January 21, 2003

The President
The White House
1600 Pennsylvania Ave, NW
Washington, DC 20500

Dear Mr. President:

The Tax Council, a group of dedicated senior tax executives from the largest employers in America, is taking this opportunity to offer its views on the proposal to eliminate the double taxation of dividends in your plan for economic growth. In addition, we offer our views on some of the tax and fiscal policy issues likely to be debated in the development of the fiscal year 2003 federal budget. In general, The Tax Council encourages the Administration to advocate tax policies that will enhance capital investment and remove barriers to competition in markets both at home and abroad.

The most recent surveys of economic activity conclude that the economic recovery is moving forward at a reasonably good pace. According to the BNA's 2003 Economic Forecast Survey published on January 2, 2003, the growth rate of real gross domestic product from the fourth quarter of 2002 to the fourth quarter of 2003 will be 3.1 percent. The apparent lack of inflationary pressure on the economy has permitted the Federal Reserve to cut interest rates, thereby reducing the cost of capital. The overall effect of tax cuts and economic stimulus legislation enacted in the last Congress appears to have added to economic growth in a timely fashion.

However, pockets of slower growth remain in certain sectors of the economy that suggest the ongoing recovery has not moved the economy completely out of the woods. We strongly endorse comments made by Dr. R. Glenn Hubbard, Chairman of the Council of Economic Advisors, in a recent speech to the Association of Manufacturing Technology regarding the risks to the recovery. As he noted in his speech, such risks include delayed investment recovery, a decline in consumer spending, possible terrorist events, the threat of war and possible shock to the world petroleum market, all of which could have an adverse effect on the recovery. However, we also believe Dr. Hubbard is correct in stating that, on balance, a realistic assessment of the magnitude of these risks suggests that projected consensus growth rates are sufficiently robust to avoid a "double dip" in the economy.

Nevertheless, a further boost to the recovery by the timely passage of an economic growth proposal early in this Congress could help assure the early return to robust economic growth and offset the risks. Economic growth and increased productivity are the keys to a strong economy. A strong economy will produce increased federal revenues that will reduce the period of time that the federal budget suffers under the strain of deficits.

Economic Growth Proposals

Your proposal to exclude dividends from taxation at the individual level is a welcome relief from double taxation of corporate earnings. The U.S. is one of the few industrialized nations to tax these earnings twice. Current law encourages firms to rely more on debt rather than equity financing, thereby increasing the cost of capital. Mitigation of this double tax would encourage firms to rely more on equity financing, leading to higher investment spending and a larger capital stock. Moreover, relieving the double taxation of dividends should enable U.S. firms to compete more successfully in global capital markets.

The Tax Council has long supported tax policies that allow the recovery of capital costs nearer the front end of the investment in plant and equipment. This allows the potential investment project to be more likely to meet the investor's required rate of return. Ultimately, this means that more capital is invested sooner, which enhances productivity and spurs growth.

Proposals such as the 30 percent expensing provision included in the economic stimulus package last year are good examples of positive tax policies that encourage growth. It is probably too early to tell specifically whether or not the 30 percent expensing provision has had its intended effect. Any new or extended capital cost recovery proposals should be sufficiently generous to encourage new investment while remaining in effect long enough to permit taxpayers with longer periods of advance planning to benefit. Any new investment incentive that would allow more rapid cost recovery would have to be drafted so that its benefits would not be diminished by the alternative minimum tax (AMT).

The AMT accelerates taxes on U.S. businesses at the worst possible time. The 90 percent limit on the use of net operating losses and the use of the foreign tax credit traps many businesses in a very complex web of additional cost and complexity. The AMT kicks in when income is temporarily down and the taxpayer business is seeking to maintain investment and employment. Moreover, as a taxpayer business sees the possibility of new growth in an otherwise sluggish market, the AMT often requires the taxpayer to pay higher taxes as new investment is placed in service before income has a chance to grow. The AMT is an extremely complex instrument of taxation that overtaxes productive investment and retards job growth. It should be repealed.

In the context of an economic growth program, the Tax Council supports the idea of enacting a temporary rule that would allow U.S. companies an 85 percent dividends received deduction on the payment of dividends from earnings and profits that are presently held in foreign subsidiaries. The proposal would permit companies for a period of twelve months to elect to pay dividends from foreign subsidiaries earnings to the U.S. parent. As our economy continues to recover, this proposal is designed to provide an injection of many billions of dollars in capital into the U.S. economy at very little revenue loss to the Government. It would enable US businesses to invest in the domestic economy with their own earnings that would otherwise be prohibitively taxed on repatriation.

WTO and U.S. Response to ETI Decision

The Tax Council agrees with the Administration's policy to fulfill all of its World Trade Organization obligations. The WTO rules are essential to opening up markets and insuring fair rules for international trade. While the U.S. should meet its obligations, the U.S. should insist that other members of the WTO fulfill their obligations as well. Administration recommendations for the repeal of the ETI rules should be accompanied by recommendations that address, within the framework of the WTO rules, the anti-competitive effects of repeal on those taxpayers who will no longer benefit from the ETI. The Tax Council understands that any similar export subsidy will not be permitted, but urges the Administration to adopt policies that limit any competitive disadvantage for U.S. exporters and that recognize the importance of preserving, as much as possible, the value of long-term contracts entered into in reliance on current law.

Simplification and Rationalization of the Tax Code

The members of The Tax Council serve on the front lines of tax administration as leaders of major company tax compliance and business planning efforts. They live constantly with the fact that the current Tax Code is overly complex and that many of the rules adversely affect modern business decision-making on both domestic and international matters.

Certainly the Department of the Treasury is correct to study the many options for broad tax reform and be prepared to recommend those options that are likely to put the U.S. on a more competitive and administratively workable revenue system. Any major tax reform agenda must include careful study of the transition issues that inevitably present themselves. Long-term tax reform is a goal worth pursuing, but it should not come at the expense of ignoring long-needed repairs to the current system.

Low corporate tax rates contribute to national economic growth and the creation of jobs. Reducing the corporate tax rate of 35% would encourage economic growth, while reflecting the need to make U.S. rates more competitive with those in other industrialized countries.

The international tax rules are long overdue for simplification and rationalization. The Tax Council welcomes and supports the recent Department of the Treasury statements regarding the urgent need to modernize these rules. The ability of U.S. based firms to compete in markets both at home and abroad has been compromised by the current rules. U.S. companies should face roughly the same rate of taxation as their competitors within the countries where they compete for business. U.S. tax rules whose complexity and cost outweigh any useful purpose should be repealed or replaced.

More specifically the principle of taxing the foreign earnings of U.S. companies only when they are paid as dividends to the U.S. parent company should be strengthened. The exception to this principle is the Subpart F regime, which was included in the Internal Revenue Code in 1962. Although it was originally intended to tax passive types of income, it has since been expanded to taxing many forms of active trade or business income, including foreign base company sales and service income, income form shipping activities and oil related income. These U.S. rules applied to so-called controlled foreign corporations are more aggressive than those of any other industrial country.

The Tax Council applauds the Department of the Treasury support for repeal of the foreign base company sales and service rules. U.S. companies must establish themselves in foreign markets in order to grow. Without the growth from foreign markets, U.S. firms would stagnate. Repeal of these foreign base company rules will enable U.S. companies to reap the benefits of operating on a regional basis around the world without facing current taxation at home. This will level the playing field, as the foreign-based competitors of U.S. companies are generally not taxed currently on their foreign income.

The Tax Council also applauds the Department of the Treasury position on the foreign tax credit. The foreign tax credit was adopted in 1918 as method to relieve double taxation of foreign earnings. Because the U.S. taxes on a worldwide basis, the absence of the foreign tax credit would mean that U.S. companies' foreign income would be taxed once by the foreign countries in which they operate and a second time by the U.S. The foreign tax credit is limited to relieving this double taxation by allowing a credit for the foreign tax paid against the U.S. tax that would otherwise be applied to that foreign income.

Unfortunately, the U.S. rules do not permit a full and effective credit, and some foreign income is taxed twice. The current interest allocation rules distort the calculation of the foreign tax credit limitation. The current rules require that a portion of the U.S. interest expense be allocated to a U.S. multinational group's investment in its foreign subsidiaries. However, the rules ignore the interest expense actually incurred by those foreign subsidiaries. This over-allocation of U.S. interest expense reduces the foreign tax credits the group can claim for the taxes it pays to foreign countries. Of course, the U.S. interest expense so allocated is not deductible for foreign tax purposes and, therefore, does not reduce the foreign taxes the multinational group actually pays. Thus, the result is the double taxation of income earned by the U.S. multinational group. The Tax Council recommends that the anomalies created by the current rules be resolved by allocating interest expense on the basis of worldwide fungibility. This solution should also permit companies whose business model requires special financing or other arrangements the flexibility of elections so that the rules can be applied on a separate group or "water's edge" basis.

There are several other international tax rules that should be updated to reflect present economic realities. The reduction in the baskets to three (including the repeal of the foreign oil income basket), the extension of the carryforward rules to ten years, the resourcing of domestic losses, applying the look-through rules to all dividends received by a so-called 10/50 company regardless of the year in which the earnings and profits were accumulated, and other improvements to the tax credit mechanism would permit credits for foreign taxes to be utilized prior to their expiration. As noted above, the 90 percent limit on the foreign tax credit under the AMT is another clear example of double taxation of foreign income.

These changes should not be viewed as tax cuts, but simply a recognition that U.S. companies that are paying U.S. and foreign taxes on the same income should be allowed to use the foreign tax credit to mitigate double taxation, rather than simply calculating theoretical tax credits that may never be realized.

The Research and Development Tax Credit

The Tax Council believes that a permanent research and development tax credit should be a building block in the foundation of a stronger and more productive economy. The Tax Council also supports strengthening the credit to make it available to a broader range of research-intensive companies.

The R&D credit is a proven, effective means of encouraging companies to engage in long-term, high-risk research in the United States. R&D was a major driver of strong economic growth during the past decade and increased R&D will be essential to making the economy more productive in the coming years. However, the increased competitiveness of the world economy is making it difficult for U.S. companies to devote the resources necessary to perform high cost research that, in many cases, may yield sufficient bottom line benefits only in the distant future.

While the existing credit remains a strong incentive for many companies to perform increased research, lack of a permanent credit makes it difficult for companies to take risks, the profitability of which may be dependent upon the ability to use the credit over the life of a project that may last five to ten years. Moreover, there are a significant number of research-intensive companies that cannot maximize their research capabilities because their particular circumstances prevent them from utilizing the current credit.

For these reasons, the Tax Council believes it is essential to make the current credit permanent and to provide for a new alternative credit calculation that will enable a larger number of research intensive companies to benefit.

The Tax Council appreciates the opportunity to offer these comments. We look forward to working with you on these and other matters.

Sincerely,

Roger J. LeMaster
Executive Director