IRET Institute For Research On The Economics Of Taxation

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

THE FOREIGN INCOME TAX RATIONALIZATION AND SIMPLIFICATION ACT OF 1992

Statement of Norman B. Ture, President
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Presented to
The Committee on Ways and Means
U.S. House of Representatives
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Summary

- H.R. 5270 should help to focus attention on the barriers erected by the existing foreign tax provisions to effective competition by American businesses in world markets.

- Simplification of the existing foreign tax provisions is highly desirable, but reducing the tax biases against the free movement of capital and business operations by both U.S. and foreign companies is even more important an objective.

- H.R. 5270 is seriously flawed by the revenue neutrality requirement. Tax neutrality, not revenue neutrality, should guide tax policy.

- Constructive revision of the foreign tax provisions should move in the direction of territoriality, which conforms with the tax neutrality criterion.

- Repeal of deferral for controlled foreign corporations is a seriously retrogressive step. Instead, tax revisions should focus on repeal of Subpart F applications that do not satisfy tax neutrality requirements.

- The proposed cutback of the section 936 credit is another step backward. Section 936's tax sparing, combined with Operation Bootstrap, freed up incentives for new investment and business operations in Puerto Rico, demonstrating the efficiency of this strategy for achieving substantial gains in employment, output, and income. A section 936 approach would be far more effective than government-to-government loans in helping Eastern European nations to develop free markets and achieve economic growth.

- The proposed special section 482 rules for foreign-owned corporations are bad in principle and are not warranted by evidence of deliberate misrepresentation of transfer prices of foreign-owned domestic companies. Since most of the parents of foreign-owned companies are Japanese or European and subject to tax rates in their home jurisdiction as high or higher than those in the United States, it is implausible that artificial transfer prices would be used to allocate an excessive amount of the parent-subsidiary's combined earnings to the parent.

- The proposal to subject certain stock gains of foreign persons to U.S. tax represents an unwarranted assertion of authority by the United States to tax the income of non-resident foreign citizens. Like the proposal to apply special transfer pricing rules to foreign-owned U.S. companies, this proposal would significantly raise the tax cost of investment and business operations by foreigners in the United States. The result would be less capital, fewer jobs, lower output, and less income in the domestic economy. The loss would be ours.

- The proposed repeal of the alternative minimum tax foreign tax credit limitation is a significant plus in H.R. 5270. The AMT should be repealed in toto, but failing that, repeal of its FTC limitation is highly desirable.

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Mr. Chairman, Members of the Committee, I am pleased to have the opportunity to appear here today to offer my views on H.R. 5270, "Foreign Income Tax Rationalization and Simplification Act of 1992." In preparing this statement, I have benefitted from discussions with the tax officers of several U.S. companies with substantial foreign business operations. The views I present in this statement, however, are my own, not necessarily those of those individuals, IRET, its board of directors, or its contributors.

Overview

Messrs. Rostenkowski and Gradison are to be commended for introducing H.R. 5270, primarily because it will help to focus attention of the Congress on the barriers erected by the existing foreign tax provisions to effective competition by American companies in the world marketplace. I have on earlier occasions maintained to this Committee that the existing provisions are highly protectionist, virtually the equivalent of a protectionist trade policy, and like trade protectionism, costly in terms of economic efficiency, employment, and living standards.

They deal with enormous complexity with highly complex tax matters and impose inordinately great compliance costs on the businesses subject to them. They have the effect of raising the cost of capital faced by U.S. companies in their foreign business operations, both compared to the capital costs of companies of other nationalities operating in the foreign jurisdictions and relative to the cost that would prevail if the tax laws more closely conformed with the requirements of tax neutrality.

Simplification of the tax rules applied to American companies' foreign business operations, to U.S. possessions corporations, and to U.S. subsidiaries of foreign businesses is certainly commendable in and of itself. Simplification, however, should not be taken as the ultimate test of the desirability of the proposed revisions. It could be achieved by revisions of the Code that would enormously penalize U.S. multinational operations, greatly reducing the American business presence around the world, with enormous attendant costs in terms of lost jobs and living standards in the United States. In the current and prospective world market environment, more important than simplification should be reducing existing tax biases against the free movement of capital and business operations, by both U.S. and foreign companies, to their most productive locations. To this end, the Committee should seek out those features of the present law that impede capital and business mobility and that raise the cost of capital for American businesses in either or both foreign and domestic markets. It should seek to revise those features, if not to eliminate them entirely, in order to moderate their adverse effects. The question is whether H.R. 5270 serves that objective to any significant extent.

The answer, I believe, is that some of the provisions of the bill would be small steps in the right direction. Other provisions, however, would be far more substantial steps backwards.

The unfortunate influence of revenue neutrality

This unhappy combination of initiatives is the regrettable consequence of "revenue neutrality," the nemesis of constructive tax policy. Good tax policy calls for elimination or modification of provisions of the law that fail to satisfy the basic canons of taxation. Doing so almost invariably entails what are estimated to be revenue losses. Revenue neutrality confronts this Committee with the virtually impossible task of identifying revenue-raising provisions that are not themselves injurious. In practice, it requires the Committee to say to the taxpayers involved, "In order to help you, I've got to hurt you. Moreover, I've got to hurt you just as much as I help you." It is difficult to conceive of a more inane rule to guide tax policy. Revenue neutrality dictates that there can be no significant improvement in the tax structure.

Appropriate fiscal policy does not call for revenue neutrality. Instead, it urges that, at least under most circumstances, tax changes that reduce revenues should be offset by spending reductions in equal amount. Tax increases should be reserved for offsetting spending increases that have been determined to be worth their cost.

Revenue neutrality, moreover, places enormous reliance on a very weak reed — revenue estimates. This is not the occasion for a discussion of the requirements of meaningful revenue estimates and the extent to which the methodologies now used by the revenue estimators in the Treasury and on the staff of the Joint Committee on Taxation satisfy those requirements. Suffice it for the present purpose to note that the confidence level for most revenue estimates, particularly those with respect to changes in so complicated an area as that to which the foreign tax rules apply, may well be so low that these estimates should not be important ingredients in tax policy decision making.

H.R. 5270 illustrates the gross disadvantages of imposing the revenue-neutrality constraint on tax policy making. Some of its revenue-losing provisions are generally deemed to be useful, even if not major advances. Virtually all of its revenue raisers, if enacted, would be very bad tax law.

Tax neutrality should guide tax policy

Good tax law, I believe, should conform as closely as possible with the requirements of tax — not revenue — neutrality. As I have stated to this Committee on a number of prior occasions, tax neutrality calls for minimizing the tax-induced distortions among relative prices and relative costs that would result from the operations of a reasonably efficient market system in the absence of taxes. Every tax ever imposed has the effect of altering some price or prices relative to others, and perfect tax neutrality is unattainable in the real world. But good tax policy calls for taxes that to the least possible extent distort market-determined relative prices and costs.

In earlier testimony to this Committee,[1] I have attempted to explain how the existing foreign tax provisions of the federal income tax violate the tax neutrality criterion and in doing so impair the competitive position of American companies in world markets without offsetting benefits in the domestic economy. Truly constructive revision of these provisions calls for rejecting the so-called "capital export neutrality" thesis they implement and instead adopting a "territoriality" approach. As pointed out in earlier testimony, "A truly non-protectionist tax policy would neither increase nor reduce the effective rate of tax imposed by a foreign government on the income generated by a U.S. multinational's operations in its jurisdiction. This criterion clearly calls for a true territorial approach under which U.S. tax law would not reach the results of U.S. companies' foreign operations, either at the time those results are realized or on the occasion of the repatriation of the foreign earnings."[2]

True territoriality certainly does not appear to be a near-term goal of federal tax policy, certainly not as long as revenue neutrality dominates policy making and as long as tax policy makers continue to rely on the present revenue estimating methodologies. Even so, territoriality should set the guidelines for legislation in the foreign tax area. Tax changes that move the law farther away from territoriality than at present should be required to pass the most severe tests of conforming with other basic tax principles.

On the basis of these observations, allow me to offer the following appraisal of a few of the provisions in H.R. 5270

Repeal of deferral for controlled foreign corporations (sec. 201)

In the light of the tax neutrality principle and the territorial approach it calls for, the repeal of deferral for controlled foreign corporations must be seen as a very serious step backwards in tax policy. So-called deferral represents at best only a very modest abatement of the distorting effects of taxing foreign source income on a business's choice of the most efficient location for its operations. Instead of virtually universalizing subpart F's applicability by the proposed repeal of deferral for CFCs, the Committee should take a fresh and critical look at subpart F and at the fragile rationale on which its rests. The Committee would do well, I believe, to seek repeal of as many of the current subpart F applications as it could determine do not satisfy the requirements of basic tax principles. Elimination of these provisions in the Code would provide enormous progress in simplifying the foreign tax provisions.

Reduction of Puerto Rico and possession tax credit (sec. 411)

The proposed cut back of the section 936 tax credit has no apparent justification other than raising revenue. Section 936 is virtually the only significant set of provisions in the Code that at least partially embody the territoriality approach. As such, the restrictions that have been imposed on its applicability over the last decade and a half should be rigorously reexamined against the test whether they served to make the possessions corporation treatment more nearly neutral or limited its effectiveness in this regard.

The Committee would do well, moreover, to obtain an objective assessment of the effectiveness of Section 936, before it was subjected to the statutory and regulatory constraints of recent years, in promoting economic development in Puerto Rico. The extraordinary development of the Island under that program testifies to the effectiveness of new business enterprises and new investment as the means for achieving rapid gains in employment, output, and income. By the same token, it demonstrates the effectiveness of so-called "tax sparing" in freeing up the incentives for undertaking these growth-generating activities.

Operation Bootstrap, combined with possessions corporation treatment, affords a splendid model of the strategy that the United States should pursue to help the nations of Eastern Europe to establish effective free market systems and to overcome the obstacles to economic progress. A section 936 approach applied to U.S. business investment and business operations in Eastern Europe would be far more efficient than government-to-government financial assistance in assisting the economies of these emerging democracies to overcome the burdens of collectivism. Moreover, this approach would impose far less of a drain, if any, on the federal Treasury than the multi-billion dollar assistance spending programs to which we appear to be committed.

Special section 482 rules for certain foreign and foreign-owned corporations (sec. 304)

Another provision in the bill which appears to have been included only to raise revenue is section 304 that would apply special 482 rules for determining the U.S. taxable income of 25 percent foreign-owned domestic corporations. The ostensible objective of this provisions in the bill is to assure that such companies do not design transfer prices that have the effect of understating the income generated in the United States while overstating the income allocable to the foreign parent company.

The concern that transfer prices used by these foreign-owned domestic corporations are intended to avoid U.S. tax is associated with the rapid growth and increasing visibility of these companies. Some evidence suggests that the average taxable income per dollar of sales of these companies is lower than the comparable average ratio for U.S.-owned companies in the same industries in the domestic market.[3] On the other hand, there is little evidence to suggest that this lower ratio, even if it is representative of that of most foreign-owned U.S. companies, results from deliberate misrepresentation of transfer prices. More likely, it reflects the start-up and expansion costs of these new companies.

Transfer prices of these companies are subject to IRS agents' scrutiny no less than those of U.S.-owned companies; unless there is some basis for believing that the IRS cannot detect overstated transfer prices of foreign-owned companies just as readily as it can those of domestically-owned companies, it is difficult to understand why legislation to apply a formulary approach to the foreign-owned is called for.

The Committee should seek to determine whether the foreign parents of the U.S. companies that allegedly overstate transfer prices are resident of high-tax or low-tax jurisdictions and, if the former, can take advantage of special provisions in the home jurisdiction to excuse them from home-jurisdiction tax on the income allocated to the parent company. Most of the parents of foreign-owned U.S. companies are Japanese or European, where effective tax rates on income deemed to be domestic in origin are at least as high as those in the United States. It is difficult to understand why, in such cases, artificial transfer prices would be contrived in order to allocate an excessive amount of the combined parent-subsidiary earnings to the parent. Failing any such determination, the presumption should be that the transfer prices used by the foreign-owned U.S. companies are not based on tax avoidance considerations.

The Committee should also recognize that the allocation of what appears to a large share of the revenues of the foreign-owned U.S. companies to the parent company is very much the result sought by the implementation of our 482 rules. Baldly put, the objective seems to be to require U.S. companies to set transfer prices that result in the largest possible allocation of the foreign subsidiaries revenues to the U.S. parent. Apparently it's tax avoidance if another government requires its companies to do what our government asserts is good tax policy with respect to its citizens.

Relying on an arbitrary formula of the sort prescribed in section 304 of the bill is not good tax policy. Moreover, it is bad economic policy. The principal effect of this provision would be to raise the tax costs foreign-owned companies would incur in undertaking business in the United States. The results will be a smaller stock of productive capital in the United States, lower productivity levels, less employment, lower output, lower wages and other incomes than would otherwise be available in the domestic economy. The result, the Committee may recognize, is the mirror image of what happens when we impose extra tax costs on the foreign operations of our businesses.

Taxation of certain stock gains of foreign persons (sec. 301)

This proposal defies justification in terms of basic tax principles. It would simply assert the authority of the United States to tax the income of non-resident foreign citizens. The fact that a foreign corporation or an individual nonresident alien has at any time during the past five years owned as much as 10 percent of the stock of a U.S. corporation in no way determines that the gain that person may realize on the sale or other disposition of the stock is properly taxable by the United States rather than the foreign jurisdiction to whose tax laws the seller is subject. Unless that foreign jurisdiction were supinely to agree to forgive any tax it may impose on gains realized by persons subject to its tax, this proposal would subject the gain to double tax.

The proposal is bad tax law. It is also bad economic policy, for the same reasons that the proposed formulary determination of the taxable income of U.S. subsidiaries of foreign corporations is bad economic policy. If it were to become law, the proposal would significantly raise the tax cost of investment and business operations by foreigners in the United States. The loss would be ours.

Repeal of limitation on the alternative minimum tax foreign tax credit (sec.111)

On the plus side, the proposed repeal of the 90-percent limitation on the use of the alternative minimum tax foreign tax credit is certainly constructive. The AMT is bad tax law. It accentuates the bias against saving and capital inherent in the separate income taxation of corporations. It imposes a double tax whammy by (1) accelerating the taxes of business while they are growing, thereby increasing the effective tax rate imposed on them, and (2) subjecting them to taxes when they are suffering losses during recessions or production and sales slowdowns. The existing law's limitation on the foreign tax credit allowed for AMT purposes defies justification on the basis of tax principle. The AMT should be repealed in toto, but failing that, repeal of the FTC limitation is certainly a positive step.

Conclusions

As I suggested at the beginning of this statement, the authors of this bill are to be commended for initiating a legislative effort to simplify the existing foreign tax provisions and to ease the existing tax barriers to more effectively competitive participation by American businesses in the world market place. As my discussion indicates, however, the initiative is seriously flawed by the constraint that revenue neutrality imposes on it. What is needed are basic revisions of the existing foreign-tax provisions, moving in the direction of the territoriality approach to the tax treatment of foreign-source income. Particularly under existing revenue estimating methods, major steps in this direction would be scored as revenue losers, requiring offsetting revenue gains so long as revenue neutrality is an operational constraint. While some modest improvements in the direction of tax — not revenue — neutrality may be possible under that constraint, meeting the competitive challenge that American business faces calls for substantial improvements in the law. The first step toward achieving those improvements is repeal of the PAYGO — revenue neutrality — provisions in the Omnibus Reconciliation Act of 1990.

Endnotes

1. See, for example, my statement "EC92's Implications for U.S. Foreign Tax Policy," presented to the Committee on January 30, 1990. See also my statement "Enhancing America's Competitiveness," presented to the Senate Finance Committee on May 15, 1992.

2. *Op.cit.*

3. Such evidence is presented in the GAO's June 1982 report to Senator Jesse Helms, "Problems Persist in Determining Tax Effects of Intercompany Prices."