Addressing Offshore Tax Avoidance Without Harming the International Competitiveness of U.S. Businesses

The National Foreign Trade Council

I. INTRODUCTION

Congress and the Administration have focused a significant amount of attention on the so-called "tax gap," with a particular emphasis on offshore tax avoidance through the use of low-tax jurisdictions. The National Foreign Trade Council ("NFTC") fully supports legislative proposals that target abusive offshore tax avoidance in a way that does not adversely hinder the legitimate commercial operations of globally integrated U.S. businesses with active operations abroad. The NFTC believes that it is important for policymakers to carefully evaluate legislative proposals that are intended to combat offshore tax avoidance. Without careful evaluation, such proposals may in fact undermine the international competitiveness of legitimate U.S. businesses organized in low-tax jurisdictions without achieving the desired goal of combating abusive offshore tax avoidance. In this regard, it is important for policymakers to understand the legitimate business reasons for the organization and structure of U.S. businesses competing around the world, including the use of low-tax jurisdictions.

II. THE NATIONAL FOREIGN TRADE COUNCIL

Representing over 300 companies, the NFTC is the only business association in the United States dedicated solely to trade policy, export finance, international tax and human resource issues. Members of the NFTC are among the world's leading, globally integrated corporations. The NFTC advocates sound public policies that promote economic growth, jobs, and opportunity through cross-border trade and investment. The International Tax Committee of the NFTC works to reduce the economic costs and restrictions produced by tax anomalies that burden global trade, investment, and markets. In addition, the International Tax Committee works with the U.S. Treasury Department, the Senate Committee on Foreign Relations, and foreign governments to facilitate the negotiation and ratification of bilateral tax treaties.

In its position as an organization that brings together the expertise and experience of a diverse group of U.S. multinational corporations, the NFTC has a strong understanding of how U.S. international tax rules interact with cross-border business operations and how the tax law influences and affects business behavior. The organization recognizes that U.S. international tax rules must work in a way that protects the U.S. tax base and strongly believes that revenue goals can be achieved without undermining the international competitiveness of U.S. businesses.

II. IMPORTANCE OF INTERNATIONAL COMPETITIVENESS TO THE U.S. ECONOMY

A. The Active Operations of U.S. Businesses Abroad Preserve and Expand Their Valuable Contributions to the U.S. Economy

U.S. multinational corporations have adapted to increasing opportunities abroad by expanding their operations to serve foreign markets. The great majority of the world's consumers and other customers are overseas, and many markets can only be served by producing or directly operating locally. In addition to the primary reason of tapping into local customer bases, other factors that lead U.S. businesses to invest in active operations abroad include resource availability, transportation costs, turn-around times, tariffs, and other factors. Research by the Bureau of Economic Analysis confirms that "[c]ompanies tend to invest [abroad] for purposes of selling goods and services rather than for gaining access to low-cost labor and other resources for producing goods and services."[1]

The expansion of activities by U.S. businesses in markets abroad produces positive returns for the firm itself, the U.S. labor market, and the U.S. economy as a whole. Consumer markets in developing countries offer lucrative opportunities for U.S. firms to expand their customer base, which in turn produces demand for U.S.-manufactured inputs, U.S. management and other services, and U.S. know-how and other intangible property. The global operations of U.S. businesses stimulate U.S. productivity growth and U.S. job creation. Direct investment abroad creates high-paying, U.S.-based jobs. Moreover, the global operations of U.S. firms create synergies with their domestic activities such that economic prosperity abroad benefits the U.S. labor market and the domestic economy.

Foreign direct investment also helps to promote economic prosperity and create jobs in developing countries and emerging markets. Foreign direct investment increases competition in the host economy, transfers modern technology, and helps achieve a more efficient allocation of resources. The investment-related growth and prosperity in developing countries contributes to economic stability that helps create a more stable political environment. At the same time, foreign direct investment by U.S. businesses also benefits the U.S. economy by creating headquarters jobs in the United States to support and manage those foreign operations and by expanding those foreign markets for U.S. exports.

B. The U.S. International Tax Regime Must Be Considered in Light of a Competitive Global Environment

Further tightening of the U.S. international tax rules could retard the ability of U.S. businesses to compete abroad and thereby maintain or expand operations and employment at home. Policymakers should assess proposals to change the U.S. international tax rules through the prism of our long-term national economic strategy for penetrating foreign markets and preserving U.S. economic activity and employment. Congress should consider carefully how our federal tax system and regulatory environment affect the ability of U.S. businesses to compete abroad.

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[1] Bureau of Economic Analysis, *Globalization, Offshoring, and Multinational Companies: What Are the Questions, and How Well Are We Doing in Answering Them?* (Jan. 6, 2006) (presentation prepared by Ralph Kozlow, Associate Director for International Economics).

U.S. businesses will continue to operate abroad in an effort to reap the benefits of emerging markets for their U.S. investors and U.S. employees, and more generally for the U.S. economy. U.S. businesses already face considerable costs and barriers in operating abroad, such as: (1) the need to establish and maintain efficient overseas supply networks, and (2) the need to understand and address cultural differences and local norms in product development. A high tax burden relative to the tax burden borne by local firms or foreign competitors that operate in the same overseas market is an additional cost burden that further impairs the ability of a U.S. business to compete and restricts opportunities for growth.

Although the government should address illegitimate offshore activities that violate the law or unfairly erode the U.S. tax base, it should take care not to unduly restrict the legitimate activities of U.S. businesses competing in foreign markets. Illegitimate activities include using offshore bank secrecy laws to shield income from scrutiny. Legitimate activities include the use of low-tax jurisdictions for genuine business and economic purposes that allows U.S. businesses to effectively compete with local firms or foreign competitors. Any changes to the U.S. international tax rules should be carefully calibrated to protect legitimate activities by U.S. firms that allow them to remain competitive in the global marketplace.

III. CURRENT LAW PREVENTS EROSION OF THE U.S. TAX BASE

A. Statutory and Regulatory Rules Prevent Erosion of the U.S. Tax Base

The current U.S. system of comprehensive international tax rules, both statutory and regulatory, restricts the erosion of the U.S. tax base through abusive offshore structures. For example, the corporate inversion rules enacted in 2004 prevent U.S. companies from reincorporating offshore to realize the tax benefits of a foreign-based, or inverted, structure. Further, the U.S. transfer pricing rules are among the most stringent in the world and prevent improper shifting of income between U.S. taxpayers and foreign entities under common control. The U.S. international tax rules impose significant limits on the transfer of appreciated property by U.S. persons to foreign corporations in otherwise tax-deferred reorganizations. Comprehensive anti-deferral regimes, including some complex and arcane rules applicable to controlled foreign corporations and passive foreign investment companies, prevent U.S.-based multinationals from avoiding U.S. tax by artificially shifting passive income to low-tax jurisdictions. Finally, when a U.S. multinational corporation repatriates funds, limitations on the foreign tax credit ensure that foreign tax credits cannot be used to offset U.S. taxes on U.S.-source income.

B. Through Regulatory Guidance and Enforcement Efforts, the Treasury Department and the Internal Revenue Service Aggressively Combat Improper Offshore Tax Avoidance

The Treasury Department and the Internal Revenue Service ("IRS") have undertaken an ambitious regulatory and enforcement agenda to further reduce the potential for offshore tax avoidance through overly aggressive interpretations of the U.S. international tax rules. The Treasury Department and the IRS have identified transfer pricing and foreign tax credit regulatory guidance as among their top priorities, and have issued significant guidance in each area intended to curtail potential abuse.[2] In addition, the IRS has identified several international tax issues among its top enforcement priorities, and is devoting substantial resources to such issues.[3] These enforcement projects are designed to ensure that the U.S. international tax rules are accomplishing their intended objectives and that such rules cannot be exploited to achieve unintended benefits.

C. The Expansion of Tax Information Exchange Limits Opportunities to Evade U.S. Tax

The Treasury Department has expanded its network of bilateral tax treaties and tax information exchange arrangements ("TIEAs") with other countries to ensure the availability of exchange of tax information programs with significant financial centers. These arrangements help further curtail U.S. tax base erosion by deterring tax avoidance through offshore structures.

The IRS uses the information exchange provisions of bilateral tax treaties and TIEAs to obtain information necessary to examine, investigate, and prosecute suspected tax cheats. These provisions also have the effect of discouraging tax avoidance behavior because those who would contemplate cheating on their taxes will know that the IRS will have access to the information needed to identify and pursue tax cheats. The information exchange provisions of U.S. tax treaties and U.S. TIEAs provide the IRS with access to information whenever tax avoidance is suspected and generally obligate the tax authority of the other country to obtain and provide such information, notwithstanding any bank secrecy or other domestic law rules that would otherwise restrict the ability of tax authorities to obtain information.

The United States has greatly expanded its network of effective tax information exchange provisions in recent years. TIEAs with traditional offshore financial centers such as the Cayman Islands, the British Virgin Islands, and the Bahamas have recently come into force and provide the IRS with access to information for both criminal and civil tax matters. Further, the currently-pending tax treaty and protocol with Belgium contains robust information exchange provisions

[2] Prop. Treas. Reg. § 1.482-7, 71 Fed. Reg. 51,115 (Aug. 29, 2005) (addressing transfer pricing in the context of cost-sharing arrangements); Prop. Treas. Reg. § 1.901-2(e), 72 Fed. Reg. 15,081 (Mar. 30, 2007) (denying foreign tax credits arising from "highly structured passive investment arrangements").

[3] Internal Revenue Service (LMSB Division), Industry Issue Focus Fact Sheet (Mar. 2007) (describing Tier I and Tier II compliance issues).

that are unprecedented for Belgium given its traditional bank secrecy rules. These new agreements provide the IRS with important tools in combating abuse of the U.S. tax rules.

In summary, the current statutory and regulatory rules, coupled with administrative and enforcement efforts and the expansion of U.S. information exchange arrangements, serve to protect against offshore tax abuse. To the extent that additional administrative or legislative efforts to enhance transparency and information exchange are viewed as helpful in contributing to the IRS's ongoing work to effectively combat offshore tax avoidance, any such efforts should be focused on targeting specific abuses, rather than on curtailing all activities located within certain low-tax jurisdictions. Without such focus, these efforts run the risk of undermining the competitiveness of legitimate U.S. businesses without achieving the desired goal of combating offshore tax avoidance

IV. U.S. BUSINESSES WITH ACTIVE OPERATIONS ABROAD SEEK TO MINIMIZE REGULATORY AND OTHER COSTS OF SUCH OPERATIONS TO REMAIN COMPETITIVE

A. U.S. Businesses with Active Operations Abroad Compete with Local and Other Global Competitors

Market success is a function of the quality of products and services produced and the price at which they are offered. Consequently, the ability to control and reduce tax, regulatory, or other costs plays an important role in whether a business succeeds in any particular market. The tax imposed on income from foreign activities, the timing of the tax, and the costs of tax compliance affect the after-tax return on foreign investment. To the extent that direct investments abroad by U.S. businesses are subject to greater overall taxation relative to similar investments by local firms or by firms based in other countries, U.S. firms operate at a competitive disadvantage. If a U.S. business is unable to overcome the competitive disadvantage created by the U.S. tax liability imposed on foreign operations, the consequent loss in foreign market share will reduce demand for goods, services, and other inputs produced in the United States to serve the firm's overseas investment and subsequently retard the ability of U.S. businesses to maintain and expand U.S. operations and employment. As discussed in more detail below, the use of low-tax jurisdictions can help limit the costs of operating abroad, thereby allowing U.S. businesses to compete based on the quality of their products and efficiency of their operations.

B. U.S. Tax Policy Encourages the Minimization of Foreign Taxes

We note that the use of low-tax jurisdictions to minimize the foreign tax burden of overseas operations is consistent with some aspects of U.S. tax policy, which traditionally have acknowledged or even encouraged the minimization of foreign taxes. For example, the U.S. foreign tax credit rules encourage U.S. businesses to limit their foreign tax expenses by denying credits in cases where U.S. businesses do not minimize their foreign tax burdens.[4] Similarly, the

[4] *See* Treas. Reg. § 1.901-2(e)(5) (requiring reasonable efforts to minimize foreign taxes); Rev. Rul. 92-77, 1992-C.B. 197 (denying a deemed paid foreign tax credit for lack of effort to reduce foreign tax liability).

IRS has consistently ruled that foreign tax planning is a valid business purpose for a number of corporate transactions, such as reorganizations and spin-offs.[5] We note that the foreign-to-foreign related party rules of subpart F seek, in certain circumstances, to impede the use of low-tax jurisdictions to reduce foreign tax burdens; however, the continued appropriateness of these rules in today's global economy has been questioned by some policymakers.[6] Finally, it should be noted that the ability of a U.S.-based multinational to use a low-tax jurisdiction to minimize foreign taxes is limited by the laws of the foreign countries in which the multinational has operations, and that these foreign-law limitations apply equally to all companies that have operations in that country and reflect local considerations such as the maintenance of a competitive business environment and the preservation of a corporate tax base.

V. LOW-TAX JURISDICTIONS FACILITATE THE INTERNATIONAL COMPETITIVENESS OF U.S. BUSINESSES BY MINIMIZING THE COSTS OF ACTIVE FOREIGN BUSINESS OPERATIONS

U.S. businesses with operations abroad often are organized in low-tax jurisdictions for legitimate business reasons that are unrelated to the reduction of U.S. tax liability. Some of the legitimate purposes that can lead U.S. businesses to establish management centers in low-tax jurisdictions include: (1) accessing countries with well-developed legal environments, particularly as a means of protecting against an inhospitable environment in a host country; (2) protecting against onerous foreign laws or regulation, or unstable and volatile currencies in the host country; (3) facilitating an efficient exit from host country operations; and (4) facilitating efficient business financing through the use of cross-border securitizations.

A. Accessing Countries With Well-Developed Legal Environments, Particularly As a Means of Protecting Against an Inhospitable Host Country Environment

A U.S. business may create an entity in a low-tax jurisdiction in order to access that jurisdiction's well-developed legal environment. Countries with strong governance and robust and transparent laws and regulations regarding issues of importance to business interests are particularly attractive candidates for U.S. businesses seeking to establish an entity abroad.[7] In particular, a U.S. business with operations in a foreign country that lacks a well-developed legal environment may organize an entity in a low-tax jurisdiction to avoid the negative consequences of organizing in that foreign country. For example, a U.S. corporation may wish to invest directly in a developing country that is rich in natural resources or offers other commercial opportunities. However, the U.S. multinational may be reluctant to incorporate in the developing country because of possible government corruption, the potential for expropriation, or other political and business risks associated with organizing as a formal entity in the host country. In such instances, U.S. businesses often form an entity in a low-tax jurisdiction, which then invests

[5] *See* Rev. Rul. 89-101, 1989-2 C.B. 67 (corporate spin-offs); 1996 FSA LEXIS 418 (Apr. 4, 1996) (corporate organizations and reorganizations).

[6] *See* Department of Treasury (Office of Tax Policy), *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study* 42-52 (Dec. 2000).

[7] In an analogous situation, U.S. publicly-traded corporations often chose to incorporate in the State of Delaware because of its well-developed legal environment.

directly in the developing country that lacks strong governance and transparency. Organizing in the low-tax jurisdiction may allow the U.S. business to protect against the inhospitable host country environment without subjecting its active operations to multiple levels of tax that could arise if it organized in a high-tax jurisdiction. Further, organizing in the low-tax jurisdiction may allow the U.S. business to use a branch structure without subjecting the U.S. business itself to the jurisdiction of the government of the developing country.

B. Protecting Against Onerous Foreign Laws or Regulation, or Unstable and Volatile Currencies

A U.S. business may organize in a low-tax jurisdiction to avoid harmful effects arising from onerous foreign laws and regulations, unstable foreign currencies, and currency controls. For example, earnings in certain host countries may be exposed to sharp currency fluctuations. To avoid the volatility and uncertainty associated with such earnings, a U.S. corporation may establish an entity in a low-tax jurisdiction. This entity would hold the host country subsidiary, and the host country subsidiary would distribute its earnings on a current basis to the entity. The earnings from the host country could then be converted to a more stable currency. In addition, the entity in the low-tax jurisdiction could then invest or redeploy the cash to other members of its worldwide affiliated group. Similar arrangements also can be necessary when the foreign laws and regulations in the host country are overly burdensome or administratively impractical.

C. Facilitating Exit from Host Country Operations

A U.S. business may create an entity in a low-tax jurisdiction as an efficient exit strategy for its active investment in a foreign country. For example, if a U.S. business eventually wanted to divest host country operations by selling shares in a host country corporation, the U.S. business could be subject to significant host country restrictions on such sale as well as host country tax on any capital gains.[8] However, if a U.S. business owned the host country corporation through an entity located in a low-tax jurisdiction, it could sell the stock in that entity without facing the burdensome or inappropriate host country restrictions or taxation.

D. Facilitating Efficient Business Financing Through the Use of Cross-Border Securitizations

In securitization transactions, low-tax jurisdictions are often used to facilitate the financing of investments that pool the capital of U.S. and foreign investors. A securitization transaction involves the sale of fixed cash flows by an originator, such as a lender, to one or more special purpose vehicles ("SPVs"). The SPV funds the purchase of the cash flow by issuing securities, such as bonds, through international capital markets. Purchasers of SPV securities include pension funds, insurance companies, and other institutional investors in the United States and abroad. Securitization transactions promote investment and economic growth by expanding the reach of capital markets, making them more efficient, and thereby reducing

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[8] The United States in general does not impose tax on share gains of foreign persons. Further, many developed countries also do not impose tax on share gains of U.S. persons either under their domestic law or under a relevant tax treaty.

interest costs associated with capital investments. Increasingly, securitizations involve both U.S. and foreign taxpayers exchanging cross-border payments. In order to facilitate securitization transactions and reduce multiple layers of U.S. and non-U.S. withholding taxes, SPVs frequently are organized in a low-tax jurisdiction. For example, a U.S.-based financial institution that is seeking additional funding may package a portfolio of income-producing financial assets (such as mortgages or credit card receivables) and sell them to an SPV organized in a low-tax jurisdiction. The SPV would then issue bonds to investors in the international capital markets raising funds for use by the U.S. financial institution. By organizing the SPV in the low-tax jurisdiction the U.S.-based financial institution is able to obtain efficient financing without additional withholding tax.

VI. PROPOSED LEGISLATION AIMED AT PERCEIVED OFFSHORE TAX AVOIDANCE RAISES SIGNIFICANT PRACTICAL AND POLICY CONCERNS

Recent legislative proposals intended to address offshore tax avoidance would fail to address their stated goals, but would instead raise the cost of the foreign operations of U.S. businesses, thereby curtailing their ability to maintain and expand U.S. operations and employment. These proposals raise significant practical and policy concerns.

A number of proposals seek to categorize certain low-tax jurisdictions as so-called "tax havens" and seek to repeal certain tax benefits from corporations organized in these jurisdictions. However, as a practical matter, it is impossible to clearly define a "tax haven" and utilize such a definition to create a list of jurisdictions without being over- or under-inclusive, and it is impossible to maintain an updated and accurate list without monitoring developments in the tax and regulatory environments in every jurisdiction in the world Thus, legislation that proposes a list of "tax havens" (or delegates authority to the IRS to do so) will be over- or under-inclusive at the start and will quickly become obsolete. Further, labeling a jurisdiction as a so-called "tax haven" for U.S. tax purposes would effectively constitute a public rebuke of the jurisdiction's laws and policies and will inevitably entail diplomatic friction. Thus, foreign policy concerns and the potential for political considerations to interfere in the determination of "tax haven" status will likely taint the legitimacy of such legislation.

In addition to the practical concerns regarding how these proposals define a so-called "tax haven," the proposals also raise significant policy concerns. As noted above, these proposals have been introduced with the purported intent of combating offshore tax avoidance. However, rather than addressing a specific abuse through proposals to enhance transparency and information exchange with respect to abusive offshore tax avoidance activities, these proposals would make fundamental tax policy changes that would apply to all activities, whether abusive or legitimate, that are located in a defined "tax haven."

For example, S. 681 (2007)/H.R. 2136 (2007) would provide enhanced enforcement tools to the IRS with respect to financial transactions involving "offshore secrecy jurisdictions," as defined under the legislation. While such enforcement tools arguably would assist the IRS in combating abusive transactions involving these jurisdictions, the proposal would affect legitimate financial transactions as well because it broadly applies to all financial transactions involving these jurisdictions. As a result, the enactment of such a proposal would have a direct

adverse impact on the ability of U.S. financial institutions to compete with their foreign competitors. In the simplest example, a foreign taxpayer who currently maintains an account with a U.S.-based financial institution in an "offshore secrecy jurisdiction" would choose to relocate its account to a foreign-based financial institution located in the same jurisdiction in order to avoid the onerous (and, in the case of such foreign taxpayer, completely unnecessary) reporting requirements contemplated by the proposal.

Other proposals do not even provide any enhanced enforcement tools but rather fundamentally change the substantive tax treatment of all activity located in a defined "tax haven" as a kind of proxy to addressing offshore tax avoidance activity. For example, S. 396 (2007) would impose immediate U.S. tax on all income of corporations created or organized in defined "tax havens." The stated intent of the proposal is to combat offshore tax avoidance through the use of inappropriate transfer pricing.[9] As noted above, however, the U.S. transfer pricing rules are among the most stringent in the world and operate to prevent such abuse. Thus, S. 396 would impose an unnecessary and competitive substantive change on all activities in these defined "tax havens," rather than targeting only abusive activities. As a result, taxpayers with legitimate activity in these "tax havens" that are already subject to stringent transfer pricing rules would be subject to increased tax costs that would render them uncompetitive in the global marketplace.

VII. CONCLUSION

U.S. international tax rules can protect the U.S. tax base without undermining the international competitiveness of U.S. businesses. The active operations of U.S. businesses abroad preserve and expand the businesses' operations and employment in the United States. Organizing management centers in low-tax jurisdictions can facilitate the competitiveness of U.S businesses by minimizing the costs associated with their foreign operations. At the same time, current statutory and regulatory rules prevent the erosion of the U.S. tax base through abusive "offshore" structures. Ongoing regulatory guidance and enforcement efforts by the Treasury Department and the IRS, including in particular the increase in the number of effective information exchange relationships with traditional offshore financial centers, continue to reduce opportunities for offshore tax avoidance.

Proposed legislation that is intended to address improper offshore tax avoidance but that instead unduly reduces the global competitiveness of legitimate U.S. businesses raises significant practical and policy concerns. The NFTC would be pleased to work with the Congress and the Treasury Department in continuing efforts to target abusive offshore tax avoidance without unduly restricting legitimate business planning by globally integrated U.S. businesses with active operations abroad.

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[9] Congressional Record (Jan. 25, 2007) S1194-S1195.