STATEMENT OF DAVID R. TILLINGHAST

BEFORE

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

HEARING ON: CHINA AND THE FUTURE OF GLOBALIZATION

New York, NY
May 20, 2005

Statement to U.S.-China Commission

My name is David Tillinghast, and I am a partner in the law firm of Baker & McKenzie. Any views I express are personal and are not to be attributed to my firm or its clients.

As David Rosenbloom has stated, dramatic changes in international tax policy may be too difficult to achieve, but that does not mean that nothing can be done. I want to focus on three aspects of the U.S. international tax system about which I think something can be done.

David has alluded to the system's immense complexity. What needs emphasizing is that, although in the nature of things a degree – and perhaps a substantial degree – of complexity is unavoidable, a great deal of the complexity appears to me to be unnecessary. The technical details are not critical here,[*] but the principle is. Last year's legislation included two significant simplifying changes – the prospective reduction to two foreign tax credit limitation baskets and the repeal of the foreign personal holding company and foreign investment company rules (which were essentially duplicative of other provisions); but it added other provisions which contribute additional complexity. The net effect was, at best, a draw.

The reason that we do not simplify is simple: there is no political hay to be made by pushing simplicity. Some changes can be made with creating winners and losers, but others may adversely affect someone. Taxpayers want something, and it often turns out that, rather than reshape a provision, the Congress just tacks something else on to it. But the result is that both the IRS and American business is stuck in the quagmire, both heavily burdened by the amount of

[*] For those interested, many of the issues are discussed in Tillinghast, *International Tax Simplification*, <u>8 Am. J. Tax Policy</u> 187 (1990).

resources that compliance consumes. An income tax does not need to be as complex as what we have, and we would all be better off if we did something about it.

Many of the provisions of the Internal Revenue Code that relate to international income flows were written a long time ago. I may be one of the few people in the room that was in Washington in 1962, when the provisions of the Code relating to foreign controlled corporations were enacted. Provisions like these were drafted when international economic conditions were entirely different from those that exist today. Currency rates were fixed. The United Kingdom had exchange controls. But most importantly, the largest segments of the U.S. economy (and the economies of its trading partners) were brick-and-mortar businesses. Of course, there were banks, insurance companies and service operations; but since then we have witnessed not only the globalization of business generally but more significantly the dramatic decrease in the relative amount of income produced by tangible assets and the soaring amount of income attributable to intangible assets. Many concepts that are embedded in the Code were shaped by reference to tangible property and traditional business operations and simply do not work, or do not work right, when applied to globalized business operations and the cyberspace economy.

Let me give you a couple of examples. For a number of critical reasons, it is necessary under the Code to determine whether income derived by an enterprise is sourced in the United States or outside the United States. In general, we tax income derived by foreign business entities only if it is sourced in the United States. We allow U.S. entities credits for foreign taxes they pay only to the extent of the U.S. tax on their foreign-source income. The Code distinguishes U.S.-source income and foreign-source income according to the nature of the income.

One major problem arises because royalties derived from the licensing of intangible property are sourced where the intangible property is used. But in many cases this is difficult or impossible to ascertain, and in other cases it is changeable. A U.S. person that licenses an intangible for use on his or her laptop changes the source of royalty income whenever he or she uses the laptop abroad. The licensor, which must report the income, has no way of knowing where the use is or how much of it is abroad.

Software suppliers often enter into agreements with multinationals which permit use of the software in a specified number of computers but impose no geographical limits on where the use will be. Typically these are accompanied by up-front payments. Even the licensee may not know at the outset where the licensed rights will be used; if it outsources a function that uses the software to India, for example, the place of use will shift; but there is no mechanism for adjusting the source of the payment that has already been made.

An even bigger black hole exists with respect to certain payments which the Code characterizes as income from the provision of services. The applicable source rule states that the source is where the services are physically performed. But huge income streams that are thought to be properly characterized as income from the provision of services are generated without reference to geography – and any physical functions which can be identified are too unimportant to serve as rational indicators of source. The proprietor of a website may, for example, sell advertising on the site. Advertising income constitutes income from the provision of services. But where are the services performed? Where the server is located? The function of the server adds miniscule value and its location is easily changed. What the web site proprietor is being paid for is delivering an audience. That audience has been created by a variety of activities carried on over a period of time, often in many different countries. And even the proprietor may not know where that audience (or major segments of it) is (are) located.

The upshot of this is that there are large segments of income derived from intangibles as to which there is no usable source rule. The existing rules rely on physical geography, but in the cyber-world physical geography is not important. Points of view will differ on how such income should be sourced, but it is clear that we need to go back to the drawing board and bring the Internal Revenue Code into the twenty-first century.

This point leads naturally to another one to which attention needs to be paid. An important dynamic at work in the international tax field is the increasing tension that exists between the United States (and other industrialized countries) and what have typically been defined as developing countries, a category that includes the People's Republic of China, India and several other countries for which the term may not be exactly appropriate. Income earned internationally by business enterprises may be subject to tax either on the basis of the residence of the entity involved (the U.S., for example, taxes the income of corporations organized in the U.S.) or on the basis of the source of the income which it derives (India and the Peoples' Republic, like other countries, tax income which they deem to arise in those countries). This obviously raises the prospect of double taxation, which would have a chilling effect on international trade and investment.

Many countries, including the U.S., have domestic law rules for eliminating the double tax (in the U.S. the foreign tax credit rules). But given the sometimes substantial differences in the laws of different countries, these unilateral rules often do not work well enough. As a result of this (and other considerations), the United states has entered into bilateral income tax treaties with a large number of foreign countries, including some of developing countries, the most important being the Peoples' Republic and India.

The United States and the developing country involved come to the negotiating table with very different objectives. From the U.S. point of view the treaty is designed to protect U.S. companies from over-zealous taxation on income which the other country may consider to arise within its borders. The developing countries are, on the other hand, hungry for revenue and depend much more heavily than does the United States on revenues derived from taxing income of foreign businesses. They also strongly believe that the advent of the digital economy is unfairly shrinking their tax base, because in many cases it dramatically reduces foreign companies' needs to have a physical presence in their territories. These differences in view unavoidably result in compromise, so that the United States cedes to developing countries the right to tax some items of income which in other treaties would be exempted from taxation at the source.

In particular, in treaties with developing countries the United States has given the treaty partner the right to impose withholding tax on items of income constituting royalties, whereas other types of business income owned by U.S. companies cannot be taxed. This has led to serious differences over what constitutes a royalty.

Both the Peoples' Republic and India have taken the position in certain cases that income of U.S. companies which the United States and virtually all other developed countries treat in a category of income called "business profits" -- which are exempt from source-basis taxation under the treaties – do not fall in that category but must be treated as royalties which under the relevant treaties are subject to withholding tax. This not only gives rise to potential (and in many cases actual) double taxation, but of a particularly burdensome kind. The tax which is asserted is a withholding tax, one which is based on gross revenue and not on net income. A 15% withholding tax, for example, may represent a very high percentage of the company's net income --- indeed, to a company at a loss, the rate is infinite. If a withholding tax is imposed on payments made to U.S. companies by residents of the treaty country, the effect is essentially indistinguishable from the imposition of a tariff.

Over some period of time, some form of an accommodation may be achieved. The problem would be solved, of course, if the U.S. treaties with these countries were renegotiated to provide (as do most of our treaties with other developed countries) that royalties are exempt from withholding tax. A new look may be justified because the existing treaties were concluded when the development of the Asian economies was far less advanced. (The treaty with the People's Republic came into force in 1986, and the treaty with India in 1990.) Such renegotiations would, however, be time-consuming and arduous. The treaty partners would undoubtedly resist any such change strenuously. It is not in the interest of the United States to terminate the treaties, since U.S. companies would then only be worse off. Some of the asserted taxes are being contested through litigation, and this may contribute to a solution. Possibly, two other things could be done. The United States could apply diplomatic or economic pressure on its treaty partners not to adopt unreasonable interpretations that do not conform to the international consensus. It could also explore the possibility of avoiding, in cases where the source country has a valid taxing claim, the tariff-like effect of the withholding taxes. Asking these countries to tax on a net income basis is probably not realistic; the administrative problem of determining the relevant net income, including allocating over-all company expenses to that income, is just too difficult. But it might be possible to do rough justice by allowing a formulary deduction or, as Japan does in certain cases, simply imposing a withholding tax at a lowered rate as an indirect recognition that expenses are involved.