STATEMENT OF H. DAVID ROSENBLOOM

BEFORE

THE U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

HEARING ON: CHINA AND THE FUTURE OF GLOBALIZATION

New York, NY
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Mr. Chairman and Members of the Commission:

My name is H. David Rosenbloom. I am a member and Chairman of the law firm Caplin & Drysdale, Chartered, with offices in Washington, DC and New York, NY. I am also Director of the International Tax Program, a Master of Laws program at New York University School of Law.

Thank you for this opportunity to present my views on the role of tax policies in providing incentives and/or disincentives to offshore flows of trade and investment. According to the invitation I received, the Commission is interested in examining the economic theories and underpinning of the forces driving globalization and, in particular, exploring the implications of various proposals for reforming tax policies applicable to the global operations of U.S. firms.

I have worked for nearly 30 years in the field of international taxation, as a practicing attorney, a Treasury official, and an academic. The field comprises those aspects of the tax system that pertain to cross-border activities, transactions, and investment. Normally the subject breaks down into "inbound" matters and "outbound" matters — that is, transactions, activities, and investment coming into the country and transactions, activities, and investment leaving the country.

The Commission's interest is in the outbound aspects of international tax policy. Its initial focus is, as it should be, on outbound policy in general, and not as applied particularly to China. The United States has country-specific tax policies embodied in its tax treaty network but they represent recalibrations of general policies expressed in the Internal Revenue Code and operate at the margin insofar as offshore flows of trade and investment are concerned.

There is much to be said on the subject of outbound tax policy. Congress has returned to this area again and again over the past 40 years, with a view to effectuating "reform." The result has been rules of nearly impenetrable complexity studded with politically opportune rewards to specific interests of one sort or another. Few Americans, whether in Congress, the Executive Branch, or the public, have the slightest comprehension of what the rules mean, how they apply, or how much money rides on them. I do not believe the statute can withstand much more "reform" of the sort it has undergone to date.

Current law relating to outbound investment revolves around the concept of "deferral" — the lack of current taxation of foreign income earned by foreign corporations controlled by Americans. Deferral is, for all practical purposes, tantamount to exemption, since the holder of shares controlling a foreign corporation can choose if and when to repatriate earnings and subject them to U.S. tax. Prior to 2005 many U.S. controlled firms had foreign unrepatriated earnings in substantial amounts on which U.S. taxes had been "deferred" for 50 years or more.

Congress's recent decision in the American Jobs Creation Act to provide what amounts to an amnesty (in the form of a 5.25 percent tax) for these foreign earnings will doubtless produce a good deal of repatriation, but it can only reinforce the conclusion that foreign income is taxed more lightly than income earned in the United States. Congress has crossed its collective heart and sworn that it will never again do what it did in the AJCA but I do not believe them, and I do not know anyone who does. Thus, although the law has not gone so far as explicit exemption for income from foreign investment, there is clearly a strong and growing incentive favoring such investment over comparable U.S. investment.

The United States has accepted such favoritism in the name of the competitiveness of U.S. firms. We have hesitated to impose a current U.S. tax on foreign income of U.S. controlled businesses because competitors controlled in other countries may be free to earn similar income without current home country taxation. We are concerned that if we did impose U.S. taxation for the purpose of equating the burden on foreign and domestic investment we would subject our companies to disadvantage in the international marketplace. This is a real and justifiable concern.

It is therefore not surprising that U.S. laws pertaining to foreign income of U.S. firms have eschewed both full current taxation and outright exemption. Rather than making that choice we have attempted to subject certain classes of "tainted" income to current tax while leaving deferral as the rule for other income. For those not having a year or so to master the fine points, "tainted income" is income for which either the competitive case cannot be made or which is mobile enough that we cannot be sure.

The consequence of our understandable ambivalence about controlled foreign corporations has been a lack of clarity in the application of existing policy choices to many real-world situations, coupled with increasingly subtle and arbitrary definitions of "tainted income." Since we find ourselves adrift between dichotomous policy choices, we are unclear how to respond to phenomena such as contract manufacturing, hybrid branches, and other international tax exotica, not to mention real but easily transportable business activities such as those carried on by banks, securities firms, insurance companies, and other financial institutions.

In addition to the rules pertaining to deferral, the outbound tax policy of the United States encompasses a foreign tax credit as a means of alleviating international double taxation. In much the same way as the rules on deferral, but in my view even worse, the foreign tax credit rules exhibit an intricacy that defies comprehension. In my experience these rules are applied by taxpayers and reviewed by tax administrators in an uneven, unpredictable, even haphazard manner. There is little doubt that the credit is used, in fact, to shelter large amounts of income that has not borne any foreign tax.

In the circumstances, intelligent debate about policy options is, to say the least, difficult. The well advised and well heeled have all the advantages. The U.S. multinational community is generally opposed to exemption for foreign business income. That should tell us something.

In my view, sound tax policy thinking does not involve increasing or decreasing incentives and disincentives for offshore trade and investments. Politicians have been using the tax system to attempt to influence trade and investment for decades and have not been especially successful at the game. The purpose of taxation is to raise revenue: policy thinking should proceed from that point. If we want a healthy tax system that allows for economically sensible trade and investment, we should make every effort to get out of the way. A simple, efficient system, one that is perceived as fair and can be administered effectively — that is the gold standard.

In a political vacuum, a small group of knowledgeable persons could develop a system of this nature that would serve the national interest. My own preference along these lines would be exemption for active foreign business income earned in the countries that are our major trading partners, and current taxation of other income. I would apply these rules regardless of how the income is earned and how many tiers of entities there may be between the U.S. taxpayer and the income . Corporations, partnerships, trusts — they are all just pieces of paper which, in my judgment, have been accorded far too much importance in our tax laws.

There is not a scintilla of political will to consider such radical change, or anything resembling it. Too many oxen are involved, and too many of them would be gored. Thinking large in this area is simply a recipe for frustration.

In more modest terms, what might make sense? An appropriate place to begin is the current view — unstated but pervasive in U.S. tax law — that all foreign jurisdictions are equal. We see the world in binary terms: There is the United States, and then there is everywhere else. From the standpoint of logic or common sense, this is odd — China and Monaco, the Cayman Islands and Japan, Germany and Nigeria are hardly the same except that they are all not the United States. The binary view is detrimental because it constrains policy choices. If we are going to make progress in this area, we need to start calling balls and strikes.

Suppose we took the view that, notwithstanding the multinationals' position on exemption, there can be no principled objection to zero tax on active business income earned through real investments in real countries outside the United States. I would be tempted to link that approach to a "white list" of jurisdictions but that may not be necessary; we could describe what is encompassed by the concepts of "active business income" and "real investments in real countries outside the United States" and leave the rest for interpretation, including interpretation in targeted tax treaties. Suffice it to say that most investments in Japan, Australia, New Zealand, Germany, France, the United Kingdom, Canada, Norway, Sweden, Finland, Spain, and Italy should qualify for exemption. There may be special rules in some of these jurisdictions that would need to be addressed with particularity, but it is usually business opportunities in them, not advantageous tax rules, that are attracting investment from the United States.

On the other hand, we might well adopt a different stance with respect to foreign income that does not qualify under the concepts spelled out above. A jaundiced view would be appropriate for both passive income earned by American firms abroad and foreign jurisdictions that use their existing or nonexisting tax systems as lures. In my view, good tax policy lies in distinguishing countries that receive most American trade and investment from tax havens — jurisdictions of convenience whose laws have attracted stashes of money earned elsewhere.

Identifying tax havens is not so difficult. Other countries have done it; the United States can as well. Naming the players at this end of the spectrum is no more challenging than naming the important developed countries where most U.S. investment goes and where real activity occurs.

The difficult questions relate to countries in the middle — developing countries that employ tax holidays and special tax regimes to attract real investment activity from the developed world and developed countries that have tax systems in some ways not unlike our own but that use their tax systems to siphon off profits earned elsewhere. China, among other countries, falls in the former category. The latter category would include Luxembourg, Ireland, Switzerland, possibly the Netherlands.

This is the hard part. Rules for these intermediate classes of countries are debatable. My own inclination would be to withhold from the statute both broad exemption and deferral, and to deal with these countries through the treaty process. Once again, a one-size-fits-all approach is not going to produce satisfactory results. If some general rule is absolutely necessary, one option would be current taxation and a narrowly circumscribed foreign tax credit.

Fortunately, it is not necessary to solve every problem, or agree on every solution, before doing anything. The proper starting point is weaning ourselves from the notion that we are discriminating or otherwise behaving inappropriately when we think about Bermuda differently from France. A distinction of this type is not just appropriate — it is compelling. If we can take the first step of beginning to develop different rules for different situations, we will be on the way toward a better set of outbound policies for the future.