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ADDRESS

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IT IS A pleasure to be here and have this opportunity to discuss the work we are doing in Treasury with regard to tax reform.

The way we operate in the Treasury leads me to have a certain amount of knowledge, maybe even a little expertise, about the foreign aspects of the tax package. I am virtually helpless to defend the domestic side, so please do not ask me about the 3-martini lunch today. From my perspective, somewhat parochial I suppose, the President has aimed his tax reform proposals in the foreign area. The most significant reform proposals in the package (certainly the most significant structural reform proposals) are in the foreign area. I thought I would talk to you about the two biggest proposals; the proposal to terminate deferral and the proposal to terminate DISC. Because deferral is a lot more complicated and controversial (and because I have a lot to say about it), I will focus on that issue more. Afterwards, I will be happy to answer any questions on either of these aspects of the President's proposals, or on a variety of other matters that we are considering in the international tax area such as taxation of Americans abroad, foreign tax, credit rules and the international boycott rules.

Just to orient ourselves, deferral refers to the fact that a foreign subsidiary of a United States company does not currently pay tax to the United States on its income. Tax is paid to the United States when the earnings of that foreign controlled subsidiary are remitted to the United States shareholder.

Now, let me tell you how I approach this subject analytically. First of all, I think it is clear that allowing a deferral of United States taxation on the earnings of foreign subsidiaries tends to favor foreign investment by United States investors over domestic investment. If a United States company invests at home, regardless of the form of that investment, we tax the income from that investment as it is earned. We do not permit a choice between current taxation and deferred taxation. If you organize a foreign subsidiary, however, you avoid current taxation, and you are subject to taxation only upon a remittance. It is also possible to invest abroad through foreign branches and obtain current taxation if you want that, and many investors who anticipate losses do want that. The losses will offset their United States income tax liabilities on United States source income. The difference between going

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abroad through a branch and going abroad in a subsidiary is basically a difference of form. There are some impediments to the free choice of that form, but those impediments can be exaggerated. I think that most investors in most cases can, in effect, choose whether they want their income from a foreign investment to be taxed currently or on a deferred basis.

Now, point one in my thinking is that deferral is a preference for foreign investment. As I have already implied it is a preference in three distinct ways. First, it is an advantage to a taxpayer not to be taxed currently by the United States on the income from an investment. Obviously it is beneficial to pay taxes tomorrow rather than today. But even more importantly than that, the existence of deferral gives people investing abroad a choice between current taxation and deferred taxation. They can exercise this choice on an investment-by-investment basis therefore there is a considerable opportunity for planning. Third, probably most important in the scheme of things, the deferral rule permits a choice as to the time of taxation of the earnings from any investment which is structured to take advantage of the rule. In other words, it is not merely that you are deferring your taxes, or that you have an initial choice between deferred taxes and current taxes, it is also that when you choose to take advantage of deferral you are then in a situation where you have a choice as to when you will be taxed and on how much since taxation follows the timing and amount of the remittance.

No advantages like that are provided to domestic investment. For that matter, to the extent that it is all relevant in the overall structure of our tax rules, no advantages like that are provided at the individual level. We tax our citizens on a worldwide basis, regardless of where they reside.

If I am right that deferral represents a benefit for foreign investment, the next question as a matter of tax policy, it seems to me, is whether the United States should have a tax rule that favors foreign investment over domestic investment? There are other rules in the Internal Revenue Code which favor foreign investment, probably even more than the deferral rule. The overall limitation on the foreign tax credit, for example, tends to provide substantial incentives for companies to go abroad to take advantage of the ability to average credits. It is also true that the Code contains some deliberate efforts to favor domestic investment over foreign investment. But looking at the deferral rule alone, I think it does favor foreign investment and the question is: Do we want to favor foreign investment and, if so, do we want to favor all foreign investment indiscriminately?

The deferral rule is part of the statutory framework and provides an incentive to invest abroad in order to take advantage of tax rates lower than those of the United States rate. That may not be the reason for going abroad in any given case, but it has to be the reason for going abroad in some cases, and it surely is *a* reason for going abroad in a substantial number of cases. I question whether the United States wants to favor that kind of an investment, an investment made with the intention of shifting income abroad. The statutory deferral rule, since it does operate across the board, is a concession. It is given free of charge to every investor. Deferral by statute benefits the firm that provides no help to the United States at all, as well as the firm that goes abroad and draws out a considerable amount of American exports. It benefits the firm whose foreign investments really displace United States jobs and the firm whose foreign investments are entirely incremental insofar as jobs are concerned. It benefits the firm which invests in a country with tax practices that we recognize and the firm that does business in a country with tax practices which are offensive to United States standards.

Thus, once you perceive that deferral is an incentive to foreign investment, the next question is whether we want to provide such an incentive that for everyone, across the board? But even if we decide that we want to do that, deferral is still an odd way of promoting foreign investment. Deferral is really an historical accident in the sense that it reflects the view that a corporation and its shareholders are spearate. This view antedates tax rules and at least in the United States, has its roots in common law rules.

To obtain the advantages of deferral one is required to understand the interaction of the deferral rule with other quite complicated rules, the rules regarding foreign branches, the foreign tax credit, the overall limitation on the foreign tax credit and the rules regarding sources of income and deductions. Using all these rules in a way that produces maximum advantage to foreign investment requires quite a considerable degree of sophistication, and that sophistication is not available equally to all people. These tax advantages favor large companies over smaller companies. I think that in any overall policy of favoring foreign investment, if that is what we want to do, it is not at all clear we want to express this favoritism in a way which skews the advantages so that bigger companies are in a better position to take advantage of the rules than smaller ones.

The other problem with accepting deferral as a benefit to foreign investment over domestic investment is that this acceptance sits rather uneasily with the other rules that we have for taxing foreign income. Deferral rests, as I said before, on the idea that a corporation and its shareholders are separate; but the other rules, which make deferral such a benefit for foreign investment take an opposite theoretical approach, or at least a different approach, and in some regards a contradictory approach. For example, we give a foreign tax credit in the United States for taxes paid by those foreign subsidiaries organized to take advantage of the deferral privilege. That strikes me as fundamentally different from deferral because what we are saying in regard to this "deemed paid" credit is that there is a unity between the United States parent company and the foreign subsidiary, and we are going to allow a credit for the taxes paid by what is a different entity, a separate entity, if you follow the line that the deferral rule takes. A similar point can be made with regard to the overall limitation on the foreign tax credit. We allow taxes paid by a company at a higher rate than the United States rate to offset the low taxed income earned by an entirely different entity. Again, we pierce the corporate veil, disregard the separate corporate charter, look through the corporate form. It seems to me that there is a tension between such a rule and the deferral rule which rests on the concept that the foreign subsidiary is a different entity from the shareholder.

Furthermore, our recently adopted rules for the allocation of deductions contain certain "safeharbors" which provide for deductions to be allocated against foreign and United States sources according to formulas; deferral permits manipulation of the allocation. It seems to me that if you are going to try to make a reasonable allocation (in an accounting sense) between United States source and foreign source deductions, there are all sorts of ways to cut up the pie. But it is odd to cut up the pie in accordance with the remittance policy that a particular corporate group may choose to follow. That seems to me to be at least somewhat inconsistent with the idea of a basic allocation between foreign source and United States sources. All of these rules together make for a sort of patchwork quilt which rewards expertise, high tax planning budgets, and very sophisticated tax advice and planning that big companies can afford a lot better than the smaller companies. Our analysis indicates that fifty percent of the benefits of deferral in recent years has gone to thirty of the largest United States multinational companies.

The other objection to the interplay of deferral with these other complex rules, which are at least arguably inconsistent with deferral as a conceptual matter, is that we find it very hard to understand how our rules for the taxation of foreign income operate. If one goes back over recent congressional actions in this area, including the 1976 Tax Reform Act, one perceives certain actions taken, including some statutory actions, whose implications were clearly not perceived by Congress. The implications of new laws could not possibly have been understood when they were enacted, and in some instances they operate in very perverse ways. We have created an exceptionally complex system in the sense that the rules themselves are exceptionally complex; if we in the United States are ever going to sort out our method of taxing foreign income, we are going to have to start from a more or less clean slate with rules which operate consistently. I think it has been the view of the Administration (and I think it still is the view of the Administration) that the taxation of all income as earned by American controlled corporations would represent a step in the direction of rationalizing the taxation of foreign income.

Another point about deferral (and I am frank to say that there is something of a tension between this point and my basic proposition about favoring foreign investment, but I will explain, at least to my satisfaction, why this tension is acceptable) is that deferral is free not only to investors but to other countries. My own view is that tax treaties in the United States has been a terribly neglected subject. Such treaties are regarded as a pie in the sky, impossible to achieve. The rules in tax treaties, generally speaking, are not well understood. The objectives of the tax treaty program are not well understood. A large number of United States treaties are out of date, and we only have two treaties with the developing world. I think that the United States has a significant interest, given the volume of world trade and the need for reasonable tax rules between us and our trading partners, in modernizing our treaties, in entering into a greater number of treaties, and generally I think that a good deal more attention has to be paid to this subject.

One of the attractions of revoking the deferral from the statute is that we would secure control over this provision of our law. There is some indication that deferral would be a useful tool in tax treaty negotiations, including negotations with countries which currently do things that we would like to see changed by treaty. A number of our major trading partners, and Canada is a good example, reserve significant tax policy decisions for the treaty process. The United States has tended to take the view that if a rule is right, it ought to be in our statute. Sometimes we have taken that view because any other approach raises important jurisdictional questions on Capitol Hill. I think that this is a kind of "head in the sand" approach, and that we are going to have to turn to a much greater extent to the treaty process and treaty bargaining on a bilateral basis. And in that process it may make sense to consider concessions such as deferral if other countries want the concession, if the concession in a particular instance does not do serious and direct harm to United States interests and, most importantly, if we can obtain something in return for the concession.

I will not bother you with the technical details of our proposal to terminate deferral. The Administration took a somewhat different touch than I think had ever been seriously thought of before. We suggested quite simply that foreign controlled corporations should be treated for purposes of current taxation as if they were branches of the United States parent company. That approach would eliminate any tax incentive to invest abroad and eliminate the opportunity to choose between different United States tax regimes for investment abroad. It would build upon a body of law which in many respects is already in existence with respect to foreign branches and it would, I think, make for one unified and rationalized approach—a general starting point for the taxation of foreign income.

This approach has several significant advantages of fairness. It allows losses to flow through just as they do with branches now, and it removes certain complications in the computation of the foreign tax credit. It places domestic earnings and foreign earnings on the same basis. That is not to say that going to a branch basis avoids all problems. The two basic problems that have to be dealt with in any proposal to terminate deferral are the fact that a foreign country is, after all, not the United States and therefore some accommodation to local rules is necessary. Secondly, the ownership of a foreign subsidiary is evidenced by stock and not by direct ownership of assets and no statutory language can change that test. We have proposed a number of specific rules which attempt to come up with a fair and reasonable method of terminating deferral. We think that in regard to proposals that have been made in the past on this subject ours would operate as cleanly and as fairly as possible.

I want to add one other point on deferral before turning to a discussion of DISC, and I should really have said this at the outset. The Administration's package as proposed included a reduction in the corporate rate in the United States to forty-four percent from forty-eight percent. For most companies, that would add many more after-tax dollars than termination of either deferral or

DISC or both together would subtract. So for most companies, the overall proposal, including the corporate rate cut and the various improvements in the investment tax credit and depreciation rules, would leave more after-tax dollars to make investments in ways that are economically sound whether they be in the United States or abroad. The Administration perceived the package as a package. The reaction, not surprisingly, has been "well, we like the corporate rate cut just fine, but we do not like the elimination of DISC and deferral." Comments like that remind me that certain developing countries, rather than setting precise rules for business taxation, just allocate a certain amount of money to be used by the business sector and then, in effect, allow the business sector to divide up that money as the sector desires. I wonder how long DISC and deferral would last with that kind of an approach.

Let me move over to DISC and speak very briefly about it. The concept of Domestic International Sales Corporations was introduced in 1971. It provides in effect a deferral of taxation for export income from the United States. In 1976, the program was cut back so that only the income above a moving base average amount, only incremental amounts of income, would qualify for the deferral privilege. In a way, DISC is both more forthright and easier to understand then deferral as a benefit for export. I also think it is more vulnerable. Let me explain what I mean. Unlike deferral, DISC was a program aimed at promoting exports. That was its intention. That was basically its sole justification. So unlike deferral, there are only two questions about DISC: (1) Does it work with regard to its cost?; and (2) Do we want to go through the tax system to promote exports? I think those are the two major questions that DISC raises. At the same time, because DISC is really not an integral part of the Internal Revenue Code in the same way that deferral is, it always has been, and I think always will be, a fairly vulnerable provision. It is designed to do something other than what the Code is, in large terms, supposed to do and for that reason alone I think it has been from its very inception, subject to a great deal of criticism.

From the Administration's standpoint, I think the basic attitude at this time is that all the evidence so far suggests that DISC is not very cost efficient as a means of promoting exports. If it were I think we would have a very hard national question to decide because I do think that the United States has to promote more exports and I do think that effective and efficient ways of promoting exports are something that we have to examine very carefully. But we do not have to reach that question with regard to DISC, because it appears that we are paying out so much money through foregone revenue in comparison with the additional exports that we are generating that there has to be a better way.

The Administration until recently has focused on additional funding for the Export-Import Bank. That bank has the function, as I am sure you know, of lending money to support American exports that would not otherwise move from the United States because of credit terms or imperfections in the capital markets or the like. I think that the Export-Import Bank, in that sense, is more directly responsive to the problem at hand, that is, moving exports that would not otherwise move. The problem with DISC (even with the incremental provisions in place) is that you cannot be sure that you are not simply giving tax advantages for exports that would otherwise leave the United States. All the information we have indicates that export profits tend to be larger than profits from the domestic market and so, even without DISC, the question of how much is needed to produce additional exports via subsidies is a very legitimate and important one. Another aspect of DISC is that, as in the case of deferral, it has historically tended to reward large companies much more than small companies. I do not have the statistics at hand but a recent DISC report indicated that the preponderance of DISC benefits goes very much to a relatively limited number of companies. It is true that small companies have benefited from DISC as well, but in terms of the amount of tax dollars foregone there is a heavy skewing of benefits toward the largest United States firms.