very successful in selling how difficult it is to make change during the season of elections. I think you just heard from the Ranking Member that we will move forward on this, but it is very difficult for us to make change during the season of our elections as well. So I would hope that the Ambassador conveys to Mr. Lamy that there are other elections that people should be sensitive to and they are in November of this year and that we

will be moving forward on statutory changes to the Tax Code to comply with the WTO ruling.

But if we are not successful by the time of the election, it is in great part due to the fact that we do have elections and that we will address this issue and we will resolve it. But to expect us to resolve these difficult fundamental issues in an election season when everyone else gets an automatic pass from difficult decisions, because it is an electoral decision is a point I think that this Administration needs to stress with our friends as we look at the calendar that you outlined in terms of potential pitfalls along the way to a resolution of this concern.

We will be holding hearings on ways in which we can resolve this problem. But I also want to underscore what my colleague from New York said about the role that this Administration needs to play. You cannot follow and expect Congress to lead in this difficult issue. We have to be full working partners. And to a very great extent, given the brilliance and the talent and the expertise in both the USTR and in the Treasury, if you could come up with some potential resolutions that you could present to us, it would be a very great help in us moving forward. I believe we understand our responsibilities. I am not comfortable with the timeframe. It is going to be very difficult. To the degree you can buy us some time on our way to resolving the issue, it would be greatly appreciated, and to the degree you can present some potential solutions to the problem, that would also be greatly appreciated.

Mr. DAVIDSON. Mr. Chairman, could I respond to that briefly? I do think Commissioner Lamy and many in the EU understand the complexity of our system, and particularly, I think they understand the difficulty of dealing with tax legislation. Mr. Rangel referenced the complexity and difficulty of that issue in his statement as well.

So I think that there is a sound understanding. At the same time he has been very clear that he needs to see signs of progress throughout that—in the near future and very quickly. That doesn't mean—I take that as meaning that the end of the process he understands is a long time, but there are a number of steps in the interim that progress needs to be shown.

Your point about the elections in the EU I think is a very good point. This issue must also be seen in the context of the overall trading relationship and there are a number of controversial issues we have with the EU. When we have things that we are concerned about they make the point to us about we have political problems in some of our Member States, we have elections, this is going to be a difficult issue to resolve for awhile, have patience with us. I think your point is entirely accurate as well to be able to make the same point to them here. It is not a process that can be created quickly. And particularly when you are talking about the kinds of fundamental reforms that you are talking about.

In terms of the Administration presenting alternatives and interaction with the Congress, we have every intention of being full working partners and engaging proactively in putting forward some ideas of what we can move forward on, but we are going to need some help and interaction as well so that we can share some of these ideas and get a feel for whether they are moving in the right direction.

In that vein, I know that Secretary O'Neill, Ambassador Zoellick, Secretary Evans, and others are looking forward to creating a more formalized consultation process which I am sure they will be talking with you about so that we can put that full working partnership into effect in a way that moves expeditiously, at least in the interim steps toward moving toward some consensus solution. Thank you.

Chairman THOMAS. Thank you. Just so you clearly understand, the statements of my friend from New York were not taken by the Chairman as a threat or a promise. They were understood to be factual statements about the reality of the situation that we are in. The Congress—and Europeans are sophisticated enough to clearly understand our system—that clearly Congress needs to forward. But to the degree they don't see the cooperation and more importantly the understanding of the need to move forward from the Administration, they can rightly believe that we are not presenting as broad and honest an approach in trying to resolve the issue as we could. So it is going to take a full partnership. And we cannot be Alphonse and Gastone asking someone else to go through the door first. You don't wait for us, we don't wait for you. Both of us need to move forward. And the argument that somehow you have to have a formal invitation to help us address an international problem is not what I really want to hear.

What I want to hear is, you folks get it, we have got to change, notwithstanding the difficulty of the change, we are beginning with this hearing and we will move forward. Now is behind us and then is in front of us. Between now and then, our diplomatic and legislative and executive efforts, all of us have to be part of this team pulling together. I know we will. And I appreciate your testimony.

Gentleman from New York.

Mr. RANGEL. Well, I feel a little awkward in agreeing with almost everything the Chairman has said. And I don't really like the idea of foreign governments making the determination as to how quickly we are making progress. You see Mr. Davidson, your office has a very responsible diplomatic role to play. But it is the Secretary of the Treasury that has a real realistic role to play in giving us a road map as to what the Administration would like to see the objectives to be. It is never easy making dramatic changes in the Tax Code, and when the Chair asked the question, do we have to change the Tax Code, that is all we do is change the Tax Code. We change it, it doesn't mean we reached the results that we would want.

So that you could be disappointed, but you had a series of disappointments because we never really reached a point that we found an international legislative resolution of this problem that has been hanging over our heads for decades. Now I think it is safe to say that the Chairman and I have not built up a reservoir of bipartisanship that the Administration can rely on. And that means that no matter how much of us have love for our country, that we just can't wave the flag and move forward and say we want to accommodate USTR and our friends in the European Union.

We have to find out just what changes—how these changes are going to impact on American taxpayers, on American industry, whether they would be a flight of American industry if we changed

the tax system so there is no corporate taxes. It is very complicated, but a very political decision—very political decisions have to be reached.

So I think what the Chairman is saying is, you can't—you should not rely on us in coming up with the answers alone. We will do what we have done in the past and we have supported each Administration, Democrat and Republican, to let our foreign friends know that we intend to be treated fairly on this issue. But if you leave it up to us to come up with solutions that tear us apart without having your help in bringing us together, then whether or not progress has been made, it will just be a moot issue.

So I cannot think of an issue more than the war that should bring us together in a bipartisan way to try to work out before we go public, and so I am glad that the Chairman has restricted the testimony this morning to the history of what got us to where we are.

And I don't know what the Oversight Subcommittee is going to do, Mr. Chairman, but I hope that the fireworks are kept down to a minimum over there until we can get a handle as to which road we can walk down to comfortably, and then just try to work out the details to it. But if we are going to have a dramatic change in our tax law, we can just hope that the Administration helps us to progress quickly toward resolution of this long time problem we face.

Thank you, Mr. Chairman.

Chairman THOMAS. Thank you very much. As the gentleman from New York can see, there are no TV cameras at the full Committee, and the chances of a TV camera getting to a Subcommittee are even less. So our purpose of moving the issues of resolution to a Subcommittee is clearly to pursue options that not only seem to be viable but acceptable. And it will be a difficult road.

Mr. RANGEL. If I may, I think the Administration had suggested, or at least Mr. Davidson, that we might have some informal meetings between Mr. Evans, O'Neill, and USTR and Members of the Committee.

Chairman THOMAS. Let me suggest that what the Administration has proposed, my understanding is that they are going to put together a working team among the Administration and that they will bring outsiders and academians, laypeople and others in looking at options that they have. My encouragement is that they move fairly quickly through that process. We can meet informally or formally. I think work product is the most important thing, and that if they are able to come up with some suggestions as the gentleman has indicated repeatedly, we need them as soon as possible.

Mr. DAVIDSON. Mr. Chairman and Mr. Rangel, if I could just clarify my statements, I completely agree with your assessment that we need to move together on this and work closely and work quickly. I did not mean to imply in any way that we should hold back on either of the fronts before one of the other front was moving forward. I applaud the Committee for having the hearing today, beginning the process of looking at where we need to go in the formal setting of a hearing room. I think that the informal process and consultation needs to move forward simultaneously. But I don't

think we can wait on any one stage to move forward on all of them. And that is our position.

Chairman THOMAS. Gentleman from Illinois, the Chairman of the Trade Subcommittee, wish to inquire?

Mr. CRANE. Thank you, Mr. Chairman. Ms. Angus, what types of fiscal alternative proposals are being considered to keep U.S. businesses competitive in the global marketplace?

Ms. ANGUS. We believe that we need to consider the full range of options, all possible alternatives that will address this issue, but as you say, ensure that we maintain the competitiveness of U.S. businesses and their workers. We need to thoroughly examine the U.S. international tax rules. Those rules were first developed 40 years ago when the global economy and the U.S. place in that global economy were very different than they are today. We need to look at all of those rules from the beginning in order to find a way to address this issue that doesn't disadvantage U.S. businesses.

Mr. CRANE. Well, I would hope that you would incorporate in your considerations a total repeal of any tax on business whatsoever. I pushed for that for the entire time I have been in Congress, but before that, when I was teaching. And the thing that is so disturbing about taxing business is that they don't pay taxes. They gather taxes. That is a cost, like, planned equipment and labor, and you have got to pass it through and get a fair return or you are out of business.

And there are countries that are providing that kind of window of opportunity, and there are American businesses running to places like Bermuda because of it. And I would hope that we might consider something wholesome and healthy like elimination of that stupid tax all together. And I yield back the balance of my time.

Chairman THOMAS. Now that oil has been poured on troubled waters, gentleman from Michigan wish to inquire?

Mr. LEVIN. I am going to try to take back some of that oil, Mr. Chairman.

Chairman THOMAS. As long as you don't light it.

Mr. LEVIN. No. Indeed, within the bipartisan spirit the two of you preceded the Chairman and Ranking Member, I want to try to cast this in a somewhat different light, not only for those of us in this country, but for those in Europe and the WTO. First of all, we have gone over the background and I hope that there is not only a sense of disappointment in this country, but really a sense of outrage.

This was more than a gentleman's agreement. After the General Agreement on Tariffs and Trade (GATT) decision in the early 1980s, this thing was worked out through the GATT council with an official understanding. And we, as a result, passed legislation in 1984 as we all know. That legislation was an effort to fulfill the understanding that we had on this issue. And for the next—1984.

And for the next decade plus, that approach prevailed. It wasn't seriously challenged. It wasn't raised in the Uruguay round when the Europeans could have raised it and it was only after the Europeans lost a series of cases really that they raised this issue. And I think everybody should understand that—this background, so that is point one. It was more than a gentleman's agreement. It was a—it was a structure that was enacted pursuant to discussions

within the GATT, and it was the structure that prevailed without any serious challenge until the Europeans lost a series of cases. Number two, I don't think we should act as if this is a dagger at the United States. What this is is a dagger at the U.S. and European economic relationship. I don't like the nuclear trade bomb description very well.

Mr. Zoellick said trade nuclear bomb, not nuclear bomb. But if it is a trade nuclear bomb, that means that both sides better be weary about its use. And I think the same is true if you call it a dagger. In this respect, Mr. Davidson, I want to read back to you your testimony which I assume has been cleared by USTR and I think the Europeans should listen to this, and I am not saying anything that I haven't said to Mr. Zoellick and this is on page one. The solution will be found in an appreciation of the need to move the global trading system forward to advance the U.S.-European trading relationship overall, and at the same time, to find a solution to this dispute within which all parties can prosper.

Now we should embrace that language and make it clear to the Europeans and everybody else that this dispute is a threat to the global trading system. And if anybody tries to grab it to their advantage, they are, I think threatening the global trading system.

And so, we are not the only ones who should have a concern about this. So should the Europeans, and for them to think there is a major tactical advantage here I think is, for them, a serious mistake. And therefore, I want to make one last point. The Chairman talked about the difficulty of moving this in an election season. That is part of it, Mr. Chairman, but it is not only because this is an election year. These are exceptionally difficult issues. Mr. Crane says he has been advocating the change of all of his years here. That is what, Mr. Crane, 3 decades?

Now maybe that says something about the substantive difficulties. Mr. Davidson, when you talk about signs of progress, let the Europeans not misunderstand that there is an easy solution to this in terms of American policy because there is not. There are deep differences and they cannot expect to use a temporary tactical advantage to expect that there will be major tax changes in this country in any foreseeable future. We can work on it and I am glad we are going to do it, but there should not be false expectations here. And I don't want to make it difficult by saying zero will happen because if Mr. Lamy wants something to point to, we should give it to him.

But—and we will work on this issue but this is not mainly an election year issue. And their advantage is, I think something that can come back to haunt them. I told Mr. Lamy, he is like the dog that caught the bus, and I hope he takes it seriously. We didn't raise this at Doha. We didn't raise it before Doha, and we need to raise it now.

And Mr. Davidson, I will finish by saying I think the words here about where the solution will lie is surely something that should be taken seriously. We will work hard on legislation but the Europeans should understand the ramifications of action on their part challenging a structure that they lived with for more than a decade without challenge and did not really challenge until they lost a series of cases in the WTO.

Chairman THOMAS. Thank the gentleman. I want to underscore the point that he made. I did start out in my statement by saying that this is going to be very hard to do. I pointed out the elections and I stand corrected. The French elections are on April 21, and Germans in September, because that is what they always use as an excuse. And I wanted to lay the groundwork that, in fact, we have a pretty darn good one as well. But clearly, the gentleman from Michigan's point is well taken. The primary reason we may not be able to resolve this in several months is underscored. This is going to be a hard thing to do. Gentlewoman from Connecticut wish to inquire?

Mrs. JOHNSON OF CONNECTICUT. I thank the Chairman, and I too join the gentleman from Michigan in expressing my very strong concerns that after living with a regimen that was agreed to by both sides for over a decade, that they should have raised this. On the other hand, it is extremely important to us as a Nation that we have a rule based enforceable trade structure and that issue of abiding by decisions is just extremely important to America.

If we can't enforce the intellectual property provisions of the World Trade agreements, we will be the ones to pay over and over again, and it will, in the end, have a serious effect on our economy. So we depend on a rules-based system. This has gone against us. We do have to find a way to deal with it. It will take time.

But I want my colleagues on this Committee to—I want to just express to them and to you that I hope that we will deal with this issue at the same time we look at what is causing the American Tax Code to drive international mergers to be controlled by foreign entities.

We had testimony before this Committee that DaimlerChrysler is DaimlerChrysler because of our Tax Code. It could have been Chrysler Daimler. And we see now that they are downsizing. Where is the power when the tough decisions are made? They are being made out of Germany. They are not being made out of America. We had testimony behind closed doors, and we had statements behind closed doors in some of the big international bank mergers that they are going to be foreign-owned, primarily because of our Tax Code. Last year or year before we saw insurance companies organizing in Bermuda.

Now we are seeing tool makers organizing in Bermuda because it saves them millions and millions of dollars without laying anyone off or other consequences. So we do have to look at how our Tax Code is driving control over major actors in our economy offshore, and often into foreign arms. And I just think we need to look closely at that and maybe from looking at that, we will find things that also might solve this other problem or move us in a direction that will make us somewhat more harmonious with the world, because I think our tax structure is beginning to drive jobs abroad just like a few decades ago, some of our environmental regulations drove the cost of production so high that jobs went abroad. Now those things are beginning to even out at least in some parts of the world. But our Tax Code is now showing evidence of driving jobs abroad, the movie industry and all across the front. So we have our work cut out for us and we need you and the Secretary of the Treasury to begin to put a strong shoulder to the wheel. Thanks.

Chairman THOMAS. Gentleman from Washington, Mr. McDermott wish to inquire?

Mr. MCDERMOTT. Thank you, Mr. Chairman. Seems to me like you walked into a lecture hall here today and hearing lectures. And I just would make a discussion that when you put that panel or working panel together, you try and make it an open one so that we don't have any trouble with people deciding decisions being made behind closed doors. But one of the things that strikes me as I listen to this whole thing—and I think Mr. Crane is the most honest man on the Committee. At least he will put a plan on the table. Nobody else. But I have been sitting here listening to this baloney for 8 years now and nobody will put a plan on the table. Everybody says, well, we will figure it out, we will go back and we will challenge them and we keep losing.

We have done it a couple of times and you ought to learn after the second one that this isn't going to work. But I think you can count on this Committee for doing nothing. We are not going to do anything until you do something.

I think that the record in the course of last 8 years has been actually we have done very little. Now, I used to represent one of the major exporters of this country. I still represent some pieces of it, but the major piece went to Chicago. And I don't know—I used to worry about this FSC thing, but I don't worry about it anymore because it looks to me like it is permanent employment for tax lawyers and trade lawyers because nobody seems very worried about this thing.

Can you give me a cutoff date when we are really going to get slammed, or is this thing just going to go on forever, we will be looking at this when I retire in 25 years, and we will still be thinking we are going to deal with FSC one of these days? Is this just passive-aggressive on our part?

Mr. DAVIDSON. Mr. McDermott, I can't give you a specific date by which there will be retaliation and I can't tell you, regardless of the retaliation—that is actually given to the EU by the panel—what amount they may choose to proceed with. All I can say is that in conversations with Commissioner Lamy and others and Member States, that I don't think—they will not be hesitant to retaliate if they believe that we are going to go through another what you said, 8 years of doing nothing. So I don't know when the cutoff date is.

It seems to us from all the indications that we have seen—I was in Europe a couple months ago meeting with some Member States, and I received the same message from them. So I think that it is a question of looking at what—what our government is doing, how serious an effort they are taking toward—steps toward reforming the system, and I think that if we don't take those steps——

Mr. MCDERMOTT. What steps did you suggest—I mean, I heard there was some progress. What steps did you tell the Europeans that we were taking toward a resolution of this? We are going to form a Committee? Is that what the progress was?

Mr. DAVIDSON. No. We didn't give a specific list of things that we were doing, procedures we are going to be taking, other than to say that we are going to be working closely with you, with Congress, in terms of moving forward on the issue. Now, I am sure their re-

sponse is well, you know, we will believe it when we see it; the jury is out and so——

Mr. MCDERMOTT. But there is nothing in the rules of the WTO that gives them a date where they can say, look, March 1, you either do something or here comes the penalty?

Mr. DAVIDSON. Once they get the—on April 29 or thereabout, there is a perfunctory procedure——

Mr. MCDERMOTT. Perfunctory?

Mr. DAVIDSON. Well, there is one more—once they get the number from the panel, there is one more stage which they have to go through but that is perfunctory——

Mr. MCDERMOTT. The panel has to decide how much to finance——

Mr. DAVIDSON. Find how much, and then for all practical purposes essentially they can retaliate to that amount in a WTO legal manner. They don't have to wait. There are some—hopefully some consultations that go on, but——

Mr. MCDERMOTT. So Boeing airplanes could go up in price, 10 percent or 5 percent or something else, on that day.

Mr. DAVIDSON. That is right. That is right. And there is no——

Mr. MCDERMOTT. The 29th of April, when we have just laid off 30,000 people.

Mr. DAVIDSON. But there is—there is no deadline by which they have to exercise that authority; so there is an opportunity for us to continue to work through the issue to—we have established quite an arsenal of weapons here, from daggers and nuclear bombs and things like that and——

Mr. MCDERMOTT. I am more worried about price increases.

Mr. DAVIDSON. An effort to prevent that from happening I think is what we are here talking about; what is the process that prevents that from happening? And to answer your question, there is simply no set date. They can delay as long as they would like to delay before imposing retaliation, but retain the ability to do so.

Mr. MCDERMOTT. Are you betting that they will just let it ride a while?

Mr. DAVIDSON. No. I think, Mr. McDermott, our belief is that if the EU does not see what they consider to be credible progress in terms of us moving forward, that we face a high likelihood of some type of retaliation.

Mr. MCDERMOTT. So you think—if they see a Committee, do you think they would think that was credible progress?

Mr. DAVIDSON. Mr. McDermott, I can't speak to what they would see, but I think—I think what they are looking for is a credible process and that is—that is, you know, actually making some progress toward talking about the kinds of things that the Chairman was talking about and Mr. Rangel was talking about earlier.

So I don't think—if your question is can we hold a series of meetings and hearings and things like that and hope to hold off retaliation if there is no substance there, I don't think that that is going to be sufficient.

Mr. MCDERMOTT. And the substance would be a proposal on the table that we were considering—or what would the substance—I would like to know what the substance is that I need——

Mr. DAVIDSON. The substance would be a substantive discussion of options.

Mr. MCDERMOTT. Thank you. That sounds pretty clear to me.

Mr. CRANE. If the gentleman could yield for just a moment, he made a reference, and I expressed appreciation for his nice compliment, but we lost this distinguished gentleman from Chicago. He moved out to Seattle, and Seattle graciously traded off by giving us Boeing. And what we both want to guarantee is that Boeing doesn't become Lufthansa-Boeing.

Chairman THOMAS. The Chair would now like to recognize the gentleman from New York, Mr. Houghton, if he has a question or two.

Mr. HOUGHTON. Yeah. Thanks very much. I would like to make a couple of statements and then have you challenge them. First of all, I see no way in order to help a business to solve this thing in a hurry, because if something else has to happen to our tax structure it is going to take a long time. You know how the process works around here. We don't even have the ideas. Take a long time.

So something in the meantime, in the interim, has to come into play. And frankly, the only thing that I can think of, and challenge me on this, is that we—we say to the Europeans we are going to have more time on this thing. We are working on it, we are doing whatever we can, we are not going to be put on the defensive, and frankly if that is not good for you, then we are going to start challenging you.

I mean, we have just been over in—Mr. English and I have just been over at a meeting in Germany, and they are complaining about some of the steel cases, the 201 situation, forgetting entirely that they upheld—they invested in the steel industry from the government. I mean, that is something which we can challenge.

I don't know what happened as far as the foreign source income used by the tax regimes of Belgium, France and Netherlands, whether that was resolved or not. But they are not lily white clean on this thing, and frankly the only thing we can do—and, again, challenge me—is to say we have got to have time on this thing.

Now, as far as the—as far as the taxes are concerned overall, I am not convinced that—that ChryslerDaimler would have been ChryslerDaimler if we had had a different tax situation. The fact is that Daimler had more of the stock, and that is pretty clear to me, and therefore they call the shots on this. There are always going to be places you can go.

I know there was a wonderful suggestion at one time that the ideal situation would be for a business to own an island, and then have the domicile of that business on that island and establish its own tax rules. Well, that may happen in the future and they are going to be trading back and forth, and the question of where you can get the best price and the best cost structure, but those are big, big, big issues; and at the moment, it seems to that we must bide for time, and if we don't, then the people that we are trying to help are going to go under. Four billion dollars is not an inconsequential price tag. Maybe you can comment on that.

Mr. DAVIDSON. Mr. Houghton, I concur with you completely and we have made the case strongly to the Europeans that we need

time to comply. And in fact, you know, we have been working with them throughout my entire tenure at USTR for the last year or so on pushing hard on that area, and I think they do understand the complexity of this area. So we have made that case forcefully.

In terms of talking about if you were heading in the direction of filing other cases to provide leverage or something like that, for strategy like that to—I think there are some concerns about a strategy like that. You have to have—you actually have to have some arrows in your quiver that are of commensurate value, and second I think such a strategy runs the risk of a never-ending cycle of litigation that doesn't actually help you solve the underlying problem.

I think if you look at—the bananas dispute that we have been working on is a good example. You know, counter cases to the bananas dispute I am not sure would have helped us reach a resolution. Instead we rolled up our sleeves, got down to work, and we actually worked out a resolution on that case and it took some time—it took some time to do it.

I think what is going to drive the resolution of—and this is my own opinion, but I think what will ultimately drive the resolution of this will be both sides looking at it seriously, working hard, and looking at it in the context of the overall U.S.-EU relationship. We have got a lot at stake in terms of the positive trade liberalizing agenda and we can't allow disputes like this to throw those important initiatives off track.

We have the launch of the new round in Doha recently. Both the United States and the EU were instrumental in moving that forward. Both sides have a real interest in moving the broader context forward, and so I think that is the positive incentive to work through this issue and come up with a result that will actually get us there as opposed to more negative incentives. That is my own personal opinion.

Chairman THOMAS. Thank you. The gentleman from Massachusetts——

Mr. NEAL. Mr. Chairman, could you come back to me after we vote?

Chairman THOMAS. Well, I think everyone would like to do that, and, if in fact, we are not going to be able to carry on the hearing, do we have just—the Chair understands it is a vote on the rule, and so there are other Members who wish to inquire, the Chair assumes. Let us then say that we will reconvene at 20 minutes after 12, and if you will allow us to do that and remain, because there are further questions by Members of the Committee, the Committee will stand in recess until 12:20.

[Recess.]

Chairman THOMAS. The Chair wants to thank the representatives of the Administration. Holding hearings during voting clearly means we have to do two things at once sometimes, and we are not able. The gentleman from Louisiana wish to inquire?

Mr. MCCRERY. Yes, Mr. Chairman. First of all I want to thank Chairman Thomas. I and the other Members of the Select Revenue Measures Subcommittee appreciate the opportunity to move this process forward and to seek a legislative solution to this matter. So

we will be working on that at your direction, Mr. Chairman, and look forward to working with you to accomplish that goal.

I would like to pose this question to either of you or both of you, and it concerns the question of jobs in the United States. Can you tell us how the FSC or ETI rules affect jobs here in the United States, or does it have any effect on job creation or job retention here in the United States?

Ms. ANGUS. The ETI provisions, as a part of our international tax rules, help to allow U.S. companies to compete better in the international marketplace, and that in turn allows them to expand their production, investment and employment here in the United States. So these provisions, by allowing them to be more competitive in the international marketplace, in the markets where the customers are and where they need to compete, allow them to produce more here in the United States and employ more workers here in the United States.

Mr. MCCRERY. That is the right answer. Mr. Davidson, I guess you don't have anything to add to that.

Mr. DAVIDSON. Yeah. Mr. McCrery, I don't really have any economic data to back up any different opinions, so I defer to Treasury on that analysis.

Mr. MCCRERY. It sounds like she was well prepared for that. Now I would like for you to talk about this distinction between direct and indirect taxes and what difference that makes in terms of the WTO and the rules allowing indirect taxes to be rebated at the border. Can you give us a little background on that, explain that a little bit?

Ms. ANGUS. The United States imposes an income tax which is considered a direct tax. Under the trade rules as I understand them, direct taxes are not border-adjustable. So under the trade rules the U.S. income tax isn't—isn't and cannot be—rebatable on exports. An indirect tax is a tax on transactions, goods or consumption; in other words, a tax that isn't on income. The definition seems to be that indirect tax is anything that isn't a tax on income. Value added taxes and sales taxes are considered indirect taxes.

As I understand the trade rules, a tax is considered a border-adjustable indirect tax if it is levied on the destination principle. Under the trade rules, a tax is not border-adjustable if it is levied on the origin principle. There are some indirect taxes that are levied on the origin principle. Direct taxes, like income taxes, are levied on the origin principle. I think on the next panel, Mr. Hufbauer in his testimony traces this distinction in the trade rules between the treatment of direct and indirect taxes all the way back to a 1960 GATT, General Agreement on Tariffs and Trade, working party.

Mr. MCCRERY. And what difference does it make if indirect taxes are rebated at the border? What practical effect does that have?

Ms. ANGUS. Well, I think that the real issue is one of consistent treatment; the treatment on the way in, and the treatment on the way out. This distinction under the trade rules on how they allow income taxes or direct taxes to be treated versus how the rules allow indirect taxes to be treated is one that has long historical roots. I think the economists will tell us that the distinctions in incidence between direct and indirect taxes really shouldn't be rel-

evant for purposes of determining whether one or the other should be border-adjustable.

Mr. MCCRERY. But the practical effect of allowing indirect taxes to be rebated at the border, and not direct taxes as they are defined by the WTO, is that a product coming from, say, France, which has a price attached to it, part of which is the value-added tax, the indirect tax, when you subtract that part of the price, what happens to the price that we pay in the United States for that product? It is reduced, isn't it? Whereas the same product emanating from the United States, going to France, and the tax component is an income tax, that can't be rebated at the border so you don't get that reduction of the price, right?

Ms. ANGUS. Yes. And another aspect of this difference in treatment between income and non-income taxes, direct and indirect taxes, is that should be looked at in the context of the fact that the United States has a tax system that is heavily reliant on an income tax, whereas while other countries do have income taxes, a larger portion of their tax is made up of consumption taxes for which these border adjustments are permitted.

Mr. MCCRERY. Thank you.

Chairman THOMAS. I thank the gentleman. I guess that was a discussion with a lawyer about what goes on in terms of rebatable taxes at the border. I noticed during that discussion the long-time Trade Subcommittee Chair of this Committee and the interim Chairman of this Committee, the gentleman from Florida, Mr. Gibbons, came in, and I know he followed the lawyerly argument there; but I think probably if you will allow me for just a moment, a perhaps more English answer would be that the Europeans have a tax structure which allows them when they export products to rebate a tax, and when products are brought into the country, to impose it.

Let me put it another way. Since we use an income tax, and we have taxes and some of the taxes that are the largest part of our tax system are social welfare costs, the Medicare and the Social Security Trust Fund moneys, that those costs are embedded in our products, whether they are in this country or whether they go oversees. So we have social welfare costs embedded in our products domestically or internationally.

When the Germans or the Japanese or any other major industrial country with which we trade—as I said in my opening statement, we are the world's largest importer and the world's largest exporter. When their products remain in their country, it is true their social welfare costs remain, because those taxes have been added to their product domestically, whether it is Germany, Japan, or another country. But when they export those products, they get those taxes rebated, so the social welfare costs are lifted from the foreign products going into the United States. But when the U.S. exports into the EU, Japan, or any other major industrial country, those taxes are added. So we carry the embedded social welfare costs for the United States, and we carry the additional social welfare costs of every other country we export products into. But the Europeans coming to the United States have had that tax lifted. So they come into the U.S. market, the world's largest trading market, unencumbered to a very great extent by those taxes. They go

on the shelf in direct competition with U.S. products that have those taxes embedded in them.

So in one of the most fundamental ways, we are at a disadvantage by our unwillingness to change our Tax Code, and every other country with which we trade is advantaged by their Tax Code on social welfare costs.

Let me put it a bit more practical way. The United States pays the world's social welfare costs along with ours, and we don't have any other country sharing the paying of our social welfare costs because of our tax system, and we have tried to modify that slightly. That is why we are here. We have to address the fundamentals. And it seems to me—this is an editorial comment. We are not supposed to look at the future at this hearing, but it seems to me that if we come up with a solution to our current dilemma and don't deal with the rebatable tax question, we have not really taken advantage of an opportunity to make a change that puts us on a level playing field in terms of those rebatable taxes. That does narrow our options. But for us to go back into the tranche of income is to continue to pay the world's social welfare costs, and the world doesn't help us with ours. And that is an undercurrent that will continue throughout all of the discussions as to what our response will be in dealing with the ETI, Foreign Sales Corp., DISC, or any other attempt to take away the advantage the Europeans have because of their tax systems.

And I thank the Committee for allowing me to lay that out, because it is an issue that we are going to have to face. The gentleman from New York.

Mr. RANGEL. Mr. Chairman, I hope that my silence is not interpreted as being supportive of what you said.

Chairman THOMAS. Whether the gentleman is silent or voices his opinion, I have never assumed it is supportive of what I say.

The gentleman from Massachusetts wish to inquire?

Mr. NEAL. Thank you, Mr. Chairman. Just one—since you editorialized, let me do the same for just a couple of seconds. Mr. Chairman, despite the talk that we heard around here, for a considerable period of time beginning in 1992, 1993, 1994, we are no closer to a flat tax today or no closer to a consumption tax. I mean, it sounded great in terms of campaign sloganeering and all those things, but a fundamental discussion of simplification is a good starting point for all of us, and I am convinced we can find some middle ground.

But, more to the subject at hand. Ms. Angus, we have heard some comments today, and I expect we are going to hear a few more about some U.S. corporations becoming fed up with our U.S. tax system and leaving the country. Some have advocated fundamental tax reform, which will certainly take a lot of time to implement. But in the meantime, how might you respond if individuals decided that they, too, were fed up with the tax system and they decided to decamp to the Caribbean?

Is the Treasury Department disturbed about this trend? Do you have any proposals to stop these departures, either corporate or individual?

And we have also heard that some of these corporations must decide between layoffs and paying their share of U.S. income taxes.

Tough decisions indeed. What if a company shuts down the factories and moves offshore to avoid U.S. tax, and does the Treasury Department have a concern about this?

There is this great aura of patriotism that surrounds the country, and then there are those who in the next breath argue that somehow paying their share puts them at an anticompetitive position. We have read some disturbing news accounts. I assume that there are some discussions taking place within Treasury about what has been happening. And what is the long view of Treasury in this instance?

Ms. ANGUS. Thank you. We need to look carefully at these transactions that have been reported recently to understand exactly what is being done from a transactional perspective and also from a tax treatment perspective. We need to understand the impact at the corporate level. We need to understand the impact at the shareholder level. We need to make sure that the transactions are properly reported and that our laws are complied with.

We also need to examine why U.S. companies are entering into these transactions. We need to look at all the factors, tax and nontax, that may be encouraging a U.S. company to undertake this type of reorganization. An examination of the U.S. tax rules that affect international business certainly needs to be a part of that exercise.

Many parts of our international tax rules were developed 30 to 40 years ago. As I noted earlier, it was a time when the global economy looked very different and the U.S. place in that global economy was very different. We need to make sure that our international tax rules operate efficiently and appropriately in light of the current global environment. We need to make sure and address any ways in which our international tax rules may be impeding the ability of U.S. companies to compete internationally, and if there are aspects of our U.S. tax rules that are driving companies to consider this type of transaction, we need to understand that and understand why it is happening.

Mr. NEAL. Based upon preliminary discussions that you have had, would you be prepared to characterize any of what you have witnessed as tax avoidance?

Ms. ANGUS. It is very difficult to characterize anything. We certainly need to look at all of these transactions carefully. We certainly do need to make sure that our tax laws are complied with and that everyone is bearing their fair share of tax liability, and there are a number of things that we are doing in that area in a whole range of areas.

Just one particular project for which the Secretary, Secretary O'Neill, has made a major commitment, looking at internationally, is the need for us to be able to have the information about cross-border transactions so that we can enforce our tax laws.

We do everything we can to enforce our tax laws, but there are sometimes situations, particularly when you are looking at a transaction that crosses a border, where we need information from another country to ensure that our tax laws have been properly complied with. The Secretary earlier this year made a commitment that he was going to expand our network of arrangements that would allow us to have the appropriate information exchange with

other countries to get the information we need when we suspect that someone may not be complying with our tax laws and may be using the institutions of another country to avoid our tax laws.

We think it is more important than ever not to allow the financial institutions of any country to be used for any illicit purpose, including cheating on taxes. And so we are very pleased that we recently signed three new information exchange agreements with significant financial centers, and we are working to continue that, all to the end of having the information that we need to ensure that our laws are complied with.

Mr. NEAL. Mr. Chairman, can I just finish for 30 seconds? Thank you. I think I totally agree with the second half of your answer. I thought it was very good. But might I point out that when we talk about competition, that the people that are visiting my office, the corporate representatives that are coming to my office that are upset about this, they are arguing that their competitive position is being compromised by this occurrence, and I think we have to keep light of that as well.

Some of my best employers think this is outrageous that this is happening, so I am not driven here by some notion of wealth redistribution as much as hearing from those who do abide by the rules, who do pay their fair share. They are great employers and they feel very strongly that they are being put at a disadvantage by what they are witnessing.

Thank you. Thanks, Mr. Chairman.

Chairman THOMAS. Thank the gentleman. The gentleman from California, Mr. Herger, wish to inquire?

Mr. HERGER. Yes. Thank you very much, Mr. Chairman. And, Mr. Chairman, I want to thank you for the comments that you just previously made. I feel that you very accurately described and outlined the situation that the United States is both the largest importer and exporter of goods of any nation in the world.

My question, beginning question, one of a couple to you, Ms. Angus, comes from someone who has the privilege of representing one of the richest, most fertile, and productive agricultural areas in the world, the northern Sacramento Valley of California. We produce a major percentage of the world's peaches, walnuts, almonds, dried plums, all of which we in California and the United States cannot consume; we are dependent on exporting.

And today's hearing feels a little bit like, as Yogi Berra used to say, "deja vu all over again." This Committee and Congress have spent years attempting to fine-tune our tax system to provide American exporters a level playing field with their international competitors in a WTO-consistent manner.

Unfortunately, we do not have much time given the WTO's most recent decision. My questions today deal with the short term and how we manage this issue until a final resolution can be worked out. And, Ms. Angus, given the impending April retaliation determination, what specific effort is the Administration making to lessen trade tensions with the EU and to prevent the imposition of trade sanctions against U.S. goods exported to the EU?

Ms. ANGUS. I think, really, I ought to turn that question over to Peter on the trade side of things to talk about exactly what we are doing, as we face that deadline at the same time that we are look-

ing at some of these more fundamental changes to our tax system and other changes, to address this in a more long-term way.

Mr. DAVIDSON. Mr. Herger, I think—to summarize some of my earlier comments as well, I think if I get the gist of your question, Commissioner Lamy has laid out some of the criteria that he believes will be—will allow the Europeans to put off retaliation, and those are efforts on behalf of the United States to come to terms with the appellate body decision and make progress in terms of what he sees as compliance.

We had a discussion a little bit earlier with Mr. McDermott about precisely what steps need to be taken. I think it is more difficult; I think it is more art than science. But I think it is a question of managing the relationship between the United States and the EU, which gets back to the question of the close working relationship between the Administration and Congress.

So, in a nutshell, clear steps, looking at satisfying our international obligations which are credible and move us closer to a final result that is acceptable to all parties, recognizing that this is a very complex process and a topic we have talked about at length; and so it is going to take some time. Within that amount of time, a demonstration of concrete steps toward the end point, I think is the best formula that I can articulate at this point.

Mr. HERGER. So, then, would you say that the USTR is working on agreement with the EU to provide Congress the time—possibly 2 to 3 years—it may take to craft new legislation to keep U.S. businesses competitive in agriculture?

Mr. DAVIDSON. Mr. Herger, I am not sure that I would characterize it as an agreement as such. What I would characterize it as is a working understanding that, as long as we are making credible progress, EU will hold off retaliation. And again I don't know that it is possible to put down on paper precisely what the terms of such an agreement or working understanding might be, so I think it is closer to a working agreement or a working understanding than an agreement as such.

Mr. HERGER. Thank you. Thank you, Mr. Chairman.

Chairman THOMAS. Thank the gentleman. Gentlewoman from Washington wish to inquire?

Ms. DUNN. Thank you very much, Mr. Chairman. I feel the same concern that everybody else on this Committee does when it comes to FSC or ETI. I am from the same State as Congressman McDermott is from, and I represent 25,000 workers in the company that he showed concern about.

For me, it is an easy story. Airbus gets a rebate and Boeing does not, and it creates huge competitiveness problems with this. And yet the catch 22 is who is the sore thumb sticking in the air when the EU decides to retaliate? And it is going to be Boeing and it is going to be Mr. Herger's agricultural constituents. That is where it is going go, so it is going to hurt us over and over again unless we do something. So I am eager to see a solution to this problem as everybody else is eager to see a solution.

I am amazed more companies have not moved their production out of this country. Between the burden of our tax system and the huge costs of labor, particularly in a State like mine, I don't see

how shareholders are going to allow companies to continue to operate in this environment.

My interest is in a trade war. I don't want to see a trade war. I don't want to see my companies penalized because of the amount of exporting they do, because it is a very simple ratio. The more you export, the more jobs you have. So I am wondering if you have garnered data over the last years on the relationship between the number of jobs and our use of the FSC provisions or the ETI provisions. Are there data out there we ought to be using in some way to further our case?

Ms. ANGUS. I don't have data in front of me. We will certainly look into it and look for those studies. But it is absolutely clear that the ETI provisions are designed as a part of our current tax system to allow U.S. companies to compete better in the international marketplace and those marketplaces where it is absolutely essential that they be able to compete; and that ensuring their ability to compete is key to allowing them to continue to expand and grow their production and investment and employment here in the United States.

So we see a clear link between the role of these provisions and the importance of a level playing field from a tax perspective and jobs here in the United States.

Mr. DAVIDSON. Ms. Dunn, can I respond quickly to your question, or your statement, on not wanting to see a trade war?

I think that is also precisely where we are coming from, and when I was speaking earlier—before about the larger context of the U.S.-EU relationship, I think it is moving in a very positive direction overall right now. I think the launch of the round in Doha, other sectoral initiatives going on, there are some very positive directions in the relationship.

There are a number—as there are with any trading partners that have a huge volume, a trillion dollars of trade volume that we have with the EU, there are going to be cases like this which are major cases and other cases as well; and we have to manage each of those. And so what I think I have been trying to say here this morning is, it is our attempt to manage this issue with the EU in a way that moves us forward and allows us to move forward on a broader context.

But that is precisely where we are coming from, as well, because it would be very destructive for the EU to retaliate and then have this issue degenerate further.

Ms. DUNN. I appreciate that, obviously being hurtful to everybody.

As you meet with companies who come in to assist you—as we know, ETI was important to have the input of the companies, as well as tax authorities and trade authorities—are you seeing the development of—what I have heard you say so far is, the relationship is strong enough that we may be able to be allowed a little more time to solve the problem, and that we are negotiating with the EU. Are you seeing any particular direction that these discussions are going—what sort of a solution it will be, combination of tax policy and trade policy?

Mr. DAVIDSON. I can start, and then Barbara may want to answer that as well.

I think it is too early to say exactly what the ultimate proposals will be, and I think that is precisely what we want to work both with the private sector and with Congress on. We are working closely with the private sector, and as we have historically, throughout this process consulting on the stages of the litigation.

And I think it is going to be very important also to have import from the private sector in terms of where we go from here.

Barbara, do you have anything else to add?

Ms. ANGUS. I would just add and echo certain remarks that, given the importance of this matter, it is essential that we pursue all options and all possible routes to resolving this in a way that does protect American interests and, at the same time, honors our WTO obligations.

Chairman THOMAS. Thank you. Gentleman from Tennessee wish to inquire?

Mr. TANNER. Thank you very much, Mr. Chairman.

I appreciate you all being here today. I just returned from a NATO, North Atlantic Treaty Organization, trip to Brussels, and while there went by the Organization of Economic Cooperation and Development (OECD) and wound up in London. This is a very, very contentious and serious issue for the Europeans, as you know. And I was sitting here thinking as I was listening to your comments, perhaps this is the debate on the trade bill.

Because in some ways what we are talking about goes far beyond the momentary disagreement we have with the Europeans and with WTO. Because if one looks at it in context and in total, it may be that our system of taxation is doing as much, or more, to export jobs than any sort of trade agreement we could possibly enter into. And so I want to premise my remarks by saying that in my judgment, there may be no more important issue coming before this Committee any time than the subject matter at hand.

I heard you talking about origin-based taxes, territorial-based taxes versus consumption taxes. And would you explain again to the Committee the WTO rules and the way they treat—however one wishes to characterize it—consumption taxes versus territorial or direct or indirect? Could you go over that one more time, please.

Ms. ANGUS. Certainly. And perhaps Peter has something that he would like to add to this.

The WTO rules treat differently direct taxes and income—indirect taxes. The U.S. income tax is a direct tax, and under the trade rules, direct taxes are not border adjustable.

An indirect tax, a tax on transactions, goods or consumption, such as a value-added tax or a sales tax, is treated differently under the trade rules. Under the trade rules, an indirect tax that is levied on the destination principle is border adjustable. And this distinction in the trade rules or the history of the trade rules distinction between these two types of taxes dates back, all the way back to 1960.

And I think, actually, Mr. Hufbauer's testimony will cover some of the roots of that. That was before my time.

Mr. TANNER. Thank you very much. I wanted that again on the record because in looking at this issue—and I have been for the last 10 days—I am not sure that there is a fix as long as there is this difference in our system of taxation that would be WTO com-

pliant and would be capable of being passed and signed by the President.

And, Mr. Chairman, my observation was, given the distinction, I am not sure there is a legislative fix that is both WTO compliant and capable of being passed by this Congress and signed by the President, given our two extremely different philosophies with respect to taxation on this issue of border adjustability.

Do you have any ideas as to how those two could be married, as it were?

Ms. ANGUS. I think it is certainly a difficult issue. At this hearing today there has been a lot of acknowledgment about how difficult it will be to find a solution that addresses all of the needs here and something that we need to look at very carefully.

We need to keep focused on some of the objectives of the provisions that the WTO has looked at, the provisions in our tax law, their objective in ensuring a level playingfield. We need to look at the WTO rules and their treatment of taxes. And, again, we think that it is very important that we look at all aspects of this, and that our solution looks at all options and takes into account all of the things that need to be done to address this.

Mr. TANNER. I appreciate your time.

Mr. Chairman, I think that this is a question for Harry Houdini, if you can find him, to try to match these two differing philosophies together. Maybe we can get him to come testify next time. But I want to thank you for this hearing. This is the trade hearing.

Chairman THOMAS. Thank the gentleman for his comments. And his observation is a real one, and what I would offer now, prior to listening to the hearings and the comments, is that if we cannot fundamentally change the Tax Code to allow us to have the same relative advantages as the Europeans, because there is an ideological, philosophical problem associated with it, perhaps an alternative way of looking at it—and I only suggest this now, and I don't want to enter into a debate about it—is that although it is true that corporations are fictitious, people designed them originally to create an ability to accumulate capital in multiple ways, if you would view corporations as the victims in this, we might be able to deal with resolving some of the problems around the victims.

If you choose to view it as a victimless crime, then, yeah, we are back to the fundamentals of dealing with underlying Tax Code changes.

But if the corporations are the victims in this, we might be able to deal with the victims and provide a solution for the victims. And I will simply leave it at that now.

Gentleman from Georgia wish to inquire?

Mr. COLLINS. Mr. Chairman, the gentleman from Georgia is a victim. You know, Yogi was brought up awhile ago, and I believe old Yogi also said, "When you come to a fork in the road, take it." That is about where we are today. We are at the fork in the road, so we are going to take it.

You know, the Foreign Sales Corp., as I understand it, was put in place for competitive purposes, is that right, to allow our businesses to be more competitive in a global market? Is that true?

Ms. ANGUS. Yes, it was aimed in addressing differences between our tax system and other tax systems that had the effect of impeding the competitiveness. So the provisions in the context of our system were aimed at addressing exactly that issue.

Mr. COLLINS. And that provision of Tax Codes is noncompliance with the WTO rules, right?

Ms. ANGUS. Yes.

Mr. COLLINS. Based on what I hear coming from this hearing and what I read about the European Union, their only solution is repeal of that provision, basically.

Mr. DAVIDSON. You are right, Mr. Collins.

Mr. COLLINS. That is enough. Stop while you are ahead.

So we have a choice, status quo or repeal. What is the difference cost-wise? Status quo, do we not then continue to allow the business to use the Foreign Sales, and we have to pay compensation or higher tariffs on products we export? Is that the choice?

Mr. DAVIDSON. Yes, Mr. Collins. I think the costs of status quo would be most likely, probably inevitably, paying the cost of retaliation, which means putting—basically, American products being exported at a higher cost overseas, harming our ability to export, or paying compensation back here in the United States, which would be lowering the cost of European goods.

Mr. COLLINS. So it is a higher cost—reduces the advantage of being, or reduces the competitiveness of the world markets. That is the end result whether you repeal or don't repeal the status quo.

Well, back then, it relates to consumers and the cost to consumers because if you repeal or if you don't repeal, either way, the cost is going to be passed on to the consumers, domestic or foreign.

The only thing that I can see in the interim is the fact that Congress imposes a lot of cost on business. We impose cost through either rules, regulations, taxation. There are a multiple number of ways that the Congress imposes costs on business. That is where we hear a lot of discussion about tax reform.

And then the gentleman from Tennessee made a very good observation of where we are with this. Reform will come from a mandate from the people or it will not come from this Congress because it is too political. That mandate is not there yet. Further discussion of reform may lead to such a mandate.

But here we need some simplification, and that goes back to the one provision that the EU has problems with. If we were to repeal that or if we leave it in place, we need to look at the Codes themselves and see how we can change the codes that will lessen the cost to business for both domestic and foreign sales that will leave us to be in a competitive state.

Well, that is going to disrupt somewhere the cash flow in this town. I mean, the focus here in this town is the cash flow of the Treasury, because we get our cash flow from people and business and such. So that is the cash flow we ought to be focused on. This Congress, particularly this Committee, should focus on substance, substance of simplification of tax law that we have jurisdiction over that will focus on the reduction of cost of goods both domestically or exported.

As I say, there will be a disruption in cash flow. The only way you deal with the disruption in cash flow is one of two: You raise

another tax to offset that disruption or you look at your spending habits. Folks at home tell me, look at spending first, because we ain't spending a lot of money in this town.

And I see the red light is on, and I am going to close with this; and this is probably going to blow somebody's skirt up. I hear constantly that I am left out. This is just an effort on the part of some people that I am left out. You know, phone lines in my office run both ways. You can receive a call or you can make a call. When I walk down one of these halls, both ways, I meet people coming and going.

There has to be an effort on both sides to reach something—an agreement that has substance to it. And that is what we need to do here.

I appreciate your patience and your indulgence. Come back to us with something of substance, and hopefully, by the time you get back, we will have something of substance.

Thank you, Mr. Chairman.

Chairman THOMAS. Thank the gentleman.

I also would like to have heard the panel's response to you that since we are the world's largest importer and the world's largest exporter, our failure to abide by the rules is not just the direct loss of any financial transaction, but it is a fundamental erosion of the rules by which the world trades; and that we cannot afford any erosion of those rules because we will be the losers in that, not others. That is why we have fought so hard for another round to perfect, even beyond current rules, the rules of world trade.

Mr. COLLINS. Well, that is true; and it could, far beyond just the European Union.

Chairman THOMAS. It is trying to get the world to comply with the trading rules.

We are focused on America's failure to comply. The real problem is the world in general tries to fail to comply. Our job is to set the example of how we ought to operate.

Gentleman from Pennsylvania wish to inquire?

Mr. ENGLISH. Thank you, Mr. Chairman. I think this hearing has explored this issue very thoroughly, and I simply want to say that examining the WTO decision in this area leads me to associate myself with those who have said today that they are disappointed.

It is fairly clear the WTO decision overlooked existing past practices within this jurisdiction. It created a precedent for a massive intrusion into the design of individual States' tax practices. It has—by "individual States," I mean countries. It has, I think, created the specter of future intrusion into legitimate tax design and tax policy decisions that are made by sovereign States. And I am particularly concerned about the long-term impact on the world trading system.

I do have one question for the panel, and that is, looking at this decision and having analyzed it, do you see any jurisdictions within the European Union where their tax system would be equally subject to challenge, based on the principles that the WTO has announced?

Mr. DAVIDSON. Thank you, Mr. English.

I think that one of the reasons is that we decided—and there was a discussion about the process of appeal. We worked with the pri-

vate sector and worked closely with Congress. And one of the most important factors in terms of deciding to take the appeal, knowing as we did ultimately where it was likely to head, was obtaining some kind of clarity in the ultimate rules, which would both guide us in terms of our efforts to comply with the decision, but also give us some indication about where other systems might be in terms of the new appellate body standard.

I think it is unclear right now as to whether there might be EU Member-States that would be vulnerable under the current criteria. It is something that we are looking at, and we will continue to look at that as we move through the process. We will inform you further if we find any provisions there that we think need to be acted on. But for now, I think that is an interesting question and something we are going to be pursuing, but I am not sure that is an answer to our current situation of where we go from here.

Mr. ENGLISH. I recognize that. And may I say, I would welcome correspondence with you in the future as you look at other tax systems. I think it is fair game for us to assess whether we can appropriately challenge some of our trading partners' tax systems if that is the path they have chosen to pursue.

My final comment, Mr. Chairman, Mr. McDermott earlier, and I think with some justification, expressed a gloomy view of the likelihood of our coming up with a solution. I am not quite as gloomy.

I think, as you do, Mr. Chairman, that we need to have fundamental reform of the business Tax Code with the objective of creating a system which is simpler, which accommodates our exports and the capital investments that are necessary for some of our companies to compete globally. With that in mind, I would encourage Mr. McDermott and others to consider the business side of a bill that I have reintroduced in this Congress, the Simplified USA Tax, which would establish a WTO consistent business consumption tax similar to that that was included in Nunn-Domenici, but which would provide for full expensing of capital investments.

I believe that this approach to reform is certainly one of the options that needs to be considered, and I salute you, Mr. Chairman, for being willing to raise the banner of business tax reform; and I hope you receive support for that.

And I yield back the balance of my time.

Chairman THOMAS. Thank the gentleman. The gentleman from Texas, Mr. Doggett, wish to inquire?

Mr. DOGGETT. Thank you, Mr. Chairman. And thanks to both of you for your testimony this morning.

Ms. Angus, is it correct that the law at issue before us today represents legislation for which, prior to your coming to your current job, you were a principal advocate and lobbyist on behalf of the FSC 2000 coalition?

Ms. ANGUS. In my prior job, before I came to the U.S. Department of the Treasury, I did represent companies that were very interested in the issue of the FSC.

Mr. DOGGETT. That is what I wanted to ask you about.

This 2000 Coalition, in which you filed a disclosure form that you were the principal of, who are the principal individual members of that coalition?

Ms. ANGUS. I don't think that I can give—I could recite to you right now——

Mr. DOGGETT. Just tell me three or four that you remember.

Ms. ANGUS. They were—the members of that coalition were—there were several companies involved in that group, all very interested in this issue.

Mr. DOGGETT. Any of the names that you recall today? You were lobbying for them this time last year.

Ms. ANGUS. I am a little bit uncomfortable with not being able to give a complete list. I did give a complete list in disclosure forms that I filed and am certainly happy to provide that to you.

Mr. DOGGETT. You gave a complete list of all the companies that were members of the FSC 2000 Coalition?

Ms. ANGUS. In disclosure forms that I filed in connection with my current position, releasing information regarding companies——

Mr. DOGGETT. Where did you file that?

Ms. ANGUS. The financial disclosure forms.

Mr. DOGGETT. Listed the names of all the individuals?

Ms. ANGUS. Information regarding all companies with whom I worked previously.

Mr. DOGGETT. If you don't want to single out some of them today, can you provide me that information this week, the names of the individual companies that comprised the FSC 2000 Coalition?

Chairman THOMAS. If the gentleman would yield briefly.

Mr. DOGGETT. As soon as I finish with her.

Chairman THOMAS. It is on this. I want to know if there is a legal question.

Mr. DOGGETT. It is not a legal question.

Chairman THOMAS. You indicated you filed this information somewhere. Is that public information?

Ms. ANGUS. I am not certain about that. Obviously there are a variety of disclosure forms that are filed. We will certainly——

Mr. DOGGETT. I am just asking for the names of the companies that composed the FSC 2000 Coalition for which you were lobbying last year, the year before and perhaps longer before that.

Ms. ANGUS. We will certainly look into this and get you the information that——

Mr. DOGGETT. And that information will contain the names of the members of the FSC 2000 Coalition?

Ms. ANGUS. We will certainly go back and look at this and get you——

Mr. DOGGETT. What is there to look at? Can you not tell me the names of any member of the FSC 2000 Coalition that lobbied, with you as their principal, for the very bill that we have up for consideration today?

Chairman THOMAS. Will the gentleman yield? There is no bill up for consideration today.

Mr. DOGGETT. It is the law we have. The bill you lobbied for is the one that the WTO found noncompliant. And I am asking the names of any of the companies that composed the FSC 2000 Coalition for which you were working as principal.

Chairman THOMAS. I think if the witness understands the question, and I believe the concern is whether or not there is any legal concern about answering the question——

Mr. DOGGETT. To identify whom she was lobbying for?

Chairman THOMAS. If the gentleman believes that is not a problem, then my assumption is he has resources and either knows the answer——

Mr. DOGGETT. I am sure she is about to give it.

Chairman THOMAS. I am sure she is about to tell you that she will make sure that there is no legal violation to her answer and that she will provide it. But let us hear what her answer is.

Mr. RANGEL. Mr. Chairman.

Chairman THOMAS. I tell the gentleman from New York, I am trying to move away from what is getting very close to badgering the witness.

Mr. DOGGETT. It is simply asking for information from a witness.

Mr. RANGEL. I am not saying that you are wrong in that pursuit, but you could be a little more sophisticated in planting an answer in the witness' mouth.

Mr. DOGGETT. And if I may ask——

Ms. ANGUS. As I indicated earlier, I would like the opportunity to go back and determine what is appropriate information to provide, and will certainly provide all of that information that is appropriate and required.

[The information is being retained in the Committee files.]

Chairman THOMAS. Gentleman's time has expired.

Mr. DOGGETT. Mr. Chairman, I haven't been given 5 minutes.

Chairman THOMAS. You had 5 minutes.

Mr. DOGGETT. May I have just another 30 seconds?

Chairman THOMAS. Gentleman can have 30 seconds.

Mr. DOGGETT. I would extend that answer to the 877 Coalition for which you were lobbying. People that renounced their American citizenship, just like what Mr. Neal was asking about for corporations, but for individuals; and also the coalition of corporate taxpayers—taxpayers that were also involved in international tax issues.

I want to know the names of the individual companies that are part of that coalition, those three together, according to the records that are public——

Chairman THOMAS. Gentleman's extension of time has expired.

Mr. DOGGETT. Over the last 18 months, and I would like to know who did that.

Chairman THOMAS. Gentleman from Oklahoma wish to inquire?

Mr. WATKINS. Yes, sir. Thank you Mr. Chairman. And I have something that might be worthwhile. Probably a little bit of an editorial comment, but I hope it is helpful with the Committee, maybe our panel.

First, let me say I think the gentleman from Tennessee—Mr. Tanner, I think you are right on the button. This is very crucial and very important, and I think we have to work on it. I don't have all the disagreement that Mr. Doggett has because I hope we do have some people who are knowledgeable sitting at this table. And I hope we do have people that have a background in FSC and some things that are going on, because we don't want people who are totally inept sitting out here trying to resolve our problems.

And let me say to Ms. Angus here, the FSC provisions were enacted to resolve-—and I would like the panel to know this, enacted

to resolve a GATT dispute involving a prior U.S. tax regime that DISC enacted back in 1971. Remember that date, 1971.

Now, nearly a generation later, in 1998, WTO came along and said the dispute settlement—that this was not kosher. And the European Union challenged that along the way, and in 1999 a WTO panel was set up.

The point I would like to make here is, FSC came into being because we are trying to resolve differences and it was accepted then. But, Mr. Chairman, 25, 30 years later, they say, Whoa, you've got to change that. It is not a level playing field.

Well, you know, let us go back to Ground Zero. We have to level some other things in with them.

Now, Mr. Davidson, let me say that I read your statement too, and I think we have some arrows in the quivers, so to speak, that we can work with because this deals also with agriculture; and I think you indicated, I think your testimony indicated, this is about a $4 billion problem.

Mr. DAVIDSON. The EU claims that their retaliation is a $4 billion retaliation.

Mr. WATKINS. And I would like that to be considered, $4 billion against business, industry as in agriculture. I don't know what percentage of that is agriculture. Do you know?

Mr. DAVIDSON. What percentage of FSC users in the United States are agricultural?

Mr. WATKINS. Could that be provided, a real short answer?

Mr. DAVIDSON. We can certainly get back to you on that.

Mr. WATKINS. If you don't mind. But agriculture is affected with that.

Now, Mr. Chairman, also we do have some arrows in the quiver, because I would like the panel to talk about it. And you mentioned bananas, and I have led the fight about the beef industry because the EC, in an unscientific way, has blocked our beef from being sold in Europe. That is a blatant trade barrier, maybe not a big number, but maybe 250 million or more and sometimes larger than that.

But the point is, we also settled in the Uruguay talks for a peace clause, and when you get to the peace clause, it lets the ECU have $7 billion worth of agricultural subsidies, I think we have an arrow; I think we have got a big-time one. We only have about 200 million export subsidies that were accepted. They got $7 billion, and they come to us with $4 billion in FSC.

We should not consider only taxation, by itself. We should bring the subsidies to the table at the same time. And we need to have someone looking at the big picture, not just simply a tax deal. And we are talking about—because we are being hurt, Mr. Rangel. We have been sold down the drain, and we should not let them escape this time sequence and say, Oh, now today we come back 30 years later and say, Let me have that, because it was accepted then.

So I am very concerned. And, you know, I don't want to get concerned about it very much, and that is why I want you to get me the figures later.

But it is not just a fly-by-night thing for me. I end up building a Center for International Trade in Oklahoma, trying to move us forward in trade, and I find all these problems.

So an editorial comment, Mr. Chairman, I hope the comments of the gentleman from Tennessee and I hope something I said might be of help, but we need to use the arrow that we have, and we have $7 billion, and we need to take it to the table to solve this problem.

Thank you so much. I appreciate your being here, and I am glad you are knowledgeable about the FSC.

Mr. DAVIDSON. Thank you.

I think you know how important agriculture is in terms of the President's trade agenda. And Ambassador Zoellick has appeared here several times to make that point; I think it is our number one priority in terms of the new round of trade negotiations.

And we want to make sure we are continuing to make progress, as I said before, on the broader trade agenda because it is so important to keep that on track to make sure that American agricultural products are being able to be treated fairly overseas. And we have a number of issues we are engaging people on, on the GMOs, genetically modified organisms, and other issues.

Mr. WATKINS. Are we putting agriculture on the table for discussions or leaving them off? Are we resolving that at the same time?

Mr. DAVIDSON. In terms of the round, I mean, agriculture is front and center in terms of the issues we want to address.

Mr. WATKINS. Thank you.

Chairman THOMAS. Mr. Ryan, wish to inquire?

Mr. RYAN. We are in this situation because we are in this situation. It is important to note that this is the fourth time, so I think that we are in agreement here between the Administration and most members of this Committee that we need to come up with a fundamental solution.

We can't pass something that is similar to what we just had struck down by the WTO. So it is going to require this Committee and the Administration to think fundamentally how we restructure corporate taxes to respond to this, and to do so in a way that we can continue to send our businesses overseas with confidence and on a level playing field so they can compete in the global marketplace. That means jobs here in America, and that is what this is all about.

The reason I decided to comment, Ms. Angus, is there is an old trick in Washington, and I am a relatively new guy, but the oldest trick here is, if you don't want to debate somebody on the merits of an argument, impugn their motives. And I think you are seeing a little bit of that here; and it is unfortunate because it soils the tone of the debate we have here, which is a very important and time-sensitive issue.

We need to have experienced people in government. We need to have people who have experience in dealing with these types of tax issues, who know what corporations face when they run into these tax regimes and who know the consequences of this FSC ruling. So I think it is important in our executive branch that we have people who know what they are talking about, who know how these policies affect real people in our economy and how they affect corporations.

It is not an issue that we should be ashamed of in any way, and it is a shame that we have to go down the road of impugning someone's motives when we are trying to find a solution on a bipartisan

basis to an issue that we are forced to deal with. Hopefully, we will rise above that in the future.

Our next panel have some interesting ideas that we need to look at, and I just encourage you to work with us very quickly to come up with a fundamental answer to this problem. With that, I just yield.

Chairman THOMAS. I thank the gentleman.

And I want to thank the panel. Obviously we will be pursuing more specific concerns in Subcommittee, and clearly the full Committee needs to revisit it. Thank you very much.

Chair would ask the second panel to come forward. And, first of all, thank you for bearing with us.

The second panel consists of Gary Hufbauer, Senior Fellow for the Institute for International Economics; Mr. Peter Merrill, who is a Partner and Director of the Economic International Consulting Group from PricewaterhouseCoopers; and Mr. Stephen Shay, who is a Tax Partner at Ropes & Gray in Boston, Massachusetts.

We have written testimony from each of you and make it a part of the record without objection. You may address us in the time you have in any way you see fit to enlighten us from your perspective.

And if we can start with Mr. Hufbauer and move across the panel. Welcome and we look forward to your testimony. And you are going to need to turn the microphones on and they are very uni-directional.

STATEMENT OF GARY HUFBAUER, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. HUFBAUER. Thank you very much, Mr. Chairman.

As was mentioned in the earlier panel and reinforced, this case seems to date back to 1971 and these core issues have been both negotiated and litigated for more than 30 years in the GATT and WTO. I subscribe to the view that the time has come for Congress to settle this dispute once and for all; and I think it should settle the dispute by eliminating the competitive disadvantage to the U.S. economy arising from the ancient practice of taxing foreign income generated when American firms export their goods and services to world markets and when they produce abroad.

In the outline that accompanies my remarks, I traced the history. The most recent appellate body decision, while an improvement on the second panel report, contains a good deal of mischief. The second panel report stretched to declare the ETI Act was a prohibited export subsidy. The way it stretched was to create a new test which was not found in the first panel report, namely this concept of a normative benchmark for judging national tax systems.

The second appellate body used a less sweeping, "but for" rule to invalidate the ETI. In terms of legal rationale, that counts as an improvement. In addition, the second appellate body actually reaffirmed most but not all of the elements of that 1981 Council Decision that was spoken of and what had been dismissed by the first appellate body. So you had kind of a circular process. They tossed the Decision out in the first round; and in the second round, at the appellate body level, they reinstated many of the provisions. So I guess I have to say that is another improvement.

But these improvements came at a cost by comparison with the first panel report and first appellate body report. And even under the second panel report, it would have been relatively easy for the United States to mount an attack on European corporate tax systems. But the easy shots were foreclosed in the second appellate body report.

There is a lot of tax detail there, and I know people don't really want to go into that here. I am not saying that the European systems are immune to attack under the second appellate body report, but I am saying that the area of attack was substantially circumscribed.

Apart from that, there is other mischief in the second appellate body report. These WTO judicial mechanisms will become the world arbiter of what is, and what is not, foreign-source income if they go down the path they have set. And they will decide what mixture of exemptions and credit systems do and do not create prohibited export subsidies.

If this judicial activism is pursued by future appellate body judges and not curbed by WTO Members in their Doha Round negotiations, I think we will be traveling down the road of more intrusive WTO examination of national tax systems that differentiate between export oriented and domestically oriented sectors of national economies.

I believe in the virtues of uniform taxation, but I don't think those virtues should be imposed from Geneva. The challenge for Congress is to reform the U.S. tax laws so as to accomplish two goals. First, eliminate the huge bargaining chip that the WTO Appellate body has handed the European Union. I think it is a far larger chip than the EU ever contemplated in the beginning. To paraphrase Senator Dirksen, after a billion dollars, who is counting, but the FSC decision is a huge chip for the EU and Congress has to remove the chip from the table or the United States will pay for it throughout the Doha Round.

Second, I hope the Congress will remove the competitive tax disadvantage that U.S. firms face when they export to world markets and produce abroad. In his statement, Peter Merrill goes into some length on these disadvantages. Let me just say here that I totally disagree with the suggestion that Mr. Shay will be offering later in this panel to eliminate deferral.

If the United States actually eliminated the practice known as "deferral," the whole U.S. economy, including all exporters, would be placed at an extremely serious competitive disadvantage in the global marketplace, and we would see far more examples of inverted ownership. In fact, U.S. companies would become easy pickings for foreign purchasers, just based on tax differences, if we eliminate deferral.

Well, a final word on the ETI case. As a supplement to congressional action taken in consultation with the Treasury Department, the Administration should renegotiate the WTO Code on Subsidies and Countervailing Measures, both to achieve greater parity in rules that are applied to direct and indirect taxation and to curb judicial activism in the WTO. But I want to emphasize those negotiations are a supplement and not a substitute for congressional action.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Hufbauer follows:]

Statement of Gary Hufbauer, Senior Fellow, Institute for International Economics

Chairman Thomas and members of the Committee, thank you for inviting me to testify on the second WTO Appellate Body decision in the FSC/ETI case (*United States—Tax Treatment for "Foreign Sales Corporations" Recourse to Article 21.5 of the DSU by the European Communities.* AB–2001–8, decided 14 January 2002.) In a sense, this case is three decades old: its antecedents date to the Domestic International Sales Corporation legislation enacted in 1971. The core issues have been repeatedly negotiated and litigated for nearly thirty years in the GATT and now the WTO.

The time has come for Congress to settle the dispute once and for all. It should settle the dispute by eliminating the competitive disadvantage to the U.S. economy arising from our ancient practice of taxing foreign income generated when American firms export their goods and services to world markets, and when they produce abroad.

In the outline that follows, I trace the history of the current FSC dispute back to the 1960 GATT Working Party. The most recent Appellate Body decision, while an improvement on the second Panel Report contains a good deal of mischief. The second Panel Report, stretching to declare the ETI Act an export subsidy, created a new test not found in the first Panel Report—namely the concept of a "normative benchmark" for judging national tax systems. The Appellate Body used a less sweeping "but for" rule to invalidate the ETI. In terms of legal rationale, that counts as an improvement. Moreover, the Appellate Body, in its second decision, reaffirmed most (but not all) the elements of the 1981 Council Decision—a decision that had been tossed aside (not a "legal instrument") in the first Panel Report and Appellate Body decision. Again, this is an improvement.

But mischief remains. Under the second Appellate Body decision, the WTO's judicial mechanisms will become the world arbiter of what is, and what is not, foreign source income. These same mechanisms will decide what mixture of exemption and credit systems do and do not create prohibited export subsidies. This judicial activism, if pursued by future Appellate Body judges, and not curbed by the WTO members in their Doha Round negotiations, points to more intrusive WTO examination of domestic tax systems that differentiate between export-oriented and domestically-oriented sectors of national economies. Like most economists, I believe in the virtues of uniform taxation. But I do not believe these virtues should be imposed from Geneva.

The challenge for Congress is to reform U.S. tax laws so as to accomplish two goals. First, eliminate the huge bargaining chip that the WTO Appellate Body has handed to the European Union. Second, remove the competitive tax disadvantage that U.S. firms face when they export to world markets and produce abroad.

Supplementary to Congressional action, the Administration should renegotiate the WTO code on Subsidies and Countervailing Measures both to achieve greater parity in rules applied to "direct" and "indirect" taxation, and to curb judicial activism in the WTO. But negotiations in the Doha Round should be a supplement, not a substitute, for Congressional action.

Thank you.

THE FSC CASE: BACKGROUND AND IMPLICATIONS

A. Quick background

- A 1960 GATT Working Party codified the ancient distinction between permissible border adjustments for direct and indirect taxes: origin principle for direct (no adjustments at the border); destination principle for indirect (adjustments permitted at the border—i.e., impose the tax on imports, exempt the tax on exports). Hence destination principle adjustments for corporate profits taxes on export earnings (classified as a direct tax) are both an impermissible export subsidy and a violation of national treatment. But destination principle adjustments for VAT taxes on export and import sales are permitted. This distinction persists, despite the obvious economic point that a VAT amounts to a combination of a direct tax on profits, a direct tax on interest and rent paid by the corporation, and a direct tax on wages. In other words, by GATT alchemy, direct taxes can be transformed into indirect taxes and adjusted at the border. But

without this magical transformation, direct taxes cannot be adjusted at the border.

- In 1962, the United States enacted Subpart F of the Internal Revenue Code. Subpart F eliminated deferral for "foreign base company income" earned by controlled foreign corporations in tax haven countries. Base company income includes profits from handling the sales of U.S. exports to third countries. This "anti-abuse" provision put U.S. exporters at a tax disadvantage compared to other industrial country exporters.
- In 1971, faced with a growing trade deficit, the U.S. introduced the Domestic International Sales Corporation (DISC)—tax deferral for the export earnings of a U.S. corporation. In tax terms, the DISC softened the impact of Subpart F, which subjected foreign base company income to U.S. tax. The United States argued that tax deferral under the DISC was not the same as tax exemption. The EC challenged the DISC in 1974. In turn, the U.S. challenged the European "territorial approach" to taxing export earnings. Specifically, the U.S. challenged tax exemption for the portion of export earnings attributed to a sales subsidiary located in a tax haven country. (None of the European countries then or now has an effective equivalent of Subpart F for current taxation of "foreign base company income".)
- A GATT panel decided the four "tax cases" in 1976: all defendants lost. Retaliation was held in abeyance during the Tokyo Round negotiations.
- The Tokyo Round Code on Subsidies & Countervailing Duties settled the four tax cases, based on four principles: (a) the distinction between direct and indirect taxes was preserved; (b) U.S. agreed to repeal DISC (tax deferral was conceded to be an export subsidy, like tax exemption); (c) however, methods of avoiding double taxation—both the exemption method associated with territorial systems of taxation and the foreign tax credit method associated with worldwide systems of taxation—are defined not to be subsidies; (d) the arm's length pricing standard is to be observed in transactions between parent exporting companies and their foreign sales subsidiaries.
- Following the conclusion of the Tokyo Round, in 1981 a GATT Council Decision disposed of the four tax cases, with a Chairman's note that reiterated the bargain struck in the Tokyo Round Code. In particular the Chairman's note stated: "The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country and should not be regarded as export activities in terms of Article XVI:4. It is further understood that Article XVI:4 requires that arm's-length pricing be observed—Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income."
- Based on this note, in 1984 the United States repealed the DISC, and enacted the Foreign Sales Corporation (FSC). The FSC allowed partial tax exemption for the income of a foreign corporate subsidiary derived from handling U.S. export sales. The amount of income exempted was calculated by a formula designed to approximate arm's length pricing (dividing export profits between domestic and foreign sources).

B. First Round of FSC Litigation

- In 1999, the EU challenged the FSC as a violation of the Uruguay Round Code on Subsidies & Countervailing Measures (SCM). This was a surprise to the United States, since the FSC had not been challenged during the course of the Uruguay Round negotiations. The EU motivation was to create bargaining chips to resolve other WTO disputes (e.g., bananas, beef hormones), potential disputes (e.g., Airbus and steel), and pending disputes at the expiration of the agricultural peace clause (December 2003).
- The first WTO FSC Panel, in its October 1999 decision, stated that the 1981 Council Decision was not "a legal instrument" of the GATT–1947 that had been adopted by the GATT–1994, by virtue of the Annex 1A of the Uruguay Round (the grandfather or savings clause). Surprise! The Panel then went on to hold that the FSC is a prohibited export subsidy because: (a) revenue is foregone; (b) exports are taxed more favorably than production abroad. The Panel did not rule on the EC claim that FSC violates the SCM because exports are taxed more favorably than production for the home U.S. market. However, the Panel did rule that the FSC is not a permissible application of the territorial approach—i.e., the exemption approach—to avoiding taxation of foreign source income because the FSC invokes the territorial principle for only the export segment of foreign source income. In February 2000, the WTO Appellate Body affirmed the Panel Report in all essential respects.

C. The Extraterritorial Income Exclusion (ETI) Act

- In November 2000, the U.S. Congress passed the ETI Act in response to the WTO Appellate Body decision. The ETI Act excluded from the U.S. definition of gross income certain foreign source income—namely a portion of export earnings, and a portion of earnings from production abroad—with the condition that this territorial method of avoiding double tax relief could only be used if the taxpayer did not claim foreign tax credits with respect to the same earnings. The benefits of the ETI Act were also conditioned on the sale of the goods outside the United States, and the use of less than 50% non-U.S. (i.e., imported) inputs. Under the ETI Act, FSC benefits are phased out.
- In the U.S. view, the ETI Act conformed to the Appellate Body decision because: (a) revenue was no longer foregone—ETI income was no longer part of gross income subject to corporate tax; (b) export earnings and foreign production earnings were similarly taxed under the ETI Act.

D. Second Round of FSC/ETI Litigation

- The EU brought a second case to the WTO, claiming: (a) notwithstanding the ETI Act, revenue was still foregone; (b) the export contingency remained, even if foreign production was, in some circumstances, covered; (c) the U.S. content requirements for export earnings under ETI violate Article III (national treatment); (d) the FSC phase-out does not respect the first Appellate Body deadline (October 2000).
- In August 2001, the WTO FSC/ETI Panel endorsed the EU arguments in all essential respects. In reaching its decision, the Panel, like its predecessor, continued to disdain any deference to established tax practices. Instead:
  - The Panel arrogated the power to decide when a mixed system of double tax relief (territorial exemption plus foreign tax credits) amounts to a prohibited export subsidy. The ETI exclusion flunked, according to the Panel, partly because it was too broadly drawn (it could exempt income not taxed by another country) and partly because it was too narrowly drawn (only exports and selected foreign production are covered).
  - On the way to creating this power, the Panel claimed the power to say that any deduction or exclusion from gross income could amount to a departure from the "normative benchmark" of the offending nation's tax system, and thus could amount to a relief from tax "otherwise due" (SCM 1.1(ii)), and thus could amount to a subsidy.
  - The Panel did not bother to examine actual U.S. tax practice, developed since 1913, which has long allowed deferred taxation of the income of controlled foreign corporations (CFCs). In economic terms, deferral amounts to a partial or near-total exemption. The ETI provision allows an explicit exemption where prior and current law allow for its first cousin, deferral.
  - The Panel decided that the ETI exemption was "contingent on" exports—in other words, that exporting is a necessary condition for receiving the subsidy—even though the ETI exclusion also applies to foreign production in designated circumstances. This, despite footnote 4 to the SCM which states: "The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy . . .
  - Not surprising, the Panel found that the U.S. content rule violated Article III.
- The Appellate Body affirmed the Panel decision, but narrowed the rationale with two important twists. (a) The Appellate Body walked away from the Panel's "normative benchmark" concept and instead defined "revenue otherwise due" by referring to the taxation of ETI income when the taxpayer *elects* to claim a foreign tax credit rather than the exemption. Since the taxpayer will only elect the exemption method when his bottom line U.S. taxes are less under the credit method, it follows that the U.S. Treasury has foregone "revenue otherwise due". (b) The Appellate Body delved into ETI Act rules for determining the division of export income between domestic and foreign sources. Using simple-minded examples, the Appellate Body found circumstances where the rules could improperly characterize domestic source income as foreign source income.
- In important ways, the Appellate Body returned to the main outlines of the bargain struck in the 1981 GATT Council Decision. The Appellate Body reaffirmed the arm's length principle for distinguishing between domestic source and foreign source income earned on export sales. The Appellate Body confirmed that foreign source income, properly computed, could be exempt from tax and the exemption does not automatically amount to an export subsidy prohibited by the SCM.

E. Questions Raised

- First question: how big is the bargaining chip that the WTO has created for the WTO? Under the SCM, the Arbitral Panel decides the permitted level of retaliation—i.e. "appropriate countermeasures" (Article 4.11 of the SCM)—in the event that the subsidizing member does not "withdraw the subsidy without delay". The Arbitral Panel has said it will reach a decision at the end of April 2002. Once decided, the Arbitral Panel's ruling cannot be appealed. There is little case guidance on "appropriate countermeasures"—only the Brazil-Aircraft arbitration. In that case, the Arbitral Panel decided that "appropriate countermeasures" means the "the full amount of the subsidy to be withdrawn"—not the level of trade impairment to Canada (as Brazil had argued). Following this precedent, the U.S. argues that the bargaining chip is $956 million, calculated with reference to the tax benefits on FSC/ETI exports to the EU directly, and to third country markets where U.S. and EU exports compete. The EU says the bargaining chip is $4,043 million, based on total FSC tax benefits on exports to the world. Both submissions avoid an explicit calculation of the trade impact of the FSC/ETI benefit. However, their implicit calculations assume that the size of trade impact equals the size of tax benefit (i.e., an export demand elasticity of—1.0). The Arbitral Panel's decision will set an important precedent for calculating "appropriate countermeasures".
- Second question: what is in the EU shopping bag? The EU claims that it only wants the U.S. to amend or repeal the ETI law in a WTO-consistent manner. This oft-repeated EU statement is only a ploy to force the U.S. into opening negotiations, offering "compensation" in the form of concessions on other trade issues. Plausible candidates for the EU shopping bag: (a) beef hormones and potential biotechnology claims; (b) Section 201 restrictions on steel imports (but there the EU can retaliate directly); (c) agricultural subsidies. The logic from Pascal Lamy's standpoint is to hold the bargaining chip in his pocket, and threaten but not invoke retaliation. Possible outcome: a standstill on all retaliation that lasts until the end of the Doha Work Programme in 2005.
- Third question: will other WTO members use the decision to create their own bargaining chips for negotiations and dispute resolution with the United States? They would have to mount new cases against the FSC/ETI to get permission to retaliate, but the precedent seems straightforward. If this scenario unfolds, how will future Arbitral Panels go about allocating the rights to "appropriate countermeasures" among WTO complainants?
- Fourth question: will the U.S. (and possibly other members) use the logic of the WTO's decision to launch their own tax cases against their trading partners? Export processing zones, widely used by developing countries, are vulnerable. So is the U.S. export source rule. The EU countries may have arbitrary formulas for calculating exempt foreign source income tucked away in their tax laws and regulations. The Appellate Body decision is an invitation to tax litigation—member A can respond to a non-tax WTO case brought against it by launching its own tax case against member B. This danger underscores the standstill option mentioned earlier.
- Fifth question: will WTO members renegotiate the SCM in the Doha Work Programme? Two possible objectives: (a) Stop the DSM from turning itself into a World Tax Court. For example, the SCM could instruct the DSM to defer to jurisprudence established in bilateral tax treaties and the OECD for defining foreign source income. (b) Eliminate the artificial distinction between border adjustment rules for direct and indirect business taxes. For example, the SCM rules could allow members to exempt 50% of export earnings from corporate profits tax. (c) As a matter of transparency, require WTO members to publish their schedules of border tax adjustments applied on a product basis, following the Harmonized Tariff System.
- Sixth question: how will the U.S. Congress change the tax law? Congressional action is clearly necessary, both to take away bargaining chips from the EU and to avert "piling on" by other WTO members. There are three broad options: (a) The "minimal" fix—repeal the ETI Act, and exclude export income from "foreign base company" income under Subpart F. (b) Abandon export tax relief—repeal the ETI and use the revenue for other business tax reform, for example phasing out the AMT. (c) Use the WTO decision as a springboard for fundamental reform, through a territorial system of taxing corporate profits. This is clearly the best answer. Politically, it may be the most difficult.

Chairman THOMAS. Thank you Mr. Hufbauer.

Mr. Merrill.

STATEMENT OF PETER R. MERRILL, PRINCIPAL AND DIRECTOR, NATIONAL ECONOMIC CONSULTING GROUP, PRICEWATERHOUSECOOPERS LLP, AND CONSULTANT, INTERNATIONAL TAX POLICY FORUM

Mr. MERRILL. Thank you, Mr. Chairman, Mr. Rangel, Members of the Committee. I am Peter Merrill, Director of the National Economic Consulting Group at PricewaterhouseCoopers. I am also a consultant to the International Tax Policy Forum (ITPF) and co-author of a book published recently by the National Foreign Trade Council on international tax policy.

For the record, I am testifying today on my own behalf. The focus of my testimony is the relationship between U.S. tax policy and international competitiveness.

Current rules regarding the taxation of both domestic and foreign income create barriers that harm the competitiveness of U.S. companies. These rules are also horribly complex to comply with and to administer. Regardless of how the ETI dispute is ultimately resolved, I believe it is important for this Committee to review the current U.S. tax rules with a view to reducing complexities and removing impediments to U.S. competitiveness.

In a global market the competitiveness of the country depends on the ability of its enterprises to produce goods and services that are successful both at home and in foreign markets. Today, almost 80 percent of world income and purchasing power lies outside the United States. Foreign affiliate sales are growing three times as fast as domestic sales within Standard and Poor's, S&P, 500 companies.

It is a common perception that the investment abroad by U.S. multinationals comes at the expense of the domestic economy. This is an incorrect view. According to the U.S. Department of Commerce, less than 11 percent of sales by U.S.-controlled foreign corporations were made back to the United States.

In 1998, U.S. multinationals were directly responsible for almost two-thirds of all U.S. exports. A recent study by the OECD found each dollar of outward foreign direct investment is associated with $2 of additional exports. A number of studies have found U.S. investment abroad generates additional employment at home through an increase in the domestic operations of U.S. multinationals. Moreover, research has shown that workers at domestic plants owned by U.S. multinationals earn higher wages than workers at domestic plants owned by companies with only domestic operations.

In summary, U.S. multinationals provide significant contributions to the U.S. economy through sales of U.S. goods and services abroad and employment at above average wages at home.

With the reduction of the U.S. corporate income tax rate from 46 to 34 percent in 1986, it is commonly thought that the United States is a low-tax jurisdiction for corporations. While this was true immediately after the 1986 tax, it is no longer true today. The

United States increased the corporate income tax rate to 35 percent in 1991. Meanwhile, the average OECD corporate tax rate has fallen to 4.5 percentage points less than the U.S. rate.

In addition to a relatively high corporate income tax rate, the United States is one of only three OECD Member Countries that does not provide some form of relief from the double taxation of corporate dividends. For a shareholder in the top individual income tax bracket, the combination of corporate and individual income tax is over 60 percent of distributed corporate income in the United States. And while the total U.S. tax burden as a percentage of GDP is relatively light compared to other OECD countries, reliance on income and profits tax is unusually high.

In 1999, the U.S. relied on income and property taxes for almost half of all revenues, compared to slightly over a third in the average OECD country. Indeed, the United States is the only one of the 30 OECD Member Countries that does not have a national value-added tax.

A study published by the European Commission last year found that, on average, U.S. multinationals bear a higher effective tax rate when investing into the European Union than do EU multinationals. This is a European Commission study. The additional tax burden ranged from 3 to 5 percentage points depending on the type of finance.

There are a number of reasons why the United States has become an unattractive jurisdiction in which to locate the headquarters of a multinational company, aside from our relatively high corporate tax rate.

First, unlike the United States, about half of the OECD countries have a dividend exemption, also called a "territorial" tax system under which a parent company generally is not subject to tax on the active income earned by foreign subsidiaries.

Second, the foreign tax credit, which is intended to prevent double taxation of foreign-source income, has a number of deficiencies that increase the complexity and prevent full double tax relief.

Third, the scope of the U.S. anti-deferral rules under subpart F is unusually broad. While most countries tax passive income earned by controlled foreign subs, the United States is unusual in taxing a wide range of active foreign income that is reinvested abroad.

In conclusion, short of adopting a territorial tax system, there are significant opportunities to increase the competitiveness and reduce the complexity of U.S. tax rules applicable to foreign source income.

One opportunity that is worth special attention within the context of these hearings is the foreign base company sales rules adopted by Congress in 1962. Part of the benefit of the FSC regime that was rejected by the WTO was the fact that it created an exception to the base company rules. If the foreign base company rules were to be repealed, U.S. companies would be put in a position more comparable to their foreign competitors.

Moreover, the original policy rationale for the base company rules was thrown into doubt by the Treasury Department's study of subpart F.

In conclusion, U.S. rules for taxing domestic and foreign source income are out of step with other major industrial countries in a number of ways. Regardless of the ultimate resolution of the ETI case, Congress should consider changes to the U.S. system that promote economic growth and reduce the costs of complying with the tax system.

Thank you.

Chairman THOMAS. Thank you, Mr. Merrill.

Mr. Shay?

[The prepared statement of Mr. Merrill follows:]

Statement of Peter R. Merrill, Principal and Director, National Economic Consulting Group, PricewaterhouseCoopers LLP, and Consultant, International Tax Policy Forum

U.S. TAX POLICY AND INTERNATIONAL COMPETITIVENESS

I. INTRODUCTION

I am Peter Merrill, a Principal and Director of the National Economic Consulting group at PricewaterhouseCoopers LLP. I am also a consultant to the International Tax Policy Forum, a group of U.S.-based multinational companies from a broad range of industries, and co-author of a recent book published by the National Foreign Trade Council on *International Tax Policy for the 21st* Century. For the record, I am testifying today on my own behalf and not as a representative of any organization.

The focus of my testimony is the relationship between U.S. tax policy and international competitiveness. In many instances, current rules regarding the taxation of both domestic and foreign income create barriers that harm the competitiveness of U.S. companies. These rules also are horribly complex both for taxpayers to comply with and for the Internal Revenue Service to administer.

The existing extraterritorial income (ETI) tax regime serves in part to offset some of the anti-competitive features of U.S. tax policy. Thus, the WTO's adverse decision in the ETI case raises the question how Congress can strengthen the competitive position of the U.S. tax system. Regardless of how the ETI dispute is resolved, I believe it is important for this Committee to review the current U.S tax rules with a view to reducing complexity and removing impediments to U.S. competitiveness.

II. TAX POLICY AND INTERNATIONAL COMPETITIVENESS

While there are a variety of ways to define competitiveness, in this testimony I focus on the standard of living of U.S. residents as the measure of economic performance. Achieving a high standard of living ultimately rests on the productivity of U.S. investments. Growing productivity in turn requires investment—in plant and equipment and in the development and dissemination of knowledge through research and education.

The challenge for tax policy is to design a tax system that raises revenue with the least damage to the growth of productivity and national income. A poorly designed tax system can impose unnecessarily high costs to the economy—so-called dead-weight loss—by discouraging savings and investment, by causing investment to be allocated inefficiently, or by requiring excessive resources to be devoted to complying with and administering the tax rules.

III. U.S. MULTINATIONALS AND INTERNATIONAL COMPETITIVENESS

In a global market, the competitiveness of a country depends on the ability of its enterprises to produce goods and services that are successful both at home and in foreign markets. Today, almost 80 percent of world income and purchasing power lies outside of U.S. borders. Opportunities for U.S. companies to grow their businesses increasingly lie overseas. From 1986 to 1997, foreign sales of S&P 500 companies grew 10 percent a year, compared to domestic sales growth of just 3 percent annually.[1]

A. U.S. Investment Abroad and Exports

It is a common perception that investment abroad by U.S. multinationals comes at the expense of the domestic economy. This is an incorrect view. The primary motivation for U.S. multinationals to operate abroad is to compete better in *foreign*

[1] Wall Street Journal, "U.S. Firms Global Progress is Two-Edged," August 17, 1998.

markets, not *domestic* markets. According to the Commerce Department, less than 11 percent of sales by U.S.-controlled foreign corporations were made to U.S. customers.[2]

Investment abroad is required to provide services that cannot be exported, to obtain access to natural resources, and to provide goods that are costly to export due to transportation costs, tariffs, and local content requirements. Foreign investment allows U.S. multinationals to compete more effectively around the world, ultimately increasing employment and wages of U.S. workers.

While about one-fourth of U.S. multinational parent companies are in the services sector, 56 percent of all foreign affiliates are this sector, which includes distribution, marketing, and product support services.[3] Without these sales and services subsidiaries, it would be impossible to sustain current export volumes.

According to the U.S. Commerce Department, in 1998, U.S. multinationals were directly responsible, through their domestic and foreign affiliates, for $438 billion of U.S. merchandise exports—almost two-thirds of all merchandise exports.[4]

A recent study by the Organization for Economic Cooperation and Development (OECD) found that each dollar of outward foreign direct investment is associated with $2.00 of *additional* exports.[5]

B. U.S. Employment

Foreign investment by U.S. multinationals generates sales in foreign markets that generally could not be achieved by producing goods entirely at home and exporting them.

A number of studies find U.S. investment abroad generates additional employment at home through an increase in the domestic operations of U.S. multinationals. As noted by Professors David Riker and Lael Brainard:

"Specialization in complementary stages of production implies that affiliate employees in industrialized countries need not fear the multinationals' search for ever-cheaper assembly sites; rather, they benefit from an increase in employment in developing country affiliates."[6]

Moreover, workers at domestic plants owned by U.S. multinational companies earn *higher* wages than workers at domestic plants owned by companies without foreign operations, controlling for industry, size of company, and state where the plant is located.[7]

C. U.S. Research and Development

Foreign direct investment allows U.S. companies to take advantage of their scientific expertise, increasing their return on firm-specific assets, including patents, skills, and technologies. Professor Robert Lipsey notes that the ability to make use of these firm-specific assets through foreign direct investment provides an incentive to increase investment in activities that generate this know-how, such as research and development.[8]

Among U.S. multinationals, total research and development in 1996 amounted to $113 billion, of which $99 billion (88 percent) was performed in the United States.[9] Such 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.

D. Summary

U.S. multinationals provide significant contributions to the U.S. economy through:

- Sales of U.S. goods and services abroad;
- Domestic employment at above average wages; and

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[2] U.S. Department of Commerce, *Survey of Current Business* (July 2000). Note that 40 percent of the sales back to the United States were from Canadian subsidiaries.

[3] Matthew Slaughter, *Global Investments, American Returns. Mainstay III: A Report on the Domestic Contributions of American Companies with Global Operations,* Emergency Committee for American Trade (1998).

[4] National Foreign Trade Council, *The NFTC Foreign Income Project: International Tax Policy for the 21st Century*, chapter 6 (1999).

[5] OECD, *Open Markets Matter: The Benefits of Trade and Investment Liberalization*, p. 50 (1998).

[6] David Riker and Lael Brainard, *U.S. Multinationals and Competition from Low Wage Countries*, National Bureau of Economic Research Working Paper no. 5959 (1997) p. 19.

[7] Mark Doms and Bradford Jensen, *Comparing Wages, Skills, and Productivity between Domestic and Foreign-Owned Manufacturing Establishments in the United States*, mimeo. (October 1996).

[8] Robert Lipsey, "Outward Direct Investment and the U.S. Economy," in *The Effects of Taxation on Multinational Corporations*, p. 30 (1995).

[9] U.S. Department of Commerce, *Survey of Current Business* (September 1998).

- Critical domestic investments in equipment, technology, and research and development.

As a result, the United States has an important interest in insuring that its tax rules do not hinder the competitiveness of U.S. multinationals.

IV. DOMESTIC TAX COMPETITIVENESS

A. Corporate Income Tax Rate

With the reduction in the U.S. corporate income tax rate from 46 to 34 percent, as a result of the Tax Reform Act of 1986, it is commonly thought that the United States is a low-tax jurisdiction for corporations. While true immediately after the 1986 Act, it is no longer true today. The United States increased the corporate income tax rate to 35 percent in 1991. Meanwhile, 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 (see Exhibit 1). This disparity in corporate tax rates would be even larger if corporate income taxes imposed by subnational levels of government were taken into account.

B. Double Taxation of Corporate Dividends

In addition to a relatively high corporate income tax rate, the United States is one of only three OECD member countries that does not provide some form of relief from the double taxation of corporate dividends (see Exhibit 2). Most OECD countries relieve double taxation of corporate dividends at the shareholder level through some form of credit, exemption, or special tax rate for dividend income. For a shareholder in the top individual income tax bracket (38.6 percent[10]), the combination of corporate and individual income tax is over 60 percent of distributed corporate income (see Exhibit 3). The combined income tax rate on distributed corporate income is even higher if state and local tax on corporate and individual income are taken into account.

C. Reliance on Income and Profit Taxation

While the total tax burden as a percent of Gross Domestic Product (GDP) is relatively light in the United States compared to other OECD countries, reliance on income taxes to fund spending at all levels of government is unusually high. In 1999, the United States relied on income and profits taxes for almost half of all revenues (49.1 percent) while the average OECD country raised slightly over one-third of revenues (35.3 percent) from this source (see Exhibit 4). The U.S. data include sales taxes imposed by state and local governments; the federal government is even more heavily reliant on income and profits taxes as there is no broad-base consumption tax at the federal level. Indeed, the United States is the only one of the 30 OECD member countries that does not have a national value-added tax.

D. Conclusion

When compared to other OECD and EU member countries, the United States relies relatively heavily on income taxes to fund government operations, has a comparatively high corporate income tax rate, and is unusual in not providing a mechanism for relieving the double taxation of corporate income.

From a trade standpoint, heavy reliance on income taxes relative to consumption taxes may be viewed as disadvantageous because the WTO Agreement on Subsidies and Countervailing Measures permits border tax adjustments for indirect taxes such as consumption taxes, but prohibits such adjustments for income and profits taxes. However, from the standpoint of U.S. economic growth, the main reason to avoid over-reliance on income and profit taxes is that they discourage savings and investment, which are closely linked to growth in national income.

V. INTERNATIONAL TAX COMPETITIVENESS

A. Rising Level of International Competition

In 1962, when the controlled foreign corporation rules in Subpart F were adopted, the U.S. multinationals overwhelmingly dominated global markets. In this environment, the consequences of adopting tax rules that were out-of-step with other countries were of less concern to many policymakers.

Today, the increasing integration of the world economies has magnified the impact of U.S. tax rules on the international competitiveness of U.S. multinationals. Foreign markets represent an increasing fraction of the growth opportunities for

[10] Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the top individual income tax rate is scheduled to be reduced to 35 percent in 2006.

U.S. businesses. At the same time, competition from multinationals headquartered outside of the United States is becoming greater.[11]

- Of the world's 20 largest corporations, the number headquartered in the United States has declined from 18 in 1960 to just 8 in 1996.
- U.S. multinational companies' share of global cross-border investment has declined from 50 percent in 1967 to 25 percent in 1996.
- The 21,000 foreign affiliates of U.S. multinationals compete with about 260,000 foreign affiliates of foreign multinationals.

If U.S. rules for taxing foreign source income are more burdensome than those of other countries, U.S. multinationals will be less successful in global markets, with adverse consequences for exports and employment at home.

B. International Comparison of U.S. Rules for Taxing Multinational Companies

A study published by the European Commission last year found that, on average, U.S. multinational companies bear a higher effective tax rate when investing into the European Union than do EU multinationals. The additional tax burden borne by U.S. multinationals ranges from 3 to 5 percentage points depending on the type of finance used (see Exhibit 5).

In addition to the relatively high U.S. corporate income tax rate, there are a number of other reasons why United States has become a relatively unattractive jurisdiction in which to locate the headquarters of a multinational corporation.

First, about half of the OECD countries have a dividend exemption ("territorial") tax system under which a parent company generally is not subject to tax on the active income earned by a foreign subsidiary (see Exhibit 6). By contrast, the United States taxes income earned through a foreign corporation when repatriated (or when earned if subject to U.S. anti-deferral rules).

Second, the U.S. foreign tax credit, which is intended to prevent double taxation of foreign source income, has a number of deficiencies that increase complexity and prevent full double tax relief, including:[12]

- Over allocation of U.S. interest expense against foreign source income due to failure to take into account foreign debt. This reduces the foreign tax credit limitation and can cause income that has been subject to foreign tax at a rate of 35 percent or more to be subject to additional U.S. tax;
- Asymmetric loss recapture rules that have the effect of restoring U.S. but not foreign income, thereby reducing the foreign tax credit limitation;
- The limitation on foreign tax credits to 90 percent of alternative minimum tax liability;
- The limited carryover period for foreign tax credits (two years back and five years forward); and
- The complexity associated with the numerous separate foreign tax credit limitations and the "high-tax kick out" rules that move certain income out of the passive basket.

A third difference from the multinational tax rules of other countries is the unusually broad scope the U.S. anti-deferral rules under subpart F. While most countries tax passive income earned by controlled foreign subsidiaries, the United States is unusual in taxing a wide range of unrepatriated *active* income as a deemed dividend to the U.S. parent, including:[13]

- Foreign base company sales income;
- Foreign base company services income; and
- Active financial services income (an exclusion of this income from Subpart F expired last year).

The net effect of these tax differences is that 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 of the United States.

Complexity. The U.S. rules for taxing foreign source income are among the most complex in the Internal Revenue Code. A survey of Fortune 500 companies found that 43.7 percent of U.S. income tax compliance costs were attributable to foreign source income even though foreign operations represented only 26–30 percent of

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[11] See, National Foreign Trade Council, *International Tax Policy for the 21st* Century, vol. 1, 2001, pp 95–96.

[12] See, National Foreign Trade Council, *U.S. International Tax Policy for the 21st* Century, vol. 1, Part II, 2001

[13] *Ibid.*, vol. 1, Part I.

worldwide employment, assets and sales.[14] These data show that U.S. tax compliance costs related to foreign source income are grossly disproportionate. These high compliance costs are a hidden form of taxation that discourages small U.S. companies from operating abroad and makes it more difficult for larger companies to compete successfully with foreign multinationals.

The international tax recommendations in the Joint Committee on Taxation's simplification study are a good start to begin addressing the high compliance burden imposed by U.S. international tax rules.[15] It should also be noted that the Treasury Department's tax simplification project, described in the Administrations FY 2003 Budget, identifies the international tax rules as an area singled out by taxpayers as one of the biggest sources of compliance burden.[16]

C. Conclusion

Short of adopting a territorial tax system, there are significant opportunities to increase the competitiveness and reduce the complexity of the U.S. tax rules applicable to foreign source income. Indeed, there are a number of reasons to think very carefully before adopting a territorial income tax system.

First, foreign experience suggests that adopting a territorial income tax system does not guarantee a simple tax regime. OECD Countries with territorial income tax systems also have parallel foreign tax credit rules for foreign income that is not exempt. Moreover, many OECD countries with territorial income tax systems also have anti-deferral rules that tax certain income earned by foreign subsidiaries on a current basis.

Second, depending on how a territorial tax system is designed, it could cause a substantial tax increase for companies that currently repatriate dividends from high-tax jurisdictions. Present law allows excess foreign tax credits on high-taxed foreign income to be used to reduce U.S. tax on low-taxed foreign income within the same limitation category. Under a dividend exemption system, cross crediting between dividends and other types of foreign income generally is not possible.

Third, allocation of U.S. interest and other domestic expenses against foreign source income causes these expenses to be nondeductible under a territorial income tax system. Double taxation will result unless foreign governments allow a deduction for these allocated expenses.

One opportunity for international tax reform is worth special mention within the context of these hearings, i.e., the foreign base company sales rules adopted by Congress in 1962 as part of Subpart F of the Internal Revenue Code. Absent these rules, U.S. companies would be able to set up sales companies in low-tax jurisdictions and reinvest their active foreign earnings without current U.S. tax. In fact, part of the benefits of the FSC regime were attributable to the fact that it created an exception to the foreign base company sales rules.[17] Repeal of the foreign base company sales rules would put U.S. companies in a more comparable position to their foreign competitors who generally can use these structures with being subject to home country tax. Moreover, the original policy rationale for these rules was thrown into doubt by the Treasury Department's policy study on Subpart F, released in December 2000, which concluded that the economic efficiency effects of the base company rules were "ambiguous."[18]

VI. SUMMARY

U.S. rules for taxing both domestic and foreign source income are out of step with other major industrial countries in a number of ways. Regardless of the ultimate resolution of the ETI case, Congress should consider changes to the U.S. system that promote economic growth and reduce costs of complying, with and administering the tax system.

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[14] Marsha Blumenthal and Joel Slemrod, "The Compliance Costs of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications, *International Tax and Public Finance*, vol. 2, no. 1, 37–54 (1995).

[15] Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986,* JCS–3-01 (April 2001).

[16] Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2002*, *Analytical Perspectives*, p. 79

[17] This exception was one of the reasons that the FSC regime was determined by the WTO to violate the Agreement on Subsidies and Countervailing Measures under the "but for" test.]

[18] U.S. Department of the Treasury, Office of Tax Policy, *The Deferral of Income Earned through U.S. Controlled Corporations: A Policy Study* (December 2000) p. 47. The report reached similar conclusions regarding the other foreign-to-foreign related party rules of Subpart F such as the foreign base company services income rules.

If the United States is an unattractive location—from a tax standpoint—to headquarter a multinational corporation, then U.S. multinationals will lose global market share. This can happen in a variety of ways.

First, U.S. individual and institutional investors can choose to invest in foreign rather than U.S. headquartered companies. Indeed, as of 1999, almost two-thirds (66 percent) of all U.S. private investment abroad was in the form of portfolio rather than foreign direct investment. This allows U.S. investors to invest in multinational companies whose foreign operations generally are outside the scope of U.S. tax rules.

Second, in a cross-border merger, the transaction may be structured as a foreign acquisition of a U.S. company rather than the reverse. Measured by deal value, over the 1998–2000 period, between 73 and 86 percent of large cross-border transactions involving U.S. companies have been structured so that the merged company is headquartered abroad.[19] Clearly taxes are only one of many considerations in the structuring of these transactions, but it is notable that in one large transaction, taxes were specifically identified as a significant factor.[20] By choosing to be headquartered abroad, the merged entity can invest outside the United States without being subject to the complex and onerous U.S. rules that apply to the foreign source income of U.S.-headquartered companies.[21]

Third, and most starkly, a growing number of U.S. companies have structured transactions in which their U.S. parents are acquired by their own foreign subsidiaries. Such "inversion" transactions, like foreign acquisitions of U.S. companies, allow new foreign investments to be structured as subsidiaries of a foreign parent corporation and thus not subject to U.S. rules relating to the taxation of foreign source income.

Fourth, an increasing number of new ventures are being incorporated at inception as foreign corporations.

While some have suggested that reducing the U.S. tax burden on foreign source income could lead to a movement of manufacturing operations out of the United States ("runaway plants"), an alternative scenario is that a *noncompetitive* U.S. tax system will lead to a migration of multinational headquarters outside the United States.

A decline in the market share of U.S. multinationals may affect the well being of the U.S. economy because, as noted above, U.S. multinationals play an important role in promoting U.S. exports and creating high-wage jobs.

EXHIBIT 1—CENTRAL GOVERNMENT CORPORATE INCOME TAX RATES, 1986–2001

Country	1986	1991	1995	2001
Australia	49.0	39.0	33.0	34.0
Austria	30.0	30.0	34.0	34.0
Belgium	45.0	39.0	39.0	40.2
Canada	36.0	29.0	29.0	27.0
Denmark	50.0	38.0	34.0	30.0
Finland	33.0	23.0	25.0	29.0
France	45.0	34/42	33.0	33.3
Germany	56.0	50/36	45/30	25.0
Greece	49.0	46.0	35/40	37.5
Iceland	51.0	45.0	33.0	Na
Ireland	50.0	43.0	40.0	20.0
Italy	36.0	36.0	36.0	36.0
Japan	43.0	38.0	38.0	30.0
Luxembourg	40.0	33.0	33.0	30.0
Netherlands	42.0	35.0	35.0	35.0
New Zealand	45.0	33.0	33.0	33.0
Norway	28.0	27.0	19.0	28.0
Portugal	42/47	36.0	36.0	34.0
Spain	35.0	35.0	35.0	35.0
Sweden	52.0	30.0	28.0	28.0

[19] Recent examples include: AEGON–Transamerica, BP–Amoco, Daimler-Chrysler, Deutsche Bank-Bankers Trust, and Vodafone-AirTouch.

[20] *See*, John L. Loffredo, "Testimony before the Senate Finance Committee" (March 11, 1999) regarding the Daimler-Chrysler transaction.

[21] Where business reasons dictate the form of a transaction, there generally is no cause for concern. The concern we are raising is that non-competitive U.S. tax rules may be influencing the form of transactions.

EXHIBIT 1—CENTRAL GOVERNMENT CORPORATE INCOME TAX RATES, 1986–2001—Continued

Country	1986	1991	1995	2001
Switzerland	4–10	4–10	4–10	8.5
Turkey	46.0	49.0	25.0	30.0
United Kingdom	35.0	34.0	33.0	30.0
United States	**46.0**	**34.0**	**35.0**	**35.0**
Unweighted averages: [1]				
EU	42.8	35.9	34.4	31.8
OECD	41.4	35.0	32.0	30.5

[1]Midpoint tax rate used for countries with multiple rates.

Sources: Jeffrey Owens, *Tax Reform for the 21st Century*, Tax Notes International. 2001 data from American Council for Capital Formation, "The Role of Federal Tax Policy and Regulatory Reform in Promoting Economic Recovery and Long-Term Growth," November 28, 2001.

EXHIBIT 2—TAXATION OF CORPORATE DIVIDENDS IN OECD COUNTRIES, 1999

No relief from double taxation of corporate dividends	Method of relieving double taxation of corporate dividends			
	Shareholder level			Corporate level
	Imputation system (partial or complete)	Tax credit method	Special personal tax rate	
Netherlands Switzerland United States	Australia Finland [5] France Ireland [3] Mexico New Zealand Norway Portugal United Kingdom	Canada Rep. of Korea Spain	Austria Belgium [5] Czech Republic Denmark Germany [1] Greece [5] Hungary Italy Japan Luxembourg [4] Poland Sweden Turkey United Kingdom	Iceland [2]

[1] Germany recently has adopted a 50 percent dividend exclusion.
[2] Deduction for dividends paid may offset fully the corporate and personal income tax for dividends up to 15 percent of capital value. Dividends in excess of this limit are fully taxed at both levels.
[3] Ireland eliminated its imputation credit effective April 6, 1999.
[4] Luxembourg has a 50 percent dividend exclusion.
[5] Information as of 1996 based on S. Cnossen.

Sources: PricewaterhouseCoopers, Individual Taxes 1999–2000: Worldwide Summaries (John Wiley & Sons, 1999) and Sijbren Cnossen, *Reform and Harmonization of Company Tax Systems in the European Union*, Research Memorandum 9604, Erasmus University, Rotterdam (1996).

EXHIBIT 3—COMBINED U.S. INDIVIDUAL AND CORPORATE STATUTORY TAX RATE IN 2002: CORPORATE INCOME DISTRIBUTED AS DIVIDEND TO INDIVIDUAL SHAREHOLDER IN TOP BRACKET

Corporate income	$100.00
Less corporate income tax at 35% (federal)	$35.00
Net income	$65.00
Dividend assuming 100% distribution	$65.00
Less individual income tax at 38.6% (federal)	$25.09
Net income after federal and individual income tax	$39.91
Combined corporate and individual income tax rate	60.09%

EXHIBIT 4—INCOME AND PROFITS TAXATION, 1999

Percent of Total Taxation in OECD Countries		
Rank	**Country**	**Percent**
1	Australia	59%
2	Denmark	58.9%
3	New Zealand	57.2%
4	**United States**	**49.1%**
5	Canada	48.9%
6	Ireland	42.2%
7	Sweden	41.6%
8	Finland	41.1%
9	United Kingdom	39.2%
10	Iceland	39.1%
11	Belgium	38.6%
12	Luxembourg	36.2
13	Switzerland	36.2%
14	Norway	35.8%
15	Italy	34.0%
16	Japan	31.4%
17	Turkey	31.4%
18	Mexico	30.0%
19	Germany	29.8%
20	Portugal	28.8%
21	Austria	28.7
22	Spain	28.1
23	Greece	26.4%
24	Netherlands	25.3%
25	Korea	24.8%
26	France	24.0%
27	Slovak Republic	24.0%
28	Hungary	23/2%
29	Poland	22.6%
30	Czech Republic	22.3%
Unweighted averages		
	OECD	35.3%
	EU	34.9%

Source: OECD, Revenue Statistics, 1965–2000 (2001)

EXHIBIT 5—EFFECTIVE AVERAGE TAX RATE FOR INVESTMENT INTO EU

Investment from MNC based in:	Financing of foreign subsidiary			
	Retained earnings	New equity	Debt	Average
EU	30.1%	30.4%	30.2%	30.2%
US	33.2%	35.7%	34.7%	34.5%

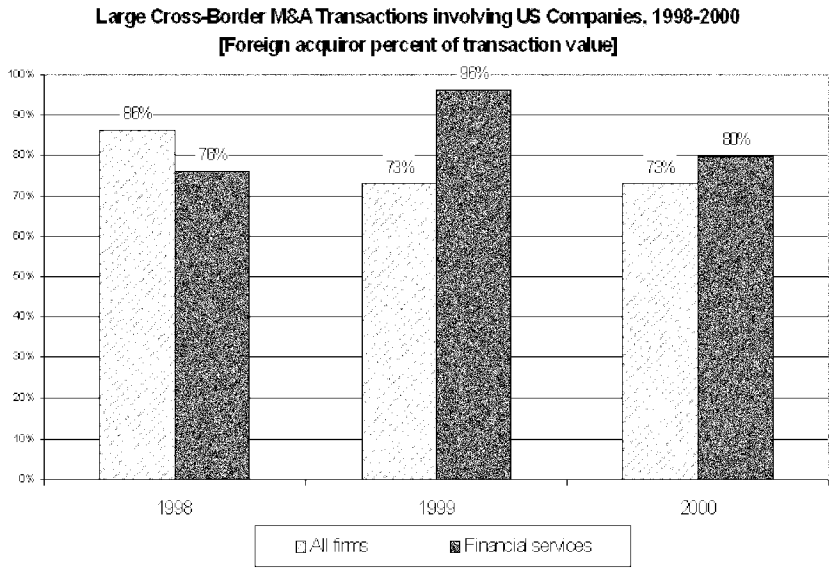
Source: Commission of the European Communities, "Towards an Internal Market without Obstacles," Com(2001)582, Brussels, October 23, 2001.

EXHIBIT 6—TAXATION OF FOREIGN SUBSIDIARY DIVIDENDS IN OECD COUNTRIES, 1999

Dividend exemption (territorial) system (Either by statute, by treaty or for listed countries)	Worldwide taxation system
1. Australia	1. Czech Republic
2. Austria	2. Greece
3. Belgium	3. Iceland[2]
4. Canada	4. Italy
5. Denmark	5. Japan
6. Finland[2]	6. Rep. of Korea
7. France	7. Mexico
8. Germany	8. New Zealand
9. Hungary	9. Norway
10. Ireland[1]	10. Poland
11. Luxembourg	11. Portugal
12. Netherlands	12. Spain[3]
13. Sweden	13. Turkey
14. Switzerland	14. United Kingdom
	15. United States

[1] Although Ireland nominally has a worldwide tax system, under the Finance Act of 1988, foreign subsidiary dividends generally are exempt if re-invested in employment-generating activities within Ireland.
[2] Information as of 1990 based on OECD.
[3] Some treaties provide for the exemption method.
Sources: (1) PricewaterhouseCoopers, Individual Taxes 1999–2000: Worldwide Summaries (John Wiley & Sons, 1999). (2) OECD, Taxing Profits in a Global Economy: Domestic and International Issues (1991).

EXHIBIT 7



STATEMENT OF STEPHEN E. SHAY, PARTNER, ROPES & GRAY, BOSTON, MASSACHUSETTS, AND LECTURER IN LAW, HARVARD LAW SCHOOL

Mr. SHAY. Thank you, Mr. Chairman, Mr. Rangel and Members of the Committee. My name is Stephen Shay. My testimony is in the record along with my biography.

I want to emphasize the views I am expressing are my personal views and do not represent the views of either my clients or my law firm. I just want to touch on four points.

The unspoken premise of everything that has been discussed so far relies on a definition of competitiveness that aligns U.S. competitiveness with benefits to U.S. multinationals. I think the Committee should adopt a view of competitiveness that is implicit in the Chairman's statement. Does any proposal ultimately improve the welfare of American citizens and residents, that is, individual citizens, individual residents? That is what all of this is ultimately about.

So when we talk about a proposal that will improve the profitability of a multinational, the task for it should be, will it meet that test, will it ultimately improve the welfare of the individual citizens and residents of this country?

Second, the ETI. What the ETI does, at the bottom line, is reduce the effective tax rate on income from exports by roughly 5.25 percent. So your effective rate, instead of 35 percent for a corporate taxpayer, is 29.75 or thereabouts.

Who benefits from the ETI? Because of other rules, we have in our code, particularly something called the "sales source rule," companies that operate abroad and have excess foreign tax credits normally will elect to take advantage of the sales source rule and not the ETI. So the ETI benefits, principally, two categories of taxpayers, those that export exclusively from the United States don't pay foreign taxes, and those that do operate abroad, that manage their foreign taxes to remain below the U.S. tax rate. That is who benefits.

The third point I would like to make relates to adoption of a territorial system, the exemption of U.S. tax on foreign business income. Is that relevant? Is that responsive to the taxpayers who are affected by a repeal or demise of the ETI? I submit that it is not.

If you adopt a territorial system, it generally has three key elements. First and most relevant, it provides that business income earned by a U.S. person outside the United States from operations outside the United States would be exempted from U.S. tax under a territorial system.

Second, losses from operations outside the United States normally would be disallowed. In other words, you have exempt income, you don't get to take deductions against exempt income.

Third, most countries—in fact, I think almost all countries that have adopted a territorial system—tax fully foreign-source interest and royalties, including royalties from the license of U.S. intellectual property abroad. Thus, the benefit of a territorial system applies where there is foreign-located economic activity and there is a lower tax rate than the U.S. tax rate.

This is not a substitute, in terms of impact, for a replacement of the ETI. There are other problems with a territorial system. First, it does create a bias if you can find a place to locate activity that is subject to a lower tax rate than the United States. If it is otherwise something you were doing in your business and you were indifferent at the margin you would place the activity where there is lower tax.

For that reason, a territorial system needs very significant safeguards, more than what we have today. You need to be sure that expenses are not allocated to foreign income. You need to be sure that pricing does not shift income to the exempt area. You need to be sure that there are anti-abuse rules, so that inappropriate transfers of businesses aren't occurring.

A territorial system is not a simplification panacea. So if this Committee chooses to look at it, you need to look at it very carefully with those in mind.

As Mr. Hufbauer has suggested, I encourage the Committee to look at other alternatives that, frankly, go the other way, that would increase the taxation of foreign income to equalize it with what it would be on U.S. income.

My time has expired. I would be happy to take any questions from the Committee.

[The prepared statement of Mr. Shay follows:]

Statement of Stephen E. Shay,* Tax Partner, Ropes & Gray, Boston, Massachusetts, and Lecturer in Law, Harvard Law School

Mr. Chairman and Members of the Committee:

My name is Stephen Shay. I am a partner in the law firm Ropes & Gray in Boston and a Lecturer in Law at Harvard Law School. I specialize in U.S. international income taxation and was formerly an International Tax Counsel for the Department of the Treasury in the Reagan Administration. I was invited last Friday by the Committee to be a witness to discuss some of the potential fundamental tax reform alternatives that the Committee might consider in response to the WTO decision.[1]

With the Chairman's permission, I would like to submit my testimony for the record and summarize my principal observations in oral remarks.

Overview

In the announcement for the Hearing, Chairman Thomas stated the purpose for the Hearing as follows:

> Although the most recent [WTO] decision comes as no surprise, it illustrates the need to fundamentally reform our tax system so that U.S. workers, farmers and businesses are not disadvantaged in international trade. This will be the first of several hearings to consider the WTO Appellate Panel decision and to examine ways to maintain the international competitiveness of the United States.

The purpose of my testimony is to describe certain fundamental international tax reform alternatives and observe how they do or do not relate to the possible elimination of the Extraterritorial Income exclusion ("ETI").

I will first briefly review the ETI and the activity it benefits. I next describe a territorial tax system, how it creates an incentive to locate investment in lower-taxed foreign countries, and how the activity it benefits differs from the activity benefited by the ETI. I then consider other approaches to international tax reform, including modifying the current U.S. system of worldwide taxation (with deferral of tax on business income earned through foreign corporations) to reduce rather than increase the incentive under current law to locate investment outside the United States in a low-taxed foreign country.

The ETI Regime

The ETI was enacted in November, 2000. Under the ETI, a taxpayer may exclude a percentage of income attributable to foreign trading gross receipts ("FTGR") or net income from FTGR.[2] The bottom line effect of the ETI is to reduce the tax rate on this income by approximately 15%. Thus, a domestic corporation subject to a 35% Federal corporate tax rate will pay a 29.75% rate on its net income subject to the ETI regime.

The ETI is designed, like the FSC, to prevent a taxpayer electing the ETI from also obtaining the full benefit of the sales source rule for exporters under the Internal Revenue Code. The sales source rule permits taxpayers that manufacture in the United States and sell outside the United States to treat 50% of the income from the sale as foreign income. In most cases, this foreign income is in the general foreign tax credit limitation category and, for firms that have enough excess foreign tax credits (i.e., have paid foreign taxes at a rate higher than the effective U.S. rate on the same general limitation category of foreign income), permits this income to be exempt from U.S. tax. The marginal rate of U.S. Federal tax on these export sales is 17.50%.[3] For taxpayers with excess foreign tax credits, the benefit of the sales source rule is generally larger than the ETI benefit. Thus, the sales source rule causes the ETI to benefit taxpayers that do not have excess foreign tax credits, that is, taxpayers that either exclusively export from the United States or, if they

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

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

[2] FTGR generally are receipts from sales of qualified foreign trade property, leasing of qualified foreign trade property for use outside the United States, certain services in connection with foreign construction projects. Certain foreign economic processes have to be met in connection with earning FTGR. Qualifying foreign trade property is defined substantially in the same manner as "export property" under the FSC, including that no more than 50% of the property may be attributable to foreign content. The principal difference in definition, apparently thought by this Committee to be sufficient to satisfy the WTO rules, was that qualifying foreign trade property need not be manufactured in the United States.

[3] If the sales source rule applies to income of $100, the U.S. tax on $50 allocated to foreign income is $17.50 and is offset by foreign tax credits, the U.S. tax on the remaining 50 would be $17.50. Thus, the effective tax rate would be 17.50%.

also conduct foreign operations, have managed their foreign taxes to remain below the effective U.S. tax rate on the same income.

Alternatives to the ETI

As noted in the Hearing announcement, on January 14, 2002, the WTO Appellate Body issued a report upholding a dispute resolution panel finding that the ETI is a prohibited export subsidy.[4] The stated objective of the Committee's Hearing is to "examine ways to maintain the international competitiveness of the United States."

As an initial matter, it may be questioned whether the ETI (and its predecessors the FSC and DISC) did in fact improve the international competitiveness of the United States by comparison with alternative ways that the foregone revenues (or tax benefits) could have been spent. There appears to be support for the position that the impact of the ETI on net exports (the increase in exports reduced by the corresponding increase in demand for imports) was modest.[5]

In the following portions of my testimony, I assume for purposes of discussion that the Committee will not adopt a fourth proposal along the lines of DISC/FSC/ETI, but instead will consider other changes to the U.S. international tax rules. As described in the next section, the alternative to the ETI most frequently discussed in recent days, a territorial tax system, creates an incentive to locate investment outside the United States and does not benefit the exporter that carries on its manufacturing and/or selling operations entirely from within the United States. A territorial system also is often heralded as a simplification panacea, but as discussed in the next section, its simplification potential generally is overstated. I urge the Committee to also consider fundamental tax reform alternatives that would have the effect of decreasing U.S. tax benefits for foreign income and directing those revenues toward alternative uses, such as investment in domestic human capital or broader reductions in the level of taxation on all business income.

Changing from A Worldwide Tax System with Deferral to A Territorial Tax System

The major approaches by which the tax system of a country (the "residence country") accounts for income earned by its residents in a foreign country ("foreign-source income") are a worldwide system and an exemption, or territorial, system. If the United States were to adopt a territorial system comparable to the systems adopted in other countries, the United States (i) would not tax its own residents' foreign-source business income that is subject to taxation in another country,[6] (ii) would disallow the deduction of foreign business losses,[7] and (iii) would tax currently portfolio dividends and all foreign source interest and royalties. In other words, only foreign-source business income would be exempt from U.S. tax and this income would bear the tax only in the foreign country where the income was produced (the "source country").

The principal objection to a territorial system is that it creates a bias, not in favor of investment in domestic production for export, but in favor of investment in foreign operations. In the worst case, this bias causes a foreign investment to be pre-

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[4] The ETI was the successor to the Foreign Sales Corporation ("FSC"), enacted by the Congress in 1984 and found by a WTO Appellate Body in February, 2000, to be a prohibited export subsidy. The FSC was the successor to the Domestic International Sales Corporation ("DISC") enacted in 1971, and found to be an export subsidy in a panel report adopted by the GATT Council in 1981. The 1981 GATT Council decision was subject to an understanding that a country need not tax export income attributable to economic processes outside their territory. This understanding was the source of the U.S. approaches in the FSC and the ETI to characterize the benefited income as being taxed in a manner comparable to the taxation under a territorial system. I do not discuss here the substance of the U.S. position nor its merits as a matter of trade law. Suffice it to say, the WTO has twice rejected the U.S. efforts in this regard.

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

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

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

ferred even though the U.S. investment has a higher before-tax rate of return and is, therefore, economically superior.[8]

The justification for exempting U.S. multinationals' foreign-source business income is based principally on a competitiveness argument that is usually stated as follows: foreign corporations operating businesses in low-tax foreign countries owned by residents of countries with a territorial tax system, as well as local businesses in the low-tax foreign countries, pay only the low local income tax on their in-country profits. Without exemption, U.S. multinationals are unduly disadvantaged when competing against these foreigners in low-tax foreign countries because in addition to the foreign tax, a U.S. multinational will pay a U.S. residual tax on its foreign profits, while the foreigners would pay only the low foreign tax. Therefore a U.S. multinational should be given a countervailing exemption from the U.S. residual tax.[9]

This argument is not a request for the United States to give U.S. multinationals relief from international double taxation. The foreign tax credit already addresses that issue. Instead, this is a request for tax system assistance that is not available to pure exporters or other earners of U.S.-source income.

Relieving U.S. multinationals' foreign-source income from U.S. tax would be a poorly structured tax assistance measure because the assistance would not be targeted at U.S. corporations that face tax-related competition. To be specific, a U.S. multinational facing little tax-related foreign competition in low-tax foreign countries, whether because (i) it is selling paten—or copyright-protected goods, (ii) its principal competitor is from a foreign country that does not have a territorial system, or (iii) its competitor is another U.S. corporation, would benefit as extensively from a territorial system as a U.S. multinational facing the tax-based competition.

In the current context of the possible repeal of the ETI, proponents of a territorial system should be required to go further than making generalized competitiveness arguments, and should link the tax benefits of an exemption system to promotion of U.S. exports. It is anticipated that the proponents will argue that these benefits for operations in lower tax foreign countries will generate greater purchases of U.S. goods because U.S. multinationals will buy from their U.S. affiliates and suppliers. Although this is a claim that deserves some scrutiny, at best this is an assertion that tax assistance to the operations of U.S. multinationals in low-taxed foreign countries indirectly encourages U.S. exports. This is a remote and somewhat speculative support for U.S. exporters and is heavily weighted for businesses with foreign operations that already are advantaged by deferral. There is no direct relationship between adoption of a territorial system and benefiting domestic U.S. exporters that do not carry on foreign operations.

Adoption of a territorial system also is not a simplification panacea. The allocation of expenses between U.S. and foreign source income would be critical to determining which expenses are allocable to exempt foreign income under a territorial system and therefore disallowed as deductions. Today, the allocation of expenses to foreign income is a potential audit issue primarily for taxpayers that have excess foreign tax credits. Under an exemption system, there would be pressure for *all taxpayers* that earn exempt foreign income to allocate expenses, such as interest and research and development costs, to domestic income and away from exempt foreign income. Thus, the IRS would have to increase its scrutiny of this difficult area.

Similar to the transfer pricing pressures existing today, taxpayers with foreign operations would have an incentive to shift U.S. income to exempt lower taxed foreign operations. Under a territorial system, however, the benefit is permanent (and not

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[8] For example, assume that USCo is a U.S. corporation considering a new business that will produce a 10 percent return, before U.S. income taxation, if the business is located in the United States, and an 8 percent return, before U.S. income taxation, if the business is established in a foreign country. Assume further that the United States will tax USCo at a flat 35 percent rate and that the foreign country will impose a 10 percent rate of tax. If USCo is exempt from U.S. tax on profits from the foreign investment under a territorial system, USCo will be choosing between after-tax returns of 6.5 percent (.10 x [1-.35]) in the U.S. location and 7.2 percent (.08 x [1-.10]) in the foreign location. In this example, the pre-tax rate of return of the U.S. investment is 20% higher than the foreign investment, but the after-tax rate of return under a territorial system is 10.77% lower than the foreign investment. Thus, the effect of a territorial system is to create a strong incentive for USCo to make the economically inferior foreign investment.

[9] Although a territorial system provides no direct benefit for foreign operations in countries with effective tax rates equal to or higher than the U.S. rate, it does offer greater potential for a U.S. multinational to reduce high foreign taxes through tax planning techniques that shift income from a high tax to a lower-tax foreign country. Although often effective today, these planning techniques would be frustrated by expansion of the high tax countries' CFC regimes which is the general trend in these countries.

a deferral of tax until repatriation) and transfer pricing would take on commensurately greater significance.

Adoption of a territorial system would not eliminate the need for anti-abuse measures that are comparable in effect to our current highly complex anti-deferral regimes. Major developed countries that have territorial systems also have adopted controlled foreign corporation ("CFC") regimes or other legislation to prevent tax-motivated offshore investment. France, for example, provides for exemption of, or a reduced tax on, foreign income, but has adopted expansive CFC legislation. Germany, which exempts foreign business income earned in treaty partner countries, has adopted foreign investment fund legislation that denies favorable tax treatment to certain diversified foreign investment funds that are not listed in Germany or do not have a tax representative in Germany. These sophisticated territorial countries recognize the need to protect the domestic tax base by reducing the incentive to shift income-producing activity abroad. Indeed, the need to protect the domestic tax base is more pronounced for a country that does not tax foreign income than for a country that taxes foreign income and employs a foreign tax credit system.

The Committee should take these considerations into account if it considers a territorial tax system.

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

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

The current U.S. system therefore is subject to many of the same criticisms as a territorial system. An appropriate response to those criticisms, however, only may be achieved through a reform of the current worldwide tax system. Adoption of a territorial system would be a second best solution to a reasoned reform of the current rules.

The original proponents of the DISC argued for the export subsidy in part on the grounds that exporters were disadvantaged relative to taxpayers that could locate their operations abroad and take advantage of deferral. In other words, an original rationale for the DISC predecessor of the ETI was to equalize for exporters the advantages realized by U.S. multinationals from deferral.[10] If the ETI is repealed and a third DISC successor is precluded by the WTO rules, as a logical matter the Committee could consider decreasing the tax advantages to earning low-taxed foreign income through foreign corporations.

Does decreasing the tax benefits for foreign income improve competitiveness? An initial question is how to define competitiveness. It is questionable whether U.S. competitiveness should be defined in terms of U.S. multinationals' profitability. A more meaningful measure of competitiveness is whether any proposal will advance the welfare of individual U.S. citizens and residents.[11] The proponents of tax assistance to enhance the returns of U.S. multinationals, and their shareholders, from foreign operations should be expected to carry the burden of demonstrating the value of the assistance will exceed both the revenue cost and the opportunity cost of alternative uses for that revenue. For example, would investment of a given amount of revenue in education grants to localities improve the living standard for Americans more than the same amount of tax relief for foreign income of U.S. multinational businesses?

I respectfully submit that the Committee should consider proposals that would cut back on the deferral benefit for foreign income as an alternative to the ETI or a territorial system. I and my co-authors, Professors Robert J. Peroni and J. Clifton

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

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

Fleming, Jr., have outlined a proposal for a broad repeal of deferral.[12] Essentially, our proposal would apply mandatory pass-through treatment to 10% or greater shareholders in foreign corporations.

One would not have to go so far as our proposal to make substantial improvements in the current international tax rules without increasing the current incentives to locate investment outside the United States. There would be substantial improvements to the controlled foreign corporation rules if the current foreign base company sales and services rules applied without exception whenever the CFC's income, determined separately for each foreign legal entity and qualified business unit of the CFC, was not taxed at a effective foreign tax rate of some minimum amount. Under current law, a safe harbor exists for income taxed at 90% of the U.S. rate; the Committee could choose to employ a lower percentage of the U.S. rate.[13] Although this is a second best approach to the mandatory pass-through approach, it would be a substantial improvement over today's rules.[14]

The kinds of changes just described could be combined with revenue neutral reductions in tax for business income generally. This approach would assist U.S. businesses that export from the United States or compete against foreign imports as well as those that operate abroad. Alternatively, any revenue increase from these changes could pay for more favorable depreciation and amortization for investment in productive property, used to improve U.S. education or fund anti-terrorism initiatives. Whatever the choice, I respectfully urge the Committee to consider international tax reform proposals that will improve the well-being of all U.S. citizens, workers, farmers and businesses and not just those in the multinational sector.

I would be pleased to work with the Committee to analyze and develop alternative fundamental international tax reform proposals.

Chairman THOMAS. I want to thank all of you, especially for your written testimony, which gives us at least a disembarking point on looking at some options that are inevitable as we are going to, as they say, round up the usual suspects. We want as much help as we can get in fully understanding what those suspects look like and clear the territorial taxes often offered as a potential.

Mr. Hufbauer, let me understand your oral statement, because I would like to ask the question this way.

We had a first appeal of the decision. We modified our position slightly, obviously, and certainly not enough; and we got a second decision. Are you saying by the fact that there was a change in the substance and manner of the second appeal that perhaps the United States would have been relatively advantaged in how many hostages we could take under the first appeal, that on balance we probably should not have taken the second appeal?

Mr. HUFBAUER. I guess it is always easy to do quarterbacking on these difficult legal decisions. But the rationale changed very dramatically between WTO reports. I know you did read, Mr. Chair-

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[12] Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. Rev. 455 (1999); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Deferral: Consider Ending It Instead of Expanding It*, 86 Tax Notes 837 (2000).

[13] The current foreign tax credit mechanism could be improved by repeal of the sales source rule combined with improvements to the interest allocation rules and allowance of foreign as well as domestic loss recapture. Finally, some simplification may be achieved in the U.S. international rules by consolidating anti-deferral rules and rationalizing the source rules.

[14] It might be argued that these changes would pressure U.S. companies to become foreign companies. If this is perceived as a significant problem, the Committee could consider a range of alternatives. For example, the Committee adapt existing U.S. tax provisions to require U.S. investors to take account at the time of sale whether a publicly-traded foreign corporation's earnings during the investor's ownership have borne a level of foreign tax equal to or greater than the U.S. corporate tax rate. If not, the investor could be taxed on the gain to make up the difference in the same manner as currently applies under Section 1248(b) of the Code. An alternative approach would be to re-examine the circumstances in which a foreign corporation should be taxed as a domestic corporation.

man, and I know everybody here did read, that first appellate body report. What the WTO focused on in the first report was the difference in taxation between production abroad and exports. And, as you know, the ETI was an attempt—and I think a good-faith attempt at the time—to come up to the letter of the first set of decisions, because foreign production and export taxation was harmonized.

The goal post moved in the second round, and in the second round the WTO said, well, what we have got to do is look at the normative benchmark. That was at the panel level, and at the appellate level—and really I am condensing a lot—they came to this "but for" test, but for ETI, the export income would be taxed with a foreign tax credit. And the only reason a company would choose ETI is because the tax was less. So, the WTO reasoned, ETI is a goner. But they moved the goal post.

Now, I suppose with a good crystal ball you could have said, if the WTO doesn't like the FSC, it is going to move the goal post to catch ETI; with this crystal ball, you wouldn't have enacted the ETI, or you would have done it differently. But that is all rewriting history. But, I want to emphasize, the goal post moved. And it moved further between the panel report and the appellate body report in the second round.

In the first round, the appellate body said, "Panel, you are in good shape." In the second round, the appellate body said, "This is a bombshell." We are going to get rid of the normative benchmark idea and instead we are going to go for a, "but for" test. Under the normative benchmark, the United States could have looked at whatever the normative benchmark—whatever that means—was for each and—every tax system, and then pointed out exceptions and 25 possible subsidies. And we could have said, "You (Country X) are not following your own normative benchmark; you (Country Y) are not following yours." We could have brought a boatload of cases.

But under the "but for" test, it will not be a boatload of potential cases. There will be some—but I don't have the expertise that Peter Merrill does or Steve Shay does to say how many. I am sure there are "but for" problems out there, but they are not as big as with the normative benchmark.

I am sorry to be so long on that.

Chairman THOMAS. I think very few, if anyone, agrees with your conclusion that they moved the goal posts. But in our pursuit of solutions, it might be at least helpful for us to understand the relationship that we are now in with the Europeans. And then the question goes not to what the goal posts did, but the why.

In your opinion, was it because we were pretty good on the ETI in terms of the first appellate decision, and it may have fit, had they remained consistent; or was it that there was too much collateral damage to the Europeans, based upon that first decision, and since we decided to try again instead of going in a different direction, that decision couldn't stand and that they needed some cover?

Clearly, it is probably a little bit of each, but do you have any insight for the Committee in helping us understand the shifting of the goal posts?

Mr. HUFBAUER. I don't have any inside information in from talking to the judges or the panelists, but I think the direction which you are seeing is absolutely right. They reflected and—they saw all the comments from here and around the world, and those judges and panelists reflected and said, "Look, we are becoming a World Tax Code Court too fast, too soon, and we are going to create just too much of a backlash."

There is a big issue on the balance between the judicial role of the WTO and its legislative (negotiating) role, I won't go into that, but the judges probably saw they were really over the hill on this one and thought, "Yeah, we don't like the FSC, we don't like the ETI, we think it is just a continuation of the DISC, and we are going to try to nail it more specifically."

Chairman THOMAS. Mr. Merrill, in your presentation, you talked about making some adjustments going back to some decisions that were made in 1962, and certainly the world has changed.

Do you have any indication of what the revenue forgone would be if we made some of those adjustments? Whether we look at it or not—as I discussed briefly with the gentleman from Tennessee, if we are going to look at victims here, there are people who are going to be looking for compensation and adjustments whether it merits it or not.

Could you give us some idea of the level of dollars we are talking about in the disruption in the Tax Code if we make some of the changes you suggested?

Mr. MERRILL. I have not done revenue estimates for these provisions, and certainly the official scorekeepers for these provisions are the Joint Committee on Taxation. And I am not aware—I have not seen any published estimates they have done on any of these provisions. It may well be that some of these provisions would be scored as relatively expensive.

Chairman THOMAS. And I think that our Joint Tax Committee does an excellent job, but it seems this is very difficult to mark, and as they are having difficulty determining what the compensation is, the actual dollar values, this Committee is going to need as bright a light as we can get on the decisions that we make relative to revenue shifts and winners and losers. Whether we like it or not, that has to be part of the decision process.

If you know of any, it would be very helpful; and we may rely on some of you in at least providing an alternative set of numbers, because in all likelihood it is going to be somewhere in between. No one is going to get this one right.

Mr. Shay, you began your testimony a little bit defensively, because Mr. Hufbauer said he disagreed with you before you started; and you identified pretty much where it was that he may have disagreed with you without his indicating any particulars. So did you guys talk ahead of time about what is obvious about the presentation Mr. Shay, that others would react negatively to or at least not agree?

Mr. SHAY. Are you asking me to point out where in my presentation——

Chairman THOMAS. I am asking you to defend the part that you felt sensitive about. I think some people maybe didn't follow.

Mr. SHAY. Well, the thrust of my testimony, which I think Gary was referring to, which I did not really spend time at length in my oral comments on, was that much of the discussion has been about how to potentially reduce U.S. taxation on foreign income by creating an exemption from U.S. tax on business income earned abroad. And indeed I think this may have come up earlier in today's hearing.

In fact, one of the original reasons for the DISC back in 1971, at least as reported in an article by somebody who was there cited in my testimony, was to equalize the treatment of exporters with those companies who could earn foreign income through foreign corporations and not pay current U.S. tax on that income. And part of what I was pointing out in my testimony is that if you go further, as some have suggested, and not just defer U.S. tax on foreign income earned through foreign corporations, but exempt from U.S. tax all foreign income, whether earned through a foreign operation directly or through a corporation, then you further exacerbate the distinction between the exporter who is operating exclusively in the United States—perhaps in Washington, perhaps in Chicago—from the multinational that is conducting part of their operations outside the United States.

So, as a matter of logic, there is an alternative approach to exempting foreign business income. It is to tax it and tax it equally so that that exporter in Washington or Chicago that may not have foreign operations is bearing the same U.S. tax burden as is the multinational, basically, that is performing aboard.

Now, then, to answer your question, the objection is made that some other countries do adopt a territorial system and do not tax that income earned in that other country when our company is in that other country. And that comes back to the first part of my testimony, Mr. Chairman, how significant is that element, the taxation element in that competitive mix; because if that is Pepsi and Coke, it is not relevant. If that is a company that is operating there under the protection of intellectual property laws that are respected in that country, so that they effectively have a monopoly on that product, the tax is not relevant.

So some of the solutions that are being proposed do not meet my criterion that I set out at the beginning of the testimony: Do they enhance overall U.S. competitiveness, not defining it in terms of the profitability of the multinational?

I am a private, practicing tax lawyer. If you give me the opportunity to advise my clients to enhance their profitability through the rules you will pass, I guarantee you I will take it, and I have taken it for 25 years.

I am here today before the Committee in a private capacity, not representing my clients, but representing what I perceive to be the best tax policy for the United States. And that is the standard I am asking the Committee to adopt, and for that reason, I am asking the Committee to include in its range of options that it is considering options that do not lower income U.S. taxation on foreign income, but increase it.

Mr. Hufbauer has extensively criticized that position, and I respect his arguments and I respect his position, but it seems to me that is what the debate should be about.

Chairman THOMAS. And I want to underscore that the reason I asked you to make those comments is that this Committee is certainly not going to arbitrarily or artificially cut off any avenue of investigation.

I do think, as you said, logic leads you to a particular position. We have to approach this with a somewhat scientific method which—more often than not, our hypotheses will be disproven. But in being disproven, it allows us then to move on to other areas.

The thrust of a fundamental change in the Tax Code is so difficult that we may have to look at some of these alternatives, and I can assure you that while we will not dismiss any alternative without having gone through the process to the best of our ability, looking at the pros and cons, and especially if we are going to add several different components together to get a full impact of exactly who the winners and losers are, our goal is not to try to respond to a WTO panel's attempt to determine our internal taxes and wind up punishing ourselves even more. Our goal is, to the best of our ability, change our system; and to the degree we can't do it, fundamentally to offset some of the negatives caused by this decision.

Gentleman from New York?

Mr. RANGEL. I thank all of you witnesses. You have been very, very helpful.

Mr. Hufbauer, do you believe there was justification for the WTO's decision to reject the way we handle our exports?

Mr. HUFBAUER. Not based on their first report. If you read the letter of the first report, I thought that the ETI—and I said so at the time, and I was obviously mistaken, but I thought it was consistent with the first panel report and the first appellate body report on the theory that we are a very contract-driven system in the WTO, and it is not a common law system.

It is becoming a common law system, and therefore, you could look at the letter, you could respect the letter and——

Mr. RANGEL. I was really referring to our last legislative response to their rejection. The last case that we lost, do you believe that was justification for the decision by the WTO to disregard what we thought was a remedial solution to our problem?

Mr. HUFBAUER. Mr. Rangel, I have read the decision. I see where they are making the arguments. I totally disagree with the second appellate body decision and the second panel report. They are the judges, not me, obviously.

Mr. RANGEL. While you disagree with their decision, you do believe under existing law that United States firms suffer a competitive disadvantage.

Mr. HUFBAUER. Yes, I do.

Mr. RANGEL. So that the WTO decision really gives us an opportunity to even better our position, even though their decision was that it put our friends at an advantage.

Mr. HUFBAUER. Absolutely. It can be changed in a way that we could be better off than we were before the FSC or before the DISC. It is up to the Congress and Treasury Department and people of America.

Mr. RANGEL. And are you suggesting that we should adopt a territorial system in terms of part of the solution to the problem that we face?

Mr. HUFBAUER. The word "territorial" is one of these plastic words that means different things to different people. And with my own nuances—and everybody would have their nuances—the fundamental answer is "yes." And I co-authored a book 10 years ago, U.S. Taxation of International Income, where we advanced this position, and while I would certainly have changes to whatever I said 10 years ago on this or any other subject, the basic answer remains "yes."

Mr. RANGEL. Would you support the suggestion made by Mr. Shay, that would create a large incentive for U.S. companies to move to countries that have low corporate taxes?

Mr. HUFBAUER. Absolutely not. I fundamentally disagree with that. Now I have to talk about one of the nuances. I go for a territorial system which is territorial with respect to countries which have normal tax systems. And I realize, "normal tax system" is a plastic term. But all these kind of "run away" arguments are talking about running away from the United States to the Bahamas or running away from the United States to I don't know where. Our whole international tax system is focused on a handful of little countries where nobody is running to except maybe some insurance companies. And that is where I would put my nuances. But our big competitors—you know the countries. U.S. companies are not going to run away to tax havens countries, but instead to Canada, to Mexico, to Germany, to Japan, to China. Under a territorial system, our companies are in fact going to be much more competitive doing business here, exporting directly, and especially exporting to their operations abroad, which Peter Merrill emphasized. This is terribly important in a global economy.

Mr. RANGEL. Mr. Shay, would you care to respond to Mr. Hufbauer?

Mr. SHAY. I guess there are two comments. One is that there are very legitimate taxing countries that have chosen to adopt a low rate of tax. A country I have enormous admiration for is Ireland, and they have chosen to adopt a corporate income tax rate which I think is now 12 percent. That is substantially below 35 percent. And I could in very good conscience counsel a client, if we had a tax-exempt system, to say if from a business perspective you could ship your product to your customers from the United States to Ireland and the customer would be equally satisfied—well, I don't think anybody here would make a different decision as to where they would locate the operation.

Second, I have been engaged in numerous planning exercises involving some of the countries that Mr. Hufbauer named that have what he calls normal tax systems, where we are able to bring the effective rate down not quite to 10 percent but substantially below 35 percent. And, in fact, I have worked with some at least former colleagues of people on the panel. So it is a complicated question.

I think the short answer is that most businesses run their businesses for business objectives first. There is a point where they come to their tax lawyers and they say, Okay, I have got two choices; does tax make a difference? Sometimes they come to the tax lawyer earlier, but the fact is taxes at the margin make a difference or else we wouldn't have been having this discussion.

Mr. RANGEL. Mr. Merrill, you are very cautious about the territorial system yourself.

Mr. MERRILL. That is correct. In my written statement, I raise a number of practical problems. I should say that in April of last year, the International Tax Policy Forum and the Brookings Institute and had a conference on territorial income taxation. All the papers for that are available on the ITPF Web site. There were a number of papers that described how territorial systems worked in Canada, Netherlands, and so forth. And what those detailed descriptions showed is that a territorial system is not necessarily a simpler tax system. So I think that is one concern.

There is also a concern that there could be a number of taxpayers that would have a substantial tax increase under a territorial tax system depending on how it was structured. And I think you would want to think carefully about redistributing the tax burdens in that way. And, frankly, one concern is that actually some exporters could face some very large tax increases under a territorial tax system, which again I think is something you would want to look at pretty carefully.

A third issue is the allocation of expenses, which under a territorial system means those expenses are nondeductible if allocated abroad. That is an issue we face today with interest allocation and the foreign tax credit. It affects so-called excess credit taxpayers. It is a much bigger problem under a territorial tax system.

So I think you have to look at it really carefully and, as Gary said, there are many different ways to do it and not all of them are particularly attractive.

Mr. CRANE. [Presiding.] I would like to throw a hypothetical question out at you, and it gets back to the proposal that I pushed for all the years that I have been here, and that is the total elimination of any tax whatsoever on business. And my argument has always been that they don't pay taxes in the first place, they gather taxes. And that is the cost of doing business just like plant and equipment and labor, and you got to pass it through and get a fair return or you are out of business.

So, given the hypothetical, let me ask you the question, if we eliminated any tax on business whatsoever in this country, what would be your assessment as to the impact on our exports?

Mr. HUFBAUER. Let me just make a distinction, Mr. Crane, between eliminating a tax on business and who actually writes the check. It is much easier for any tax authority to collect taxes from, let's say, 100,000 business firms than 100 million households. And so you do have the issue of who writes the check, if I can put it that way, who has the legal liability, which I think is quite distinct from the tax on business the way you are framing it in the question.

Now let me come to the question itself. The estimates that I have seen on responsiveness of investment to tax differences between countries, between States, between provinces, show a tremendous response. When I was young and going to university, in formal terms this responsiveness or elasticity was thought to be either zero or one half, 0.5. In other words, if you change your tax by 10 percent, at most you would get a 5 percent change in investment. Maybe you would get zero.

Recent studies are going to much higher numbers. The recent studies are more sophisticated, in their econometrics, but they are also capturing something that is happening in the real economy, which is that our firms, advised by Steve Shay and other bright people like Peter Merrill—are comparing taxes as well as everything else to a much greater extent than they once did, and probably the elasticity now internationally is three. That is to say, change your tax by 1 percentage point, and you get a 3 percentage change in investment, which is a big impact. So—Within the United States, the elasticity may be as high as 10 between States. I think if we got rid of the corporate income tax as we know it today, and replaced it with something else on a revenue-neutral basis, there would be——

Mr. CRANE. Not replace it; eliminate it entirely, and no offset. Don't come up with——

Mr. HUFBAUER. Well, then cut the spending. You would have to cut the spending side, and I am trying to deal with the fiscal balance—but keeping the fiscal balance the same by cutting spending or replacing the tax. But I think it would be a tremendous stimulus to investment and the competitiveness of the American economy in exports worldwide.

Mr. CRANE. Let me ask you one other follow-up question. To what degree do you think that provides an attraction to foreign companies to locate here in the United States?

Mr. HUFBAUER. That would be a big part of it. If we had a lower tax rate on business——

Mr. CRANE. Not lower; eliminate.

Mr. HUFBAUER. If we had elimination, you know we already have a lot of foreign direct investment in the United States.

Mr. CRANE. I have got a small steel company in my district that has just moved down to Bermuda because they don't have to pay taxes in Bermuda. What I am thinking about is the dynamics of the attraction of business here and job creation. And I don't think anyone could even begin to speculate on what that might translate into as far as increased revenues here in D.C.

Mr. HUFBAUER. I agree.

Mr. CRANE. Could you other folks comment on that, Mr. Merrill?

Mr. MERRILL. If I understand your proposal, you would dramatically reduce the tax burden on capital. That would have the effect of lowering the costs for U.S. companies that are capital intensive in producing their goods. It would make their goods more competitive in world markets. There is no doubt about that.

Your proposal, as I understand it, would make the United States a very attractive place to locate your operations, because income earned within the United States would be subject to only one level of tax for U.S. shareholders and that should attract investment into the United States.

Mr. CRANE. Mr. Shay.

Mr. SHAY. I think you would have to be careful about what you actually mean. If you mean by eliminating tax on business, as Peter just assumed, eliminating a tax on capital and only taxing wages that is one thing. But you suggested before that you didn't mean that; that what you meant was eliminating tax on business and reducing spending and leaving the income tax on individuals.

Mr. CRANE. Well, wait. I didn't say reducing spending, because I think the dynamics of it would not necessarily dictate reducing spending.

Mr. SHAY. Then I think we are getting back to where Peter was. You would be eliminating tax on business, and all of that tax revenue would be made up at the individual level, correct?

Mr. CRANE. Well, not necessarily made up. We passed a tax cut last year, $1.3 trillion over 10 years. And I have seen projections that if you eliminated any tax whatsoever on business it would amount, I think, like $25 to $30 billion a year over 10 years.

Mr. SHAY. Implicitly what you are assuming then is that, because what you anticipate to be the enhanced economic growth, there will be——

Mr. CRANE. That would be an offset that would neuter that revenue loss.

Mr. SHAY. Then I think you are assuming the answer to your question, which is there would be economic growth, which I think does incorporate Peter's response. I am not sure—where I would have difficulty with that is, I am not persuaded by the evidence I have seen that you are going to have that degree of economic growth that you make up the revenue. If you don't make up the revenue and your spending decreases, if it decreases in productivity to the United States, I am not sure where they come out.

Mr. CRANE. Do you agree or disagree that it would attract businesses here and increase jobs?

Mr. SHAY. If you define it as Peter was defining it. If you define it as eliminating the tax on capital and you apply only taxes to wages—I in fact cited an article that I co-authored, which agrees would have a great tendency to attracting foreign capital. But I think you would find it would be difficult to maintain another principle which is essential to our system, and that is taxing people on the ability to pay, because it would levy that tax burden on workers and they would have to make up for it. And the foreign investors, the reason they would be attracted here is because they would not be paying that tax.

Mr. CRANE. You are assuming you would have to have an offset for this.

Mr. SHAY. I am assuming that either you are going to reduce spending—and you are saying no to that.

Mr. CRANE. I am in favor of reducing spending, but my point is the projected budget surpluses—when we passed the $1.3 trillion tax cut last year over 10 years, there was no pass-through to put that burden on anybody in the Tax Code. The assumption was that we were producing surpluses because of record high taxes, and the taxpayers needed relief and we gave them relief with that tax measure.

Mr. SHAY. I think the facts are that the assumption was there would be economic growth that has not materialized, and that with the declining economic growth——

Mr. CRANE. That was historic economic growth.

Mr. SHAY. The future surpluses, which are no longer projected, were projected as a result of an anticipated economic growth that we are now scaling back. So in fact there would have to be a tax

makeup on the current assumptions, it seems to me, to get to what you are driving at.

Mr. CRANE. But getting back to my question, if you eliminated that tax, would it not provide an incentive for businesses to locate here and we wouldn't have DaimlerChrysler, we would have ChryslerDaimler.

Mr. SHAY. I agree with the following. If you eliminated the tax on capital you would indeed attract capital to this market—and let me hasten to say, I am not an economist, but I agree with that proposition. I will not tell you, as Mr. Houghton said earlier, there are not other dynamics as to what was Chrysler and what was Daimler. But what you would see are other collateral effects that are very dramatic socially. You would have taxes on wages that would be bearing the burden of the cost of the U.S. government, including the cost of supporting that foreign investment which is in our market. And I think that is part of the equation that the Committee as a whole would have to take into account.

Mr. CRANE. Well, I think Mr. Greenspan was testifying today, and I think there are some good turnaround events, information that was coming in today that suggests the economy may be doing better. Well let me—Mr. Levin?

Mr. LEVIN. Thank you. We kind of dipped our toes in the water—maybe more than our toes. So thank you very much.

I won't get into the last exchange, though it was interesting to hear Mr. Shay's response. So let me just suggest that what I think your testimony shows, Mr. Hufbauer, I think your analysis of the WTO decisions is a cogent one and I hope that the Europeans and others will listen to it, that if they thought that tactical advantage could be gained from dipping into this area, it is very problematic. I don't think any more murkier subject could be used to try to gain a trade advantage in this one. And I also think they should listen to the three of you as you discuss and sometimes argue about what other solutions might be undertaken by us, because if anyone thinks that that can happen in a short period of time, I think they are being misled.

And I think today, really, we didn't want to get into the substance, but you helped us do that, and it showed that we have a long journey ahead. So your testimony has been especially helpful, and I hope we will circulate it to all the Members who were unable to get here so that they realize that there is a difficult journey ahead here.

So thank you to you all very, very much.

Mr. CRANE. Mr. McCrery.

Mr. MCCRERY. Yes. Thank you, Mr. Chairman. Mr. Shay, I came in after your testimony and got in just on the tail end of your discussion with Mr. Thomas. So I heard you talking about raising taxes on foreign operations, I guess, of multinational corporations and how that would level the playingfield. And while that may be true vis-a-vis, say, Boeing and some other domestic corporation, the problem at least as I appreciate it is not a relative tax burden between American multinationals and American corporations that just do business here. The problem is the relative taxation of American companies, whether they are multinational or not, and foreign companies that are exporting into the United States. And that part

of your—maybe there is much more to your solution than that, but that part of your solution doesn't seem to address what I perceive to be the principal problem here. Did I miss something here? And I apologize if I did.

Mr. SHAY. What I pointed out was that in arguing that tax differences are the key to competitive differences, when two companies from different countries, let's assume, are competing in a third market, and the U.S. company is going to pay tax at the U.S. rate and the other company is from a country that is going to let the foreign country rate apply, even if it is lower than their home rate, my first observation is that there is no competitive issue if the local country rate is higher than the U.S. rate, because we give a credit for that, Okay. So the only circumstance that we are talking about——

Mr. MCCRERY. That is correct insofar as income is concerned.

Mr. SHAY. We will come back to indirect taxes in a moment. On direct taxes, the only circumstance, then, that your concern arises is A, the foreign country is at a lower rate than the U.S. rate; B, the other company is not taxed at the same rate as the U.S. rate back in its home country; and C, the premise is that the difference in taxation is the driver of a competitive difference. So when we talk about income tax, one of the problems that befuddles, I think it is fair to say, some economists—I am not an economist-—is what is the incidence of that tax, who ends up bearing it? Does it reflect in price? Does it reflect in lower shareholder profit and so on?

Before you give U.S. tax relief in that case, my experience is that there are very great advantages coming from the United States. We have a market that supports those companies a way that the other countries' own company market may not. There are many other factors. And so the only observation I was making is—and I left out a piece.

The other piece I observed in my testimony is there may not, in fact, be that competitive difference as a business matter if the U.S. company owns intangibles or has other benefits that effectively preclude the competitor from selling the same quality product in the market. And that may come from our R&D, research and development in the United States. It is a rich and complex picture.

So the test I was asking the Committee to apply before reducing the U.S. tax on all foreign income of a U.S. company, which is going to affect a lot of cases where we are going to be reducing our revenue not really for the immediate competitive issue addressed, we need to ask ourselves are we getting the bang for the buck? Is that a better use of our money? Because if it is going to the profitability of two U.S. companies competing in that market, then there may have been a better use for it. It may be that we could have reduced all corporate rates in this country, and that would not help the company that is not in that market but the exporter. That is the argument I was making.

Mr. MCCRERY. So you weren't making a blanket statement. You are just saying in those isolated instances, we ought to look at that in terms of relative taxation. Any of you, Mr. Merrill or Mr. Hufbauer, want to comment on what Mr. Shay just said?

Mr. MERRILL. As I understand one of the options that Steve has put forward, it would be to eliminate deferral, which would tax

U.S. companies operating abroad currently on their income, active and passive. That is something that this Committee considered 40 years ago and was proposed by the Kennedy Administration, and your Committee decided not to do that. No other country in the world has repealed deferral. The implication would be that a U.S. company doing business abroad would be taxed in a very different way than multinationals anywhere else in the world.

The consequence of that would be that it would be extremely unattractive to headquarter your company in the United States because if you were a U.S.-headquartered company, you would pay U.S. tax everywhere you operated in the world, where your foreign competitors would only pay local country tax, in most cases, where they operated.

In that sort of a world you would see an explosion of the phenomenon that we are already seeing, which is not only companies deciding to invert, which is not very common yet—only about 28 transactions—but also acquisitions of U.S. companies by foreign companies, because that allows the acquired company to operate abroad essentially free of U.S. tax where they invest outside the United States. We are not talking about income earned in the United States. We are talking about income earned outside of the United States and if the United States imposes current tax on that, the U.S. companies will very logically find ways to headquarter outside the United States.

We will also see increased portfolio investment. Two-thirds of all our investment outside the United States is not multinationals, it is pension funds, it is institutional investors, it is portfolio capital investing in foreign-headquartered companies.

So I think it would be pretty clear, Stephen, in your capacity as advisor to companies, if they had a choice to set up an operation in the United States or abroad and if they set up the operation in the United States, their entire foreign operations would be subject to current U.S. tax. If they set up abroad, only their U.S.-source income would be subject to tax; it is obviously what you would advise your companies to do. So that type of activity, setting up headquarters abroad, would skyrocket.

Mr. MCCRERY. [Presiding.] Thank you. Very quickly, Mr. Hufbauer.

Mr. HUFBAUER. I obviously affiliate myself with what Peter Merrill has just said. And the way I see it is, without making a lot of complication, if you tried to make taxation of U.S. companies working abroad equivalent to what taxation is in the United States and try to achieve that parity, ("capital export neutrality" in the lingo of the tax world), you have the competitive problem all of these other different companies used in different places. It is not 1950, when 80 percent of multinationals were U.S.-based; it is 2002, and it is down to a quarter or something like that.

Anyway, you have a lot of companies based in other countries who can do business in those low-tax countries and not face this disadvantage that we are suddenly going to impose on U.S. companies doing business there.

And then the point you made, Mr. McCrery, was that they will produce in those countries and ship back into the United States.

So you have got the third country competition coming back into the United States.

And what kind of parity do you want to achieve? If you try to achieve the parity that Steve is advocating, I think you are just putting all U.S.-based companies at a horrendous competitive disadvantage in a global market.

Mr. MCCRERY. Thank you.

Mr. McDermott?

Mr. MCDERMOTT. Thank you, Mr. Chairman. I am not sure I am smart enough to ask any questions here, but I do have some anyway.

Mr. Shay, I was reading your testimony, and in the first paragraph, or the bottom paragraph on the first page, it says: I next describe a territorial tax system, how it creates an incentive to locate investment in lower tax forum countries and how the activity it benefits differs from the activity benefited by the ETI.

Unfortunately, coming from Seattle, one does think about Boeing. You mentioned Chicago and Washington, and I suppose you were talking about Boeing. They are the biggest exporter. And what I am trying to figure out is, I watch these companies like Stanley sort of go off to Bermuda, and I figure, well, I wonder about Boeing.

How does this extraterritorial thing affect Boeing? Would they have to move their headquarters or would they have to move their production out of Seattle and Wichita to get the benefit?

Or tell me how they would construct it under this new system or this extraterritorial system.

Mr. SHAY. Let me start with today. What has been happening, what you are referring to is a phenomenon where companies that are U.S. corporations in their parent companies are engaging in reorganizations, in most cases taxable, but because their stock prices have been down, they are willing to take that hit, although that is actually quite a difficult issue, for them to transfer the parent company to another jurisdiction.

It does not necessarily mean at all that the group's headquarters leave the United States. In fact, a well-known example is Tyco, which took advantage of a merger a couple of years ago, to merge into a company that is a Bermuda company but the headquarters of Tyco, the executive headquarters, are in New Hampshire. The U.S. operations remain in the United States. They are in U.S. corporations.

What is going on, though, is their other non-U.S. operations, by being under a foreign parent, are not being subjected to rules that they would be subjected to if it were a domestic corporation parent. It really is the phenomenon that Peter was accusing me of permitting to happen under my proposal, for which I have a response buried in the testimony at footnote 14; that is what has been going on.

The ETI really has nothing to do with that at all. The adoption of a territorial system does not answer that in any sort of directly coherent way. It is a creature are of the fact that today we honor the identification of a legal entity called a corporation and treat it as a U.S. taxpayer if it is organized under the laws of a State or the District of Columbia. And if it is organized under the laws of

the Cayman Islands, we say it is a foreign corporation and we accord enormous—quite substantial significance to that.

Now that significance does not apply if they are actually operating in the United States; we will tax them. If that Cayman Islands company is actually operating in the United States, we will tax them. If they own a subsidiary in the United States, we will tax that subsidiary. But what it does mean is that our rules affecting the non-U.S. income are basically cut out.

Part of my proposal that Peter was criticizing would be an effort that would make that less relevant or not relevant. Now, I did not describe my proposal in detail in testimony, and indeed in the article I refer to, we have thought about additional things that would have to be done basically to address the concern that Peter has addressed, and indeed some of that is in my testimony buried in the footnote.

This is a complicated area, but I think one thing that should be clear about it is that you have a set of issues that are raised by the inversion transactions. They are susceptible to being dealt with by this Committee, but essentially the options boil down to, adopt rules that make it irrelevant, because basically you are not going to try to tax foreign income at all; or try to fix what you currently have and try to have more of an equalized taxation of all of your income, have neutral taxation of U.S. and foreign income. And these are difficult issues.

The comments that Gary made and Peter made, they are legitimate comments, but they are not insoluble issues if there is the will.

Mr. And what is the solution for Boeing, then, so that they could keep jobs in the United States and not be at a disadvantage with Airbus?

Mr. SHAY. That is a unique situation because you essentially have a two-competitor market. And the answer that I frankly—I am not at all comfortable that that is a tax-driven problem or that there is the problem—I don't know enough about how they are disadvantaged vis-a-vis Airbus, I don't know enough that it derives from the tax treatment of Airbus as opposed to government purchasing approaches, other nontax issues.

I am very reluctant, and I think we all should be, to assume that there is a tax answer for everything. There is not. They have to compete head to head with Airbus. They do it by having the best educated workers and having good management that prunes away all the excess costs and all the ABCs of good business, and in my experience, tax comes at the end of the dog.

Mr. MCCRERY. Before going to Mr. Watkins, that may be true, but at least at margin the tax burden is relevant, and I think that is what Mr. McDermott is getting at.

Mr. WATKINS. Mr. Chairman and Members of the Committee, I will say thanks for these two panels, the one earlier and Messrs. Hufbauer, Merrill and Shay. I think this is probably the most informative educational phase of this, and I appreciate getting some meat around the bone, because I think it is very good. Tax does affect that—there is no question about it—in many ways.

Mr. Hufbauer, you said, in the fifties, 80 percent of the corporations were U.S.-based. Was this multinationals?

Mr. HUFBAUER. I am giving very loose figures, but if you looked at multinational, or what was called "foreign direct investment," multinational corporations, and go back to those years 40, 50 years ago, it was predominantly a U.S.-driven phenomenon. But now, of course, a lot of other folks are in the game.

Mr. WATKINS. We are in a global economy, and it is not really that way.

Mr. Merrill, you have an—I have read all of your statements. All of you have some very good—I will take it home and read it, and I will read it on the plane flying back and forth. But I noticed, Mr. Merrill stated of the world's 20 largest corporations, the number headquartered in the United States has declined from 18 in 1960 to just 8. I think everyone who is wanting to tax corporations should look at that a little bit. Declined from 18 out of the top 20, from 18 to down to only 8. And the multinational companies' share of global cross-border investment has declined from 50 percent in 1967; now it is down to only 25 percent. We were talking about an economic base out here, or our economic undergirding of our country; some of it is gradually eroding in the United States.

I do not know about Boeing, Mr. Shay, but taxes do matter. But I know—my friend, Mr. McDermott, just left, but I also know that subsidies matter. And I also know that some of the environmental and labor deals matter because there are some variables, more than just taxes, as you say.

But I know I speak of "taxes" and "Texas," I have two colleagues here Mr. Brady and Mr. Doggett. I am from Oklahoma; that is just above, geographically, Texas. The fact is, Texas does not have a corporate tax or a personal income tax, though it has a franchise. I know we lose businesses and industries from Oklahoma to Texas because of that very reason.

Now, they could have the same environmental base that we have because most of it is the United States. But it is tax driven.

Let me assure you, I think what we are talking about is—and today it is probably one of the most significant issues facing the future of our country and its role if we are going to remain the number one economic power in the world, which also drives where we are as far as militarily, educationally or anything else—we have got to have the base to do that.

I appreciate this, Mr. Chairman. Again, I think this is a very, very important—to my friend from Tennessee, I hate that he left because I know that he is also concerned about some of these things we were just talking about. I will talk to him personally.

I thank you so much for being here. I will probably have some questions I may call some of you on or ask you to give me more information on. Thank you.

Mr. MCCRERY. Mr. Hayworth.

Mr. HAYWORTH. Thank you, Mr. Chairman.

Gentlemen, thank you for coming down and for your testimony today. And I listened with interest to my colleague from Oklahoma talking about the environment he sees at home and the analogy with what transpires internationally in terms of tax law.

Mr. Merrill, you pointed out during your testimony, foreign markets in today's global economy represent an ever-increasing opportunity for the growth of U.S. companies. Furthermore, competition

for these markets is at an all-time high. And echoes of what my friend from Oklahoma talked about, Mr. Merrill, in your testimony you also point out that our U.S. tax rules put our companies at a disadvantage when competing in foreign markets.

To amplify this and get past theory and abstraction, can you offer an example-—I don't know if you would call it "everyday" or something that is so compelling and so notable that it certainly bears amplification in this type of setting?

Mr. MERRILL. I think one of the most graphic examples is the U.S.-owned foreign shipping industry. That is an area where Congress, in 1986, actually did what Steve recommends. It terminated deferral for foreign shipping income. The result is that the U.S.-owned foreign shipping income has been eliminated. There are very, very few carriers left now that operate a foreign flag fleet.

And this happened because they sold or they decontrolled. They sold majority ownership so they would get out of these rules. I think that is an example where it is crystal clear the United States changed the law in 1986 and U.S. ownership of a foreign flag fleet was almost eliminated.

Mr. HAYWORTH. Thank you, sir. Would anyone else care to elaborate?

Mr. Shay, we do not have an equal-time provision, but do—were there mitigating circumstances in your mind or would you concur with Mr. Merrill's analysis?

Mr. SHAY. Well, I can't speak to the shipping case, because I have not studied it, but part of my caution is that you are being asked by companies to reduce their tax burden.

I served 5 years in the Treasury. I had to use the word "no" more than any other word in the 5 years I was in the Treasury, because when you are in your position in the Treasury, you are always going to be asked to reduce the tax burden.

The question is, is it in the overall best interest of the United States? And the analogy I would make to my private experience is, sometimes clients say, if I can just make that investment, I will have a bigger market share.

That is not the only question. Will they make a profit? There are some investments you should not make.

And that is the way you should analyze each of the questions that come before you. Because my clients do not just go for market share if they are not going to make a profit. And the analogy here is, if the United States is going to invest in our multinationals, which we do, we reap a huge benefit.

Let me summarize—first, tax does matter; I have been clear about that in my testimony.

Two, these are very important issues. But part of the importance is not only listening to the people who get the benefit. If you ask my clients would they like the ETI, would they like a territorial system, and you ask me, am I lobbying for them, of course, I would say yes. How can you say no?

But that is not the issue before you. You folks have a difficult task. You have got to sort out what is not just in the best interest of the companies, but what is in the best interest of the country.

And the first point I made in my oral testimony is that there is not a perfect identity, notwithstanding the old statement of Mr.

Wilson from General Motors. We have limited resources for the government. Tax is coercion, so when we impose that coercion, if we are going to reduce it on the multinationals and we are going to keep spending the same and we do not have surpluses, it is going to come from somewhere else. And that is just the burden we are under.

So I am not going to speak to the shipping example, but I just want to say that it is not automatic that tax is causing—you have to be skeptical and shine a light on the question of whether in a particular case tax is creating a competitive disadvantage.

I do not want to go further because it wasn't in your question. But there has been a lot of discussion here today about the advantage of countries that use indirect taxes to give an export an advantage to their exports. I have not heard any part of this discussion today getting into some of the economics of the difference between an indirect tax or a direct tax; and I encourage the Committee to find the people who can inform them adequately on that issue, because it is not as simple as today's discussion has suggested.

Mr. MCCRERY. Thank you. Mr. Doggett.

Mr. DOGGETT. Thank you very much, and thanks to all of you for staying for an informative discussion.

Mr. Merrill, are you still lobbying for the contract manufacturing coalition?

Mr. MERRILL. Yes, sir. Well, as you may have read in the Wall Street Journal today, our legislative practice at PricewaterhouseCoopers has been sold to Clark/Bardes and that project has gone with it.

Mr. DOGGETT. All right. Were you lobbying for them before yesterday, or the sale?

Mr. MERRILL. I was registered as a lobbyist because I did some economic work for the coalition.

Mr. DOGGETT. And also for the FSC 2000 coalition?

Mr. MERRILL. I was registered for them. I did some economic work for that group.

Mr. DOGGETT. Is your former client, Enron, or any of its subsidiaries, partnerships, or joint ventures a Member of either of those coalitions or any of the other coalitions that your firm has represented?

Mr. MERRILL. Well, I can only tell you about the International Tax Policy Forum. And there was a Wall Street Journal article—incorrect, actually-—but Enron was a Member of the International Tax Policy Forum along with 30 other companies. It withdrew when it became bankrupt.

Mr. DOGGETT. Do you know if it is a Member of the FSC 2000 coalition for which you lobbied?

Mr. MERRILL. No. I would not know; my role there was to provide economic research for Ken Kies.

Mr. DOGGETT. As to either of those coalitions, can you tell us who some of the other Members are?

Mr. MERRILL. I do not believe that would be appropriate for me to disclose more than I disclosed in the lobby disclosure form.

Mr. DOGGETT. The lobby disclosure form, of course, discloses nothing, except for the name of the coalition. It does not identify a single company, does it?

Mr. MERRILL. As far as I know, it does not.

Mr. DOGGETT. Yes, sir. Are you declining to tell me and the Committee today the names of any of the Members of the coalitions for which you have been lobbying right up to this past week?

Mr. MERRILL. Well, one, I certainly do not know all the names.

Mr. DOGGETT. No, I am not asking you for all of them. I am asking if you can identify any of them for the Committee.

Mr. MERRILL. I think it would be unfair for me to identify a few and not all. And I actually want to find out about disclosing all by asking whether it is possible to do that with the clients involved, since that is not something they agreed to.

Mr. DOGGETT. Just so the record will be clear as to the FSC 2000 coalition, you will not identify any of the Members of that coalition to us today?

Mr. MERRILL. Not today. I would be happy to find out from the coalition whether they would be prepared——

Mr. DOGGETT. The coalition is something that is set up in your office there at Pricewaterhouse isn't it?

Mr. MERRILL. It is not there at the moment. It is at Clark/Bardes.

Mr. DOGGETT. That was the case last week or last month?

Mr. MERRILL. Right. Right.

Mr. DOGGETT. With reference to the Contract Manufacturing Coalition, you decline to provide any of those names, though that also is an entity set up there at Pricewaterhouse?

Mr. MERRILL. Right. Again, it is no longer with PricewaterhouseCoopers. At this point I would not be prepared to disclose more than I was disclosing on the lobby disclosure forms.

Mr. DOGGETT. And the Multinational Tax Coalition, its work was directed at a regulation of the Treasury Department was it not—9835, I believe?

Mr. MERRILL. Actually, I am trying to recall. I think it was originally 9811 and then 9835.

Mr. DOGGETT. I believe that is right. And that is where—that coalition lobbied in an effort to try to bring change to 9811 and 9835 Treasury IRS proposals?

Mr. MERRILL. That is correct.

Mr. DOGGETT. And can you tell the Committee the names of any of the members of that coalition which was also formed there at Pricewaterhouse?

Mr. MERRILL. The same answer.

Mr. DOGGETT. Am I correct—since the caution light is on—am I correct that if Enron or one of its subsidiaries or Global Crossings or the ABC Corporation wants to hide its identity in its lobbying efforts of Treasury or any other part of this Congress or of our government, all they have to do is come to firms like the one you have worked for and form a coalition with them and hide their identity from the public? Is that the way it works?

Mr. MERRILL. I am not an expert on lobby disclosure rules. All I can tell you is that we disclose everything we are required to disclose.

Mr. DOGGETT. A coalition could consist of nothing but Enron and itself, could it not?

Mr. MERRILL. I don't know the answer to that.

Mr. DOGGETT. Thank you very much. And thank you, Mr. Chairman.

Mr. MCCRERY. Mr. Brady.

Mr. BRADY. I am confused. Mr. Merrill, are you complying with all of the disclosure laws that Congress has asked you to comply with?

Mr. MERRILL. I certainly hope so. We have someone in our office whose job it is to file the lobby disclosure forms, and we have a regular canvassing of the entire Washington office. We are very conservative in our disclosure. Even though I, for example, haven't talked to any Member of Congress or staff about any of the coalitions that were just mentioned, we still disclose that I worked on it; and I feel that we ought to be conservative and disclose everything that we might conceivably be required to disclose. I hope that we are doing a complete and thorough job on that.

Mr. BRADY. I appreciate you for following the laws of the land and engaging in legal activity the last time I checked.

Obviously, we have a big problem in front of us. This was a great panel, by the way—extremely informative.

Sort of narrowing it back down to the end, Mr. Chairman, with a simple question. We ought to be trying to find a solution that is real and is not in your interest but in the interest of America.

The question is, at this point, what would you recommend to Congress, if our goal is a substantial solution that creates American jobs or at least makes us more competitive to do so, what approach would you recommend that we take at this point for each of the panelists?

Mr. HUFBAUER. Well, I would recommend going to a modified territorial system. To spell out the modifications would take more time than anybody wants today, but I would be happy to talk about that later.

I believe the foreign tax credit system is hopelessly complex and hard to administer. I appreciate what Stephen Shay has said, that a territorial system is not easy. I am not saying it is easy. I am saying it is an improvement over where we are today. Instead of chasing these wills-of-the-wisp and so forth. And in connection with that, I would provide for equivalent taxation of U.S. export earnings exactly like—well, not exactly, but very similar to what the Netherlands or France does. That would be part of this general system that I would urge.

Mr. BRADY. Do you mind, at some point, could we get your thought on the modifications?

Mr. HUFBAUER. I would be delighted, Congressman.

Mr. BRADY. Thank you, sir.

Mr. MERRILL. I will take this as an opportunity to mention a book done for the National Foreign Trade Council. It is called "U.S. International Tax Policy for the 21st century." It represents the work of four or five different authors; I was one of them. And the purpose of this book is essentially a blueprint for how to reform the U.S. taxation of multinational companies. So I think that would provide a place to start.

It does not address territorial taxation. It takes as a starting point our existing worldwide system and asks the question, how can we make our existing worldwide tax system simpler, more competitive, in many cases not inconsistent with the capital export neutrality doctrine.

Mr. BRADY. Would it address the WTO dispute?

Mr. MERRILL. It does not directly address the WTO issues that are at stake. It asks, how can we make our multinationals more competitive. That would, I think indirectly address that issue, because as I testified, multinationals are an extremely important part of U.S. exports. They account for two-thirds of U.S. exports. In many cases, the foreign operations of multinationals are the sellers, distributors, the servicers of U.S. exports. So I think the two go hand in hand.

Mr. BRADY. Great.

Mr. MCCRERY. Mr. Brady, I am afraid I have to close this hearing. We have a vote. They are holding the vote for you and me.

Thank you, gentlemen, very much for your testimony. The hearing is adjourned.

[Whereupon, at 3 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of MTI Services Limited, Princeton, New Jersey, and the Western Growers Association, Irvine, California

MTI Services Limited (MTIS) and the Western Growers Association (WGA) submit the following written testimony to the Committee for its consideration. We appreciate this opportunity to make our views known.

History of the FSC–ETI Dispute—The Role of Decisions Made in the 1960s

Regarding the history of the FSC–ETI dispute, the origins lie with the enactment of Subpart F in 1962 and the tightening of the section 482 allocation regulations in 1968. These changes, taken together, tightened the tax regime too much, with the result that exporters, among others, were unfairly disadvantaged.[1] At the beginning of the 1970s, the decision was made, in effect, to loosen the rules. However, instead of amending Subpart F and the allocation regulations, it was thought better to enact a new, separate set of rules—the DISC provisions. These provisions and the subsequent FSC and ETI rules give the appearance of special exceptions for exporters, when in fact they are a modification in the treatment of international income.[2] It is submitted that Congress should reconsider the decision made in the early 1970s not to amend the Subpart F and section 482 rules.

The WTO Appellate Body's Decision—A Misconception of the Nature of U.S. Tax Rules

The WTO Appellate Body's conclusions are based in part on the notion that the normal or "benchmark" rule is that U.S. persons are taxable on their foreign source income and, therefore, ETI operates as an exception; thus, the United States foregoes revenue that otherwise would be due. The U.S. tax system, however, is not this pristine. For example, Americans residing abroad are exempt from U.S. tax, up to the level of $80,000, on their foreign earned income.[3] Moreover, the United States has repeatedly argued that the FSC and ETI regimes are not that distant from what could be achieved, albeit with a good deal more trouble, under existing "regular" international tax rules. Indeed, as noted below, exporters, with clarification by the Internal Revenue Service of existing law, could obtain the same level of benefits.

Impact of Changes in the FSC–ETI Rules—Effects on Medium Size and Smaller Taxpayers

The FSC–ETI tax benefit, while not enormous, is significant for the typical medium size and smaller exporter. The impact of changes in this area of the tax law

[1] We would emphasize that, in our view, the problem extends beyond just Subpart F.

[2] Cohen & Hankin, "A Decade of DISC: Genesis and Analysis," 2 VA. TAX REV. 7, 225 (1982); Bruce, Lieberman & Hickey, 934 T.M., Foreign Sales Corporations.

[3] Section 911.

on these exporters is great. The changes create confusion. Transitioning from one regime to another is costly and time-consuming. They cause an air of uncertainty. Many smaller exporters are simply falling by the wayside; how many will not be know for certain until the tax return information for 2002 is captured, presumably in late 2003 or early 2004.[4]

The EU's Request for Sanctions—A Proposal for Attacking the Numbers

The European Union's estimate of the harm caused it by the ETI provisions (approximately $4 billion per annum) is grossly overstated for the reasons stated by the United States in its submissions and the "fall off" in use, especially among smaller exporters. The Treasury Department and taxpayers, working together, can drive down the revenue loss due to ETI by engineering a solution under existing "regular" U.S. international tax statutory and treaty provisions. One approach is for the Internal Revenue Service to issue pre-filing agreements under existing law, without regard to the ETI provisions, to shareholders and their multiple ownership entities and to take such other steps as may be necessary, including negotiate with treaty partners, to clarify the tax treatment of these taxpayers under section 245(a) and sections 951–964. [5] There may be other approaches. The point is a simple one: It is within the Treasury Department's and taxpayers' power to "devalue" the figure that underpins the EU's position on sanctions and, in so doing, to promote a reasonable negotiated resolution. It would be surprising if highly intelligent tax lawyers in the Service and accounting and law firms could not map out a suitable plan. Then, the more companies that "buy into" the solution, *i.e.*, obtain an agreement, the more effective it is.

Driving down the figure for sanctions and negotiating a resolution buys time for a larger solution in the form of rethinking Subpart F and the income allocation rules.

Multiple Ownership—Need for Continued Support

Whatever approaches are contemplated in the future, these approaches should accommodate U.S. exporters that wish to band together in a shared entity of some sort. These provisions have always existed—with DISCs, FSCs and the ETI regime. They should continue to exist. They help medium size and smaller companies that cannot afford the time and expense of "going it alone." It is a way of "outsourcing," in a fashion, some of the international aspects of their business. Also, these provisions are used by trade associations and state trade development offices to help their members and constituents.

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MTIS is a FSC–ETI management company that manages solo and shared entities, some of which are "sponsored" by organizations, such as the Delaware Economic Development Office, the Pennsylvania Office of International Trade and the National Association of Manufacturers. It is based Hamilton, Bermuda, with a subsidiary in Princeton, NJ. Over the last 16 years, MTIS and its subsidiary have helped approximately 500 exporters utilize the relevant benefits. Annually its companies export around $500 million in total. These companies represent a broad spectrum of exporters from small (a couple of million dollars of gross receipts from exports) to medium size (approximately $50 million gross receipts from exports). The items of export range from automobile parts to fishing line, and they include agricultural and forest products.

WGA, which is headquartered in Irvine, California, is the largest and most active regional fresh produce trade association in the United States. Its members grow, pack and ship over 90% of the fresh vegetables and 60% of the fresh fruit grown in California and Arizona. The actual items (carrots, tomatoes, broccoli, citrus, lettuce, etc.) number in excess of 250; and they constitute over 50% of the fresh produce grown in the United States. They are shipped throughout Europe and Asia, as well as Canada and Mexico. WGA began creating shared FSCs for its members in 1992. Since that time, it estimates that its members have shipped over $1.5 billion through its shared entities. Approximately 95 companies participate in the WGA export program. The smallest of these has exports of around $400,000.

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[4] Experience shows that it takes some time for taxpayers to understand a new set of rules such as the ETI rules. With FSCs, the "learning curve" extended for 8–10 years. With ETI, we believe, it is shorter but still considerable.

[5] For an explanation of how this might be achieved, *see* Bruce, "The WTO's FSC Ruling: Let's All Relax," 86 Tax Notes 1927 (Mar. 27, 2000). It will be noted that this type of approach is WTO-legal. There are no special provisions associated with it that benefit exporters; therefore, there is nothing that can properly be characterized as a subsidy.

Statement of William A. Reinsch, President, National Foreign Trade Council

The National Foreign Trade Council (NFTC), founded in 1914, is an association of businesses with some 400 members. It is the oldest and largest U.S. association of businesses devoted to international trade matters. Its membership consists primarily of U.S. firms engaged in all aspects of international business, trade, and investment. Most of the largest U.S. manufacturing companies are NFTC members. The NFTC's emphasis is to encourage policies that will expand open trade and U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities and anomalies.

Introduction

The NFTC applauds Chairman Thomas's decision to hold a hearing on the WTO Appellate Body ruling in *United States—Tax Treatment for "Foreign Sales Corporations"—Recourse to Article 21.5 of the DSU by the European Communities*. This statement follows the outline of the matters identified in the announcement of the hearing: (1) outline the history of the FSC–ETI dispute, (2) analyze the January 14, 2002, WTO Appellate Panel Decision, and (3) discuss the potential trade ramifications of the decision. Regarding the potential trade ramifications, this statement highlights the importance of developing a process for resolving the FSC–ETI dispute in a manner that preserves the competitiveness of American companies while lessening trans-Atlantic trade tensions. The NFTC appreciates the opportunity to submit its views for the hearing record.

Background

The Domestic International Sales Corporation ("DISC") provisions were enacted to restore the competitiveness of U.S. exporters that were adversely affected by the 1962 enactment of the Subpart F rules. The WTO FSC–ETI case can be traced back to 1972 when the European Community ("EC") objected to the 1971 enactment of the DISC legislation, and the United States counter-claimed that the tax exemptions for foreign-source income provided by Belgium, France, and the Netherlands were export subsidies. A 1976 GATT panel issued reports finding both that the DISC had some characteristics of an illegal export subsidy and that the three European territorial tax systems provided impermissible export subsidies. It was not until 1981 that the parties agreed to the adoption of the GATT panel's reports, based on an "Understanding" adopted by the GATT Council that provided the blueprint that was used to develop the Foreign Sale Corporation (FSC) as a replacement for the DISC. In particular, the 1981 Understanding made clear that a country is not required to tax income from foreign economic processes.

The FSC provided a limited tax exemption for certain U.S. export transactions. Income earned in these transactions from economic activities occurring within the United States was fully taxed. Income earned in FSC transactions from economic activities taking place outside the United States was subject to an exemption. The FSC replicated central aspects of territorial taxation as applied to export transactions. The major difference between the FSC and territorial tax systems was that the FSC applied specifically to exports while territorial systems applied to exports as well as other international transactions.

The 1981 Understanding laid the issue to rest for more than 15 years until the European Commission ("Commission") challenged the FSC in late 1997. Regrettably, both a WTO Panel and Appellate Body all but ignored the 1981 Understanding in holding that the FSC was a prohibited export subsidy. Accordingly, the United States repealed the FSC regime and enacted a regime for "extraterritorial income" ("ETI") in November 2000. The ETI regime represented a fundamental change in U.S. tax law, notably, a new, general exclusion of income earned in a broad range of overseas transactions. Unlike the FSC, the ETI regime did not require any exportation from the United States and was available to (essentially) all U.S. taxpayers—treating foreign and domestic businesses subject to U.S. taxation alike.

Nevertheless, the Commission brought a WTO challenge immediately following enactment of the ETI regime. In August of last year, a WTO Panel agreed with the Commission, and the Appellate Body affirmed the Panel's decision on January 14, 2002. The matter is now before an arbitration panel where the Commission is seeking authorization to impose more than $4 billion in trade sanctions on U.S. exports. The arbitration process likely will be completed by the end of April 2002, at which time the Commission would be free to retaliate.

Brief Analysis of WTO Appellate Body Report

The January 14, 2002, Appellate Body Report upheld each of the adverse "findings" (as opposed to the rationale) of the Panel that considered the validity of the ETI regime. As in the original dispute, the Appellate Body was required to determine whether the ETI regime provides a subsidy before reaching the issues of whether the subsidy confers a benefit and whether the subsidy is contingent on export performance. The Appellate Body was also required to decide whether the ETI is inconsistent with GATT 1994 by reason of the foreign articles/labor limitation.

To summarize the principal conclusions in the Appellate Body's report, any elective, replacement regime that departs from an otherwise applicable general rule would be viewed as granting a subsidy. It is now clear, however, that a WTO member can provide an export subsidy in the form of a tax exemption if it is a measure to avoid double taxation of foreign-source income. In this regard, the foreign economic process requirement under the ETI regime was viewed as sufficient to establish the presence of "some" foreign-source income, but the ETI regime as a whole fell short of adequately identifying "foreign-source income" (primarily because allocation rules apply fixed percentages to amounts that may include domestic-source income).

The Appellate Body also upheld the Panel's finding that, by virtue of the fair market value rule, the ETI regime accords less favorable treatment to imported products than to like products of U.S. origin, within the meaning of Article III:4 of the GATT 1994. Similarly, the Appellate Body upheld the Panel's finding "that the ETI measure involves export subsidies inconsistent with the United States' obligations under Articles 3.3, 8, and 10.1 of the *Agreement on Agriculture*. Finally, the Appellate Body made clear that the United States has no legal basis for providing transition rules that extend the time-period for fully withdrawing the prohibited FSC subsidies.

Trade Ramifications

The dispute between the United States and the Commission over the ETI provisions poses a grave danger to the future stability of the trans-Atlantic economic relationship and, more broadly, the global trading system. As an organization that represents companies keenly interested in the future progress of both, the NFTC believes it is imperative that this dispute be resolved equitably.

The European Union is one of our largest trading partners; in 2000 the two-way volume of U.S.-EU trade totaled roughly $385 billion. In recent years, however, the relationship has been marred by a number of contentious trade disputes, many of which have been litigated before the WTO (hormone-fed beef, bananas, Havana Rum, and the 1916 Antidumping Act). Other potential trade cases may follow: the systemic failure of the Commission to approve GMO products absent scientific backing and the U.S. imposition of section 201 tariffs on steel imports. If both parties do not pull back from the brink of this seemingly ceaseless trade litigation, the NFTC fears they may be risking long-term damage to the health of this vital economic partnership.

This continued deterioration in U.S.-Commission relations will have consequences for the broader trading system as well. The United States and the Commission have traditionally played leading roles in charting and driving the global trade agenda, as evidenced by the successful creation and expansion of the GATT and then the WTO to cover an ever broader array of trade disciplines (*i.e.* services, intellectual property). A fractured U.S.-EU relationship will hamper the ability to successfully complete the Doha Round and strengthen the hand of nations inclined to retard progress.

The Resolution Process

The NFTC agrees with comments made by Chairman Thomas and other Members of the Committee that it is important for the United States—as the world's leading exporter—to comply with its international trade obligations in a timely manner so as to set an example for other WTO member countries. To achieve this end, the Administration must demonstrate leadership by implementing a comprehensive process that will lead to an acceptable resolution of the FSC–ETI dispute that does not place U.S. businesses at a competitive disadvantage.

The Administration must make the resolution of this dispute a high priority. In the end, some combination of trade and tax initiatives may be necessary to resolve this dispute. It seems clear, however, that a legislative response or a negotiated solution would take time to develop and implement, and that this should be accomplished without subjecting American businesses to a competitive disadvantage. Thus, the NFTC urges the chairman and members of this Committee to press the

Administration to engage the Commission in serious, high-level discussions, with the aim of avoiding retaliation before an accord is reached. In addition to forcefully and consistently negotiating with the Commission on the issue of the timetable for coming into compliance, the Administration should seek assurances that the Commission would be willing to consult with our government to obtain a measure of certainty regarding any response that may be forthcoming.

In any event, the Administration and the Congressional tax-writing committees should remain focused on leveling the playing field between U.S. exporters and their foreign competitors. The NFTC looks forward to working with the Committee and its staff in resolving this issue.

Conclusion

It is imperative that the United States and the Commission agree on a mutually acceptable solution that ensures that U.S. businesses, farmers, and workers are not placed at a disadvantage in relation to their foreign competitors. Resolving this matter and avoiding the destabilizing consequences it threatens are as important as any trade issue currently facing our country. The NFTC stands ready to work with this Committee and the Administration to achieve this result.

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