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Panel Three Discussion Transcript

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PANEL III: DISCUSSION TRANSCRIPT

PATRICK CRAWFORD: Okay, very good. Hugh, you had the first hand up.

HUGH AULT: To start off with, a comparative law footnote, which is sort of my thing these days, it would be interesting to take a look at the Australian system, which is very much like this in the sense that it has good countries that it gives exemptions to. It has bad income in countries on which it has accrual taxation, and it has a third category in which it gives deferral and a foreign tax credit to a mid-category of countries. So, I think there is some interesting comparative work to do there.

Secondly, I would just like to make the observation that we've had a fascinating two hour discussion on what U.S. international tax policy should be, and I was listening very closely and did not hear the word "capital export neutrality" or "capital import neutrality" during that discussion. It seems to me that's quite appropriate.

As I said in the discussion, I think that's quite appropriate because I really think it does put the focus on where it should be, and in what circumstances, and how should we be relieving double taxation, and what do we have to do in relieving double taxation so we don't end up with non-taxation. I think that is the appropriate focus of this discussion and I commented on Mike Graetz's paper in another setting about slaying the dragon of capital export neutrality. I was saying Michael and The Dragon could be the title of the paper, but I wasn't entirely sure that the dragon was there. Now you can debate that, but it certainly wasn't in our discussion this morning and I think that's quite appropriate.

Thirdly, I think as far as simplicity, another aspect is sort of taking in the tax culture that we are. In other words, a sort of hyper-lexus that we bring to all tax problems, and I think that simplicity versus complexity in the setting of the credit versus the exemption, to a certain extent, depends less on the nature of the structure of the system than it does on how we go about implementing and applying the tax laws. Maybe there will be some simplicity, but think about it: you need source rule. You're going to have source rule for the exemptions. We're going to have source rules between the U.S. and foreign countries, we're going to have source rules between listed and non-listed countries. How are we going to articulate those source rules? Are they going to look like the source rules we have in the credit? It's the same problem. It's the same structural problem.

Fourthly, as Charlie has pointed out, you're going to have a 61A kind of allocation rule, so you're going to have to deal with the same problems as 265, but structurally, it's the same problem. Fifth, you're going to have transfer pricing, but transfer pricing in the guise of attribution to PEs. Exactly the same problem, the royalty problem comes up because of the historical rule that we don't allow dean's payments in a PE setting, but we do in independent entities. This is a reasonable tax, you say with respect. Well, is it going to be income tax? We've got to worry about income. What's the character of the tax? So, we're going to have rulings about whether it's an income tax or not. Finally, you're going to have some kind of pass through because you don't want a passive income that happens to be earned by a company that's in a good country that might. I think if you push all the way through—I'm agnostic on this—I think there might be simplicity savings, but I don't think it's self-evident.

Finally on the credit, I'm curious about eliminating the credit on portfolio income because—and I think John pointed out—that's certainly not where the complexity problems are when I get a dividend from the investment I made in Germany, and the simplification that we have now with carving out the $300. That's not the problem of where the complexity in the credit is. It's the business part, and there, from Charlie's point I mean, we're not talking about little old widows here. We're talking about companies that hire people we train to work tax computer programs to figure out these things. So, I wouldn't give up too quickly on the complexity—that some level of complexity is going to be necessary.

H. DAVID ROSENBLOOM: Can I just say a couple of quick things on that Hugh? I'm not sure why you're talking about the character of the tax. Let me make clear what I propose, and obviously it can be viewed a lot of different ways. My proposal is to make a judgment about countries, and if they've got real tax systems imposed in a serious way, I'd forget about whether they're imposing income taxes. I realize there's going to be a lot of movement. There are going to be some countries where it's going to be quite ambiguous. But I think for most of our major trading partners, it's not going to be ambiguous. Now, they could change, that's a different problem. But, if you went out and surveyed the world today, I don't think you'd hesitate, for example, to come to the conclusion that Japan has got a real income tax system. They may not, in some respects, do everything that we would do, but they have a real income tax system that they apply seriously. So, the character of the tax, to my way of thinking, is not an issue because once you get on the list, you'd be exempt. If there is a credit piece in non-listed countries, it would still be there.

Secondly, on passive income, this is in my suggestion. We haven't identified it, and it may be a little bit astonishing. I would give up on passive income if it was attributable to a permanent establishment. If somebody wants to transfer their passive income and run it out of their Japanese company, then I would basically—and this comes back to a point I made earlier—essentially the whole question in this area is what use do you make of what's going on in the foreign country. I am very reluctant to make use of it at the retail level on a taxpayer-by-taxpayer basis. I would try to make a judgment on a country if they're likely to tax, if it looks like they're likely to tax, and I would try, probably, to insist that the taxpayer didn't tell different stories to the country from those told to the U.S. But, if somebody wants to stick their passive income in the Japanese corporation, I would exempt it in my proposal. That could be a crazy feature but I would. That's what's implicit in what I'm saying.

Finally, on portfolio, you put your finger on a difference in rationale at least between what Michael (Graetz) was saying and what I think. I don't think there's that much complexity in the individual credit. That's not underlying my point. I'm just not sure I understand what the rationale is for a foreign tax credit for a portfolio investment. In that sense, I think I'm a lot closer to where Gary Hufbauer is. I just think that giving the credit for the stuff takes the monkey off the back of these countries who then come along and basically suck revenue out of the U.S. Treasury, and again, I don't see why we should do that. So those are my comments.

PATRICK CRAWFORD: Any other questions?

REUVEN AVI-YONAH: So, I have to start by saying that I agree with, I would say, 99 percent of what David Rosenbloom is proposing, just as I agree with 99 percent of what Michael Graetz proposed yesterday. I actually think these proposals are very similar, but what follows from that is what I think Peggy Musgrave wrote in reaction to Michael. It is not inconsistent with the position that believes in capital export neutrality—to mention an awful term—to adopt part of these proposals simply because, as I see, the point is that you don't give an exemption unless you believe that there is a reasonable tax rate in other countries. I think nobody is such a theologian of efficiency to say that a differential of a couple of points or whatever, especially if you say that Ireland is not on your list, that's all perfectly fine and good. Now I think the real problem is that if you peruse recent publications, you will find immediately that the Alsace problem is a widespread and common one. All of these countries that you mentioned, every single one of them, has preferential regimes that enable you to act to load extremely low tax; sometimes zero tax active income from within these borders. But what do you do about them? I mean, if dreams come true and all of the regimes are abolished within the next five years, then that's all well and good and we can go to the proposal. But until that happens, I think that the Australians actually do try to differentiate. But all that obviously adds some complexity. But I think that really is a big judgment call.

The last comment I want to make is to reiterate something Michael does very nicely in his paper and that is—and I hope you won't accuse me of corporate whining—but there is a question of how this compares to what other countries do. While, by and large, I think that there are some similarities, I do think in the proposal, especially in its pure deduction, only two categories form. But, I think the no deferral credit form regimes are significantly harsher than what most countries do under their CFC regime. Now, I don't have any particular problem with that *per se* because of competitiveness gripes. But, I do think that there is the issue that Michael also identified in his paper—which is the issue of cross mergers and expatriation of companies and so on and the incentive that this would give, which in my experience, is a real, live one for start-ups being incorporated abroad, etcetera, etcetera. I mean, to move the headquarters of the United States—and this goes back to Gary Hufbauer's writing about importers and so on and so forth. So I think doing this on a unilateral basis requires some thinking in that regard.

PATRICK CRAWFORD: Okay why don't we take Victor's question now.

VICTOR THURONYI: I just wanted to speak to the treatment of the non-listed countries. That would be most of the countries of the world, there's at least more than half. They're the countries that I've worked in the last ten years or so, and what has struck me about my experience is the remarkable degree of consensus that existed in those countries on the tax system that they have, and in particular on the income tax. I think it's not something you would have expected just from logic, and one thing that must have contributed to it is the foreign tax credit that the United States has had and I would be concerned, I think, that this effect of the credit seems to me to be salutary for those who want to have an income tax. That is that it fosters a degree of international harmonization.

And then, secondly, on the question of rates and preferential regimes, obviously these countries are struggling with the idea of whether they should grant tax holidays or other kinds of preferences to attract investments, and the existence of the credit in the United States and other countries that have the credit system likely may tip the balance in favor of getting those countries to move away from tax holidays and in favor of other ways. You know, we keep saying that for countries to attract investments they should work on improving their general legal and investment climate; not necessarily true with the tax system. But, this question of the point tax credit is sort of one element of that balance and I would like to keep as much on the right side of that balance as possible to encourage countries not to cool down their tax competition.

PATRICK CRAWFORD: Philip?

PHILIP WEST: I'll try to run through a number of points pretty quickly. First, to pick up on Hugh Ault's comparative angle, there are no countries around the table, other than the United States, Canada, and the Netherlands. The Netherlands, of course, does not have anti-deferral rules. Canada is the only country besides the United States that has an anti-deferral regime that does not key off of a country or a rate. Every other country around the world that has a CFC regime keys off of a good country, bad country, or high rate, low rate and I believe there are about 18; 19 if you count Italy; 20 if you count Israel, which is further away than Italy right now.

There are a lot of different ways to implement this kind of approach. We heard from John Steines and David Rosenbloom, and the colloquy between them that maybe you need a combination of country and rate. You can also think of different variations. You can set a rate. We had minimum distribution rules. That's, in effect, a variation on this. You can talk about lower rates and use a cliff or a make-up tax. If you have a rate of a certain percentage below a threshold amount, then you pick up an excess in the United States. If you have a rate below a certain amount, then you don't get deferral at all and the interaction with credit. I agree with David talking about deferral. But, we lose sight of the fact that, as Hugh Ault said, the dichotomy is exemption versus world-wide tax with credit. That is the fundamental debate; deferral is gravy and non-deferral as Bob Peroni said, has a lot of appeal. Let me go through some narrow points. I don't agree with Charlie that per country limitation is tantamount to an item by item limitation. I do think it's important to remember, though, that the reason we moved away from it was its complexity and that's my understanding from before I was at Treasury. Part of it is the number of different countries you would have to deal with and part of it is the treatment of inter-company and inter-branch transactions that I think made it seem untenable.

On use of the list for foreign policy purposes, I think it evolves into related points as to whether you think the card should be used for social purposes. I think Mike Graetz said only the purist would say we shouldn't use the card for those purposes. Maybe it's a little bit larger group of people that think using the card for social, and I guess foreign policy purposes, is not the way to go, but I think we're sort of past that now and it is used that way as a practical matter.

On John's point about why the foreign tax credit is limited to income type taxes, I'm not sure an income tax is a better tax. But, I think the theory is that the credit is designed to alleviate double taxation and is basic in security about whether the same base is being subjected to the same kind of tax. We have an income tax, and to give credit against an income tax for something that's not an income tax raises that insecurity. On Charlie's point on sparing, I think, Charlie, you may have understood that the trend is away from tax sparing. You know it's not only the OECD report. I think if you look at what countries are doing around the world, I think there's less of an appetite for sparing credit and treaties than there used to be.

On simplification benefits—the one I don't have a good and empirical way to evaluate, but the one number that I think is interesting in my understanding—the number of U.S. taxpayers that have foreign subsidiaries, discounting fiscs that have active foreign subsidiaries, is between three and five thousand taxpayers. And that's the world we're talking about, and that may lead you to believe that you know there's merit to what Charlie's saying. That a small group of taxpayers can get advice and can, in effect, enforce the laws through their advisors.

I think the only other last point I would make is on Bermuda. Having an income tax treaty that's only to give a PE protection on the insurance income is not a full income tax.

STANFORD ROSS: Well, I found David Rosenbloom's paper and the comments really stimulating. I was there at the beginning. I was five years out of law school, and it was Stanley's theories and thoughts that really laid behind the 61 proposals and the 62 active elements. It was largely based on equity, and a lot of the work Peggy Richman did. In fact, I remember after the proposals were made, we scurried around and found a finance economist somewhere at Swarthmore who never stuck with the field, who I helped write a paper on. I think that the 1962 Act's reasonable accomodation provision was politically necessary at the time. You're dealing with American companies that were very dominant, you're getting law firms telling them to set these places up and that they can transfer price with no profit, that the law permitted that—very famous firms. It was the Europeans that were complaining like mad about, "can't you control your own corporations, you're supposed to be helping us with economic recovery and you know we're getting raped, pillaged and burned over here."

So we didn't get everything we wanted from our tax standpoint. The LBC exceptions to deferral never made much sense because that was the Kennedy administration's foreign policy. I went over to State and got a definition and we did what we could, but it was a reasonable accommodation and compared to the compromises that get made today, it really wasn't all that bad at that time. We got a half a loaf you know, not just a slice of the bread. It was never meant for the U.S. to be a tax policeman for the world, but it was meant that we always helped internationally; just like some of our ideas about foreign tax credits and equity might influence other people. Seeing Tom Fields here reminds me that 1992 was the 20th anniversary of Tax Notes and he asked me to write a piece on the international area. I happened to look at it the day before I came here and I saw the 20 years since—actually it was 30 years since—the 1962 Act. Now, it's building off that platform. There's something better but it's just a continued degenerative period where you kept getting these mutations like a cancerous growth that you know everybody who had a good idea to carry out the logic. So, they gummed up the credit and gummed up subpart F, and probably the worst decision that was made in that period was those of you who are students of history. In 1978, the Senate voted to eliminate deferral and I went to the conference and I pleaded with Larry Woodworth not to take more tightenings and kind of permutations on subpart F, but to go back to the minimum distributions proposal holistic approach and try to get it into some sort of an international minimum tax. And I still think that's a good idea and I also think it ties in with the first panel.

I think, given the new technology and the way international accounting standards are becoming more harmonized and everything, I would carry David's idea about simplicity in getting this stuff together further. I'd have a foreign basket. I would sort of start with financial and probably have to adjust it for all kinds of tax reasons. But, after all, it's getting reported to creditors and shareholders, and there are still some ethical standards for the accounting firms so they can't manipulate it entirely. I would have the foreign taxes in as a deduction so that I didn't have to worry about whether there's an income tax to do that and then, if there's a profit at the end, I'd just slug a tax on it. It would be a foreign basket attached to the domestic consolidated return and I'd get 5% because when it all comes down to it—the consistent thing over the last 40 years—it is a question of whether the U.S. tax authorities are going to pluck that goose out there at all and will there be hissing and corporate whining, and it would be louder than ever. I would not allow a loss in this foreign basket to come in. I would defer it, let it be carried over. There are obviously lots of problems with this and that and the other thing. But, I think that I admire Bob Peroni going back to what I'd call a classic position, like eliminating deferral and keeping the credit strong or simple. I think after 40 years, it's more quixotic than ever, with hopes that you would be able to get all that done. Mine is probably not just the second best, like David's is the third best, because if you have the right political circumstances there is something to be said for a sort of international minimum tax with the precedent of minimum distribution which went off in the wrong direction, but should have been resurrected.

One last thing I would like to say about this is I'm really impressed at how big an industry grew out of this. When I went to treasury, I was Stanley's first hire in 1961. There were two guys brought across from the IRS who knew something about this field. Nobody in Treasury itself. Larry Stone came and joined me. There weren't a lot of people you could talk to out there who weren't in practice. There wasn't a legal and public finance profession and look here we all are here today thanks to Victor Zonana and we've got the same issues to continue to chew over. Thank you Victor.