ORGANIZATION *for* INTERNATIONAL INVESTMENT
Global Investment Grows America's Economy

Comments to the Senate Finance Committee
International Tax Working Group
April 15, 2015

The Organization for International Investment (OFII) appreciates the opportunity to submit comments to the Senate Finance Committee International Tax Working Group.

OFII is a business association representing U.S. subsidiaries of global companies, a business community that plays a critical role in U.S. job creation and economic growth. OFII advocates for policies that increase U.S. competitiveness in attracting foreign direct investment (FDI) and works to ensure fair and non-discriminatory treatment for its member companies.

Tax reform is a unique opportunity to make the United States significantly more competitive as a location for business investment in a challenging global environment. In a recent survey of 101 Chief Financial Officers (CFOs) of insourcing companies, the U.S. tax system was ranked as the top area of improvement in order to increase investment in the United States.[1] Further, 54 percent of the CFOs said the corporate tax rate has the most impact on their business out of all the U.S. tax policies. The U.S. statutory rate – the highest in the developed world – is out of step with international norms, creates an artificial barrier to inward investment, and harms overall U.S. competitiveness.

The following comments focus on the role FDI plays in strengthening the American economy and international tax policies with the greatest impact on FDI flows, including recent proposals by the Obama Administration and the Organization for Economic Cooperation and Development (OECD).

I. Foreign Direct Investment is Vital to the U.S. Economy

FDI has long been vital to the American economy, supporting local communities in all 50 states and generating precisely the types of high-value jobs and economic activities that policymakers want to maintain and grow.

FDI Supports Well-paying Jobs. U.S. subsidiaries of global companies employ 5.8 million Americans, according to the most recent U.S. government statistics.[2] This accounts for five percent of the total private sector workforce. Insourcing companies, with a combined payroll of $455 billion, compensate their employees at levels 33 percent higher than the economy-wide average.

FDI Benefits American Communities. FDI provides direct and indirect benefits for American communities. For example, U.S. subsidiaries support a vibrant American supply base, purchasing goods and services from local businesses to sustain and grow their U.S. operations. A recent economic study exploring the impact of FDI over a ten year-period demonstrated that insourcing manufacturers increased their purchase of local intermediate inputs by 48 percent, compared to just 13 percent for U.S. manufacturers overall.[3] Insourcing companies reinvested nearly $100 billion of their earnings back into U.S. operations and spent an additional $201 billion on expansion, plant construction and new equipment

[1] Organization for International Investment and PriceWaterhouseCoopers LLP. (2014). *Insourcing Survey*. Washington, DC. Web site: http://www.ofii.org/CFOsurvey
[2] U.S. Department of Commerce, Bureau of Economic Analysis (BEA). (Released January 2015).
[3] Organization for International Investment. (2013). *Insourcing companies: how they raise our game.* Washington, DC: Ikenson, Daniel J. Web site: http://www.ofii.org/sites/default/files/OFIIRaisingOurGame_FULL.pdf

to upgrade and expand their domestic operations. Further, insourcing companies increased charitable contributions by 44 percent over the last decade, in stark contrast to an economy-wide contraction in private sector charitable giving.[4]

FDI Helps Drive American Manufacturing. More FDI flows into the manufacturing sector than any other area of the economy, accounting for one third of cumulative investments in the United States. In 2013 alone, $95 billion of FDI was put into U.S. manufacturing. These investments by insourcing companies support 2.2 million high-wage manufacturing jobs, nearly 20 percent of all manufacturing jobs in the United States. These insourcing manufacturing jobs have a positive ripple effect throughout the economy, with each manufacturing job at a U.S. subsidiary supporting five additional jobs in the broader economy.[5]

II. Importance of Interest Deductibility for FDI and Jobs

The ability to deduct interest as an ordinary and necessary business expense is a longstanding principle of U.S. tax policy that is critical to global investment in the United States. All companies use debt as a basic and essential tool to finance new investments, expansions, and existing operations. The use of debt in conjunction with equity investments optimizes the overall cost of an investment and therefore the return on investment, helping to fuel positive economic activity that grows the economy.

The deduction for interest expense reduces the after-tax cost of debt financing and thus lowers the cost of capital for all businesses operating in the U.S., making investing here more attractive. Proposed changes to the tax code that would penalize debt by arbitrarily limiting the deductibility of interest carry a significant risk of reducing domestic investment, employment, wages, and economic growth.

Importantly, global companies looking to make new investments have a wide array of choices on where to locate that investment. There is intense international competition for global investment as countries want to attract these high wage jobs that increase the standard of living for their citizens. While the United States remains the largest recipient of worldwide cross-border investment, its share of global investment has dropped dramatically in recent years, from 37 percent in 2000 to just 19 percent in 2013.[6] This precipitous fall is far steeper than other developed economies, many of which have maintained or grown their relative share over the same period. The decline is a result of a number of factors, but in part due to the development of emerging economies as attractive investment locations and the aggressive efforts of other countries to attract job-creating investment from abroad.

Arbitrarily low limits for the deductibility of interest expense will further increase the effective tax rate, creating a barrier to investment in the United States. Research shows that foreign direct investment is not only sensitive to high corporate headline tax rates,[7] but also to limitations on interest deductibility, which reduce foreign direct investment and adversely impact employment, particularly in countries with already relatively high tax rates.[8] The authors of the analysis concluded the report with a cautionary note on recent international initiatives:

> From this perspective, our results raise concerns about recent initiatives to limit profit shifting by multinational firms such as the action plan by the OECD against 'profit shifting and base erosion' (BEPS). Action 4 of the OECD proposal explicitly includes the development of measures to limit

[4] Ikenson 2013
[5] Organization for International Investment. (2012). *Chain Reaction.* Washington, DC. Web site: http://www.ofii.org/resources/chain-reaction
[6] UNCTAD. 2013.
[7] De Mooij, R.A. and S. Ederveen (2003), Taxation and foreign direct investment: a synthesis of empirical research, International Tax and Public Finance 10(6), 673-93.
[8] Buettner, T., M. Overesch, and G. Wamser (2014), Anti profit-shifting rules and foreign direct investment, CESifo Working Paper No. 4710, 03/2014.

base erosion via interest deductions. Our findings suggest that policymakers considering those restrictions should not only take account of adverse effects on foreign direct investment but should also be aware of a higher tax-rate sensitivity of foreign direct investment under such provisions.[9]

These concerns are also supported by additional analysis demonstrating that thin capitalization rules alter global companies' investment location decisions, meaning countries will lose real investment and employment opportunities if they adopt rules that are artificially restrictive.[10]

To ensure tax reform meets the principle of economic growth as outlined by Senate Finance Committee Chairman Orrin Hatch and other Congressional leaders, the International Tax Working Group should carefully consider the impact further limitations on interest deductibility would have on investment and economic activity in the United States.

III. Current U.S. Limitations on Interest Deductibility are Sufficient

U.S. subsidiaries of global companies are currently subject to unique interest limitations under Section 163(j) of the Internal Revenue Code, which was enacted to prevent base erosion through "excess" interest expense. Section 163(j) limits deductions of interest on loans from a foreign related party, such as a non-U.S. parent company. It also imposes limitations on deductions of interest paid to an *unrelated* lender, such as a U.S. bank, when the loan is guaranteed by a foreign related party (e.g., a parent or affiliate company). Under current law, interest expense is not disallowed if the U.S. group satisfies one of the following two conditions: (1) the ratio of debt to equity does not exceed 1.5 to 1; or (2) net interest expense does not exceed a cash flow limitation, i.e., 50 percent of adjusted taxable income ("ATI"). Taxpayers are allowed to carry forward excess limitation (i.e., the excess, if any, of 50-percent of ATI over net interest expense) from the three preceding years. Disallowed interest may be carried forward indefinitely and deducted to the extent of excess limitation in future years.

The U.S. tax law has robust statutory (e.g., Sections 385 and 482) and common law tools that require taxpayers to employ only an appropriate amount of related party debt financing and on terms that are comparable to what would be agreed on an arm's length basis with unrelated parties. In order for interest to be deductible, the taxpayer must establish that it was paid in respect of a bona fide debt, which is determined under a broad set of common law standards. These standards are vigorously enforced by the IRS and are applied as a threshold matter before the mechanical and arbitrary limitation rules under current law Section 163(j).

While the OECD Base Erosion and Profit Shifting (BEPS) project has raised recent concerns that related party debt may be used to strip earnings, examination of IRS data and reports issued by the U.S. Department of Treasury do not support these concerns. The Treasury Department has periodically reviewed data on U.S. subsidiaries in relation to 163(j). A 2007 report found no evidence of wide-spread earnings stripping by traditional U.S. subsidiaries.[11] A subsequent 2008 Treasury study found that U.S. subsidiaries and U.S.-headquartered corporations were largely on par in their levels of debt and profitability.

Likewise, recent IRS data from 2002 to 2011 (the latest available) on U.S. subsidiaries' tax payments, debt levels, and interest expense, both in aggregate and in comparison with all U.S. taxable corporations,

---

[9] Buettner et al. No. 4710, 03/2014.

[10] Merlo, V., N. Riedel, and G. Wamser (2014), Anti-Avoidance Legislations and the Location Choice of Multinational Firms, mimeo.

[11] U.S. Department of Treasury. (2007). *Earnings stripping transfer pricing and U.S. income tax treaties*. Washington, DC.

suggest the current rules are working as intended and do not support the need for further refinements. To the contrary, the data show:

- U.S. subsidiaries' tax payments have doubled from $18 billion in 2002 to $36 billion in 2011, accounting for 16 percent of all corporate tax payments in 2011.
- The effective U.S. corporate tax rate (measured as a percent of assets) of U.S. subsidiaries is comparable to that of all U.S. corporations.
- U.S. subsidiaries' interest deductions, both in the aggregate and as a percentage of receipts, have declined sharply since 2007; interest deductions as a percentage of receipts are below those of all U.S. companies.
- U.S. subsidiaries' long-term debt has declined as a share of assets and is similar to that of all U.S. corporations.

Further detail of this analysis is provided in Appendix A, but from an empirical standpoint, the IRS tax return data support the view that earnings stripping is neither a significant nor a growing problem and that the current rules do not require further refinement.

IV. Importance of Preventing International Double Taxation and Protecting the Arm's Length Principle

Before addressing individual proposals on interest deductibility (as discussed in Section V), it is important to review the core international tax principles that protect cross-border trade and investment. These core principles could be breached if the wrong policies are pursued.

First, the avoidance of international double taxation of the same item of income is one of the most important policy objectives of international taxation. According to the Committee on Fiscal Affairs of the OECD:

> [The] harmful effects [of international double taxation] on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries.[12]

International double taxation is a barrier to international investment, results in the misallocation of resources, and promotes business inefficiencies. In introducing its study on income tax treaties, the American Law Institute observed:

> Perhaps the most important policy which income tax treaties are designed to implement is to avoid the double taxation of income, which can arise when two (or more) countries seek to levy a tax on the same income base ... If a person or entity is subject to taxation on income on the basis of both personal and source jurisdiction, a double tax obviously can arise; and this duplicative burden could have chilling effects on international trade, investment, and commerce. For this reason, it has long been customary for nations to adopt measures to alleviate the double tax burden.[13]

A second core principle of international taxation, and one of the most significant rules on which international consensus generally has been achieved, is the "arm's length principle." This principle governs the allocation of income and deductions between related persons that engage in a cross-border transactions. The application of the arm's length principle by both taxing jurisdictions ensures that income earned in a transaction between the two parties is subject to tax in the hands of only one person

---

[12] Report of the Committee on Fiscal Affairs, *Model Tax Convention on Income and Capital*, Introduction, par. 1.
[13] American Law Institute, *Federal Income Tax Project: International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties* ("ALI Treaty Study") (Philadelphia, 1992) at 5.

and that the other person is allowed a commensurate amount of deduction for the related expense or cost of goods sold.

The arm's length principle has been the international standard for allocation of income and deductions ever since the 1930s, when the Fiscal Committee of the League of Nations adopted an early version of this principle after rejecting a formulary apportionment method.[14] The United States has used the arm's length principle since the IRS first issued regulations setting it forth in 1935. According to the OECD Committee on Fiscal Affairs:

> A move away from the arm's length principle would…threaten the international consensus, thereby substantially increasing the risk of double taxation. Experience under the arm's length principle has become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations. This shared understanding is of great practical value in achieving the objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation.[15]

Thus, the arm's length principle should continue to be respected when establishing rules governing the deductibility of interest for related party loans. This means that the business factors, which dictate the business limit for the amount of debt a multinational can borrow, should be considered when evaluating related party debt instruments. These factors include industry norms, business practices, the debt/equity ratio of the borrower, the financial condition of the borrower, and other terms and conditions that a third-party lender would require of a similarly situated borrower. Failing to take these factors into account when setting limits on the deductibility of interest will result in the denial of a deduction for the expense while the income payment is taxed by the recipient's jurisdiction, thus subjecting taxpayers to double taxation.

Any tax policy abandoning the long-held and internationally recognized principles of avoiding double taxation and the arm's length principle will result in economic consequences leading to less investment and job loss—the exact opposite of the goal of tax reform.

V. Recent Proposals on Interest Deductibility will Deter FDI in the United States, Jeopardizing Job Creation and Economic Growth

This section provides background and analysis on some of the recent proposals to further restrict interest deductibility.

A. Fiscal Year 2016 Green Book Group-Wide Proposal

The FY 2016 Treasury Green Book (Treasury Proposal) would impose a new limitation on interest expense deductions arising from both third party and related party debt. This proposal would apply to a financial reporting group that prepares its financial statements applying U.S. Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), or any other approved method. The Treasury Proposal would limit a U.S. group's net interest expense deduction for tax purposes based on its proportionate share of the financial reporting group's net interest expense reported in the group's financial statements. A U.S. group's share of the financial reporting group's net interest expense would be computed based on its proportionate share of the group earnings reported in the group's financial statements. Under the Treasury Proposal, disallowed interest expense for tax purposes can be carried forward indefinitely, and excess limitation for tax purposes (reflecting net interest expense

[14] J. Weiner, *Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level* ("Weiner") (Washington, 1996), reprinted in *Tax Notes International* (December 23, 1996) 2113, 2116.

[15] *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010 Update*, OECD Committee on Fiscal Affairs, (Transfer Pricing Guidelines) (Paris, 2010) at par. 1.15.

below the U.S. group's proportionate share) can be carried forward three years. For those financial reporting groups that are unable to substantiate the U.S. group's share of the net interest expense, or for those groups that make an election, the Treasury would apply a limitation of ten percent of adjusted taxable income (as computed under section 163(j)) that would apply to both third party and internal debt.

The Treasury Proposal departs in two meaningful ways from current law: the Treasury Proposal reduces the default limitation from 50 percent to ten percent of adjusted gross income, and the interest deduction limitation is expanded from related party debt and certain guaranteed unrelated party debt to all debt. Financial service entities, a term to be defined by the Secretary, would be excluded from a financial reporting group.

This proposal is similar to an option considered in the OECD BEPS Action 4 Discussion Draft.

Concerns with a Group-Wide Leverage Test

OFII is concerned that the Treasury Proposal abandons the arm's length principle, and would result in double taxation and deter global investment in the United States. In addition, it creates unnecessary volatility and uncertainty that would impair long-term investment decisions.

The group-wide test is based on the overly simplistic assumption that the location where earnings are generated or assets are located equates with the location of financing needs for business operations and expansions. In fact, the opposite is generally true – an entity with significant profits may be able to self-finance, but a start-up entity or struggling entity must seek financing because it lacks other options. As discussed below, financing needs are driven by a variety of non-tax factors, such as the business cycle of the investment and the capital needs of the industry sector.

Abandons the Arm's Length Principle

OFII believes that rules governing the deductibility of interest on debt must respect the legal entity that is the borrower and continue to take into account industry norms, business practices, the debt/equity ratio, and the financial condition of that borrower, as well as other terms and conditions that a third party lender would require of a similarly situated borrower. These factors appropriately reflect the borrowing needs and capabilities of an entity within a multinational corporate (MNC) group. This ensures that a borrower who is a member of an MNC is treated similar to a borrower who is a standalone entity.. In addition, deduction is evaluated based on the borrower's situation and investment and not on factors in the larger MNC group. For example, a member of an MNC that decides to enter into a new manufacturing line may need to incur significant debt to fund its new operations, while a member of the MNC group in a mature business may not require the same continued financing to run its business. Limiting interest deductibility of the borrower based on the combined borrowing ratios of the MNC group in this example makes no sense.

An MNC may also have multiple lines of business with very different financing needs. For example, an MNC may have a financial institution within its group along with other businesses; the financial business will be in a net investment position but the nonfinancial business may be in a net debt position. The group-wide test would ignore the separate financing needs of certain entities within the group, abandoning any reliance on the arm's length principle and moving to an apportionment method. Other countries may view this approach as a tacit acknowledgement that allocation based on financial statements is appropriate for other expenses and income, which could result in significant denial of deductions for bona fide expenses, double taxation, and wholesale abandonment of the arm's length principle.

The Treasury Proposal also incorrectly assumes that different parts of the business borrow at the same rate. Some corporate groups have affiliates that have separate external credit ratings, and thus borrow at different rates and terms. For example, the pricing of a loan to an entity in a country with a highly volatile currency and currency restrictions (e.g., Venezuela) will be priced differently from a loan to an entity in a jurisdiction with a more stable currency. A limitation that will move based on changes in the business environment or on apportionment based on group investment would make it very difficult for lenders and borrowers to properly price debt.

Creates Volatility and Uncertainty, Thereby Limiting New Investment

The problems with the group-wide test are further exacerbated by its inherent volatility. An MNC group company's ability to deduct interest will fluctuate from year to year even where there is no change in its debt profile, not only because of fluctuations in its own profitability or asset values, but also because of fluctuations in the profitability or asset values of other group members in other countries. This volatility also brings with it accounting issues. For example, if the deduction cannot reasonably be used, then it may not be recognized for accounting purposes, resulting in a larger tax expense to the company. This uncertainty regarding interest deductibility and its impact on financial statements would impair a company's ability to forecast after-tax cash flows and therefore would impair an entity's borrowing capacity, increase the cost of capital, and reduce the ability to make new investments.

The volatility created by the Treasury Proposal would not be corrected by carryforwards, even if permitted indefinitely. A carryforward is only a solution if there will be excess capacity above the limitation amount against which the deduction may be used in future periods; this may not always be the case, particularly in capital-intensive industries that are in a continuing borrowing/investing mode. Moreover, to utilize carryforwards, not only would the company's individual earnings have to improve, but they would have to improve as a percentage of total group income. Furthermore, deleveraging elsewhere in the group would bring down the total amount of interest allowed under the group-wide test, and that could negatively impact the remaining borrowers.

In discussing these concerns with Treasury officials, it is apparent that there is a mistaken belief that the inherent volatility of the group-wide test can be addressed by reallocating debt within the group to minimize disallowances and prevent double taxation. This assumption (that debt can be easily shifted within the group) ignores many practical and legal limitations these types of transactions would face, for example:

- Non-tax regulatory restrictions on borrowing under banking or foreign exchange rules, such as local exchange controls or the requirement for registration of debt in certain countries.
- Corporate law constraints on funding subsidiary jurisdictions with debt (such as restrictions associated with a lack of retained earnings or other distributable reserves or capital).
- Differing withholding tax rates for interest payments compared to other payments, which serve as a disincentive to using debt or trigger interest gross-up provisions in financing arrangements and thus increase the cost of debt.
- Gains and losses on currency exchange and associated increased hedging costs.
- Industry specific limitations, such as oil and gas production sharing agreement regimes, bank or other financial regulatory requirements, cost accounting standards compliance requirements that may be imposed on industries such as defense contractors, or companies that operate under restrictions under special security agreements or proxy agreements with governments.
- Timing differences between when a company needs the funds and when the profits from an investment are realized (e.g., the need for funding before the investment is profitable).
- Inability to allocate debt to a joint venture in violation of the commercial agreement with the third-party investor.

- A requirement that third-party financing or project financing be collateralized by local assets (making the use of debt less attractive), and debt covenant restrictions on using the funds or moving them outside the jurisdiction (also making the use of debt less attractive).
- Inability to borrow in one jurisdiction and move the proceeds of the borrowing to another jurisdiction because of restrictions on use of the proceeds to pay dividends or capital reductions under local law.

Moreover, such “self-help” measures, even if possible, would have to be done frequently as the borrower’s percentage of the group-wide ratios would be constantly shifting. The combination of the frequency and the above restrictions, demonstrate fundamental flaws in the group-wide test. A proposal that substitutes the arm’s length principle with “self-help” behavior to prevent international double taxation is fundamentally flawed and at cross-purposes with international efforts.

Creates Double Taxation

Ultimately, the inevitable result of a group-wide test would be increased instances of double taxation. The reality that financing needs do not always match where earnings are generated or assets are located, the inability for MNCs to reallocate debt to prevent disallowances, and the fact that all countries will not implement the group-wide test in the exact same manner would result in MNCs having interest expense disallowed in one country while having the interest included in income in the other country. This double taxation is contrary to U.S. and international tax principles and would decrease cross-border investment. Accordingly, OFII believes the Treasury Proposal should be wholly rejected by the Committee because it: 1) creates double taxation, 2) abandons the arm’s length principle contrary to the U.S. objective related to transfer pricing, and 3) results in enormous complexity for taxpayers and administrators contrary to the objectives of tax reform.

B. Fixed Ratio Test as Outlined by the OECD in Action 4 Discussion Draft

One of the options for interest deductibility limitations as outlined by the OECD in Action 4 Discussion Draft is a fixed ratio test. This approach is similar, in theory, to current U.S. restrictions under Section 163(j), but vastly differs due to the implication that countries should adopt much lower ratios to address BEPS concerns. This approach is flawed on several accounts.

First, the OECD fails to clearly articulate what constitutes base erosion or excessive interest expense and has not provided clear evidence to support the anecdotal concerns related to interest payments, outside the hybrid instrument context. For example, the examples highlighted in the Discussion Draft to demonstrate the ways companies may use interest deductibility to shift profits are all being addressed by other OECD work streams, including hybrid mismatches, harmful tax practices, and controlled foreign companies. As demonstrated earlier and in greater detail in Appendix I, there does not appear to be evidence that related-party loans result in an earnings stripping problem under current U.S. rules. Clearly, more research examining the OECD’s assumptions and the economic impact of the proposed changes must be explored before the United States, and other countries, move to implement the OECD’s recommendations related to interest deductibility.

Secondly, a ratio that is set at an arbitrarily low level would effectively abandon the arm’s length principle. While Section 163(j) is not a true arms-length standard, allowing interest deductions for taxpayers whose net interest expense does not exceed 50 percent of ATI recognizes the cash flow factor a third-party lender would take into account when evaluating a borrower. Lowering this ratio (in the absence of evidence that arm’s length lending standards have shifted), means further deviating from the arm’s length principle and would result in increased instances of double taxation of cross-border interest payments.

The OECD Discussion Draft also fails to consider the level of market interest rates in a jurisdiction at the time of the borrowing. Interest rates today, in many jurisdictions, are at historic lows, which makes current interest ratios an inappropriate measure in jurisdictions with higher than average interest rates or during economic periods where interest rates are at more normal levels.

Although the Discussion Draft acknowledges that each country adopting a fixed ratio test would determine the appropriate ratio, it suggests that a ratio greater than 10 percent of EBITDA is excessive. It is important to note that the evidence to support this assumption was based on a very narrow analysis of the financial statements of the top 79 largest non-financial companies in the world by market capitalization. The analysis concluded that because the highest market capitalization companies on a global consolidated basis did not have a net interest expense to EBITDA of more than10 percent, a ratio higher than that level must ipso facto be "excessive." This data, however, is an extremely narrow sample consisting of only the top most well-capitalized firms. It fails to respect separate legal entities by looking only at consolidated ratios and ignoring internal financing. The data is also based on a blended global borrowing rate and today's economic conditions. This means the data fails to take into account an individual jurisdiction borrowing rate and previous economic conditions that will likely reemerge in the future. Most importantly, the data does not reflect business financing needs or industry norms. This evidence is a very flawed foundation upon which to base such an important and fundamental policy shift.

Using this flawed data to extrapolate that all businesses should be prevented from deducting interest in excess of an artificially low fixed ratio – far lower than bank lending standards – is inappropriate and harmful to investment. As discussed above, debt ratios vary among different companies for many reasons. For example, certain industries (e.g., infrastructure) are by their nature more capital intensive than others. In addition, debt ratios are affected by the life cycle of the business, its size, and even whether the business is publicly owned or privately held. A company that is in the start-up phase of its investment is more likely to have a higher debt ratio.

As also discussed above, setting low limits for the deductibility of interest expense would increase the effective tax rate on investment and create disincentives to investment as a result. Low fixed ratio levels would also result in double taxation of interest payments, creating an artificial barrier to cross-border investment – all in contradiction of the key principles of international taxation. If the United States moved to adopt this punitive standard, it would reduce global investment in the United States, resulting in lower wages, fewer jobs, less economic stability and growth, and, ultimately, less prosperity for the country.

C. Tax Reform Act of 2014, H.R. 1

The Tax Reform Act of 2014 included a provision to reduce the current limitation of interest expense from 50 percent to 40 percent of ATI (cash flow measure) and removed the ability for taxpayers to carryforward excess limitation for up to three years.

OFII appreciates the reduction to 40 percent was intended to be done on a non-discriminatory basis to mirror the proposed thin capitalization rules for U.S.-based multinationals. However, OFII still cautions that moving away from the 50 percent limitation departs from the arm's length standard and would result in increased instances of double taxation of interest payments. Additionally, IRS data does not support the need for further restrictions, and research demonstrates that such changes are likely at cross-purposes with the tax reform goals of increasing investment and growing the U.S. economy. OFII also urges that the three-year carryforward of excess limitation under present law be retained. Like the carryforward of disallowed interest expense, the carryforward of excess limitation has a smoothing effect on the application of the cash flow test over the course of business cycles and is analogous to the carryback and carryforward of net operating and capital losses under present law. Moreover, the carryforward reflects the fact that an arm’s length lender would take into account several years of prior cash flow in making a credit decision. This rationale remains valid today.

VI. Conclusion

Foreign direct investment is a critical component to American economic strength and prosperity. OFII believes, and the data supports, that tax reform which reduces the U.S. corporate tax rate, ensures non-discriminatory treatment of U.S. subsidiaries of foreign businesses, and protects the longstanding ability of companies to deduct interest as an ordinary business expense will encourage greater investment in the United States.

OFII looks forward to our continued work with the Committee in advancing tax reform that would spur economic growth and job creation through additional foreign direct investment.

APPENDIX A
STATISTICAL INFORMATION ON U.S. SUBSIDIARIES

A. Overview

A number of recent international tax developments, including the OECD on the Base Erosion and Profit Shifting (BEPS) project, have raised concerns that related party debt is being used to erode the tax base. From an empirical standpoint, the tax return data analyzed in this section do not support the view that earnings stripping is either a significant or growing problem.

The most relevant data for assessing whether there is an earnings stripping problem are income tax returns filed by U.S. corporations. The IRS tabulates tax return information for U.S. subsidiaries of foreign-based companies ("U.S. subsidiaries") as well as all U.S. corporations. By comparing tax return information of U.S. subsidiaries and all U.S. corporations, it can be determined whether U.S. subsidiaries pay less tax, are more highly leveraged, borrow more heavily from shareholders, or pay higher interest rates than all U.S. corporations. For this purpose, we analyzed tax return data for 2002 through 2011, the most recent year for which data are available from the IRS.[1]

B. Recent IRS Data (2002-2011)

The most recent publicly available IRS data on U.S. subsidiaries and all U.S. corporations do not indicate any significant or growing earnings stripping problem in the United States.[2] These data show:

- U.S. subsidiaries' tax payments have doubled from $18 billion in 2002 to $36 billion in 2011, accounting for 16 percent of all corporate tax payments in 2011.
- The effective U.S. corporate tax rate (measured as a percent of assets) of U.S. subsidiaries is comparable to that of all U.S. corporations.
- U.S. subsidiaries' interest deductions both in the aggregate and as a percentage of receipts have declined sharply since 2007; interest deductions as a percentage of receipts are below those of all U.S. companies.
- U.S. subsidiaries' long-term debt has declined as a share of assets and is similar to that of all U.S. corporations.

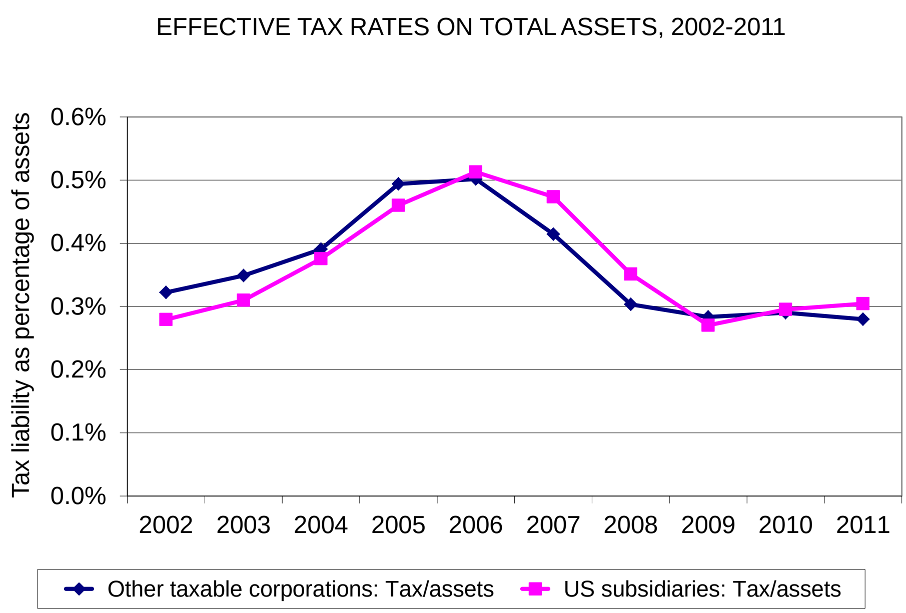
[1] IRS tabulations of corporate income tax returns for any calendar year include fiscal year returns that have at least six months of overlap with the calendar year. For example, IRS data for 2011 includes returns with fiscal years ending after June 30, 2011, and before July 1, 2012.

[2] Data discussed in this section are from U.S. corporate income tax returns filed with the IRS that are collected and reported by the SOI Division. Comparisons are made using the most recent data available. The most recent aggregate data are for tax year 2011. These figures compare U.S. subsidiaries of foreign parents having 50 percent or more foreign ownership with data for all taxable U.S. corporations. Taxable U.S. corporation data are from all corporate tax returns filed with IRS, less those of S-corporations, which operate in pass-through form.

Effective tax rates of U.S. subsidiaries and all U.S. corporations are comparable

A key indicator of the extent to which earnings stripping may be a significant problem is whether U.S. subsidiary taxes are significantly lower than those of comparable U.S. companies. IRS data (see Figure 1) show that the effective tax rate of U.S. subsidiaries[3] (measured as a percent of assets) is comparable to that of all U.S. corporations. There are various ways to compute effective tax rates on economic income. This analysis uses taxes paid relative to total assets because a company's assets represent its ability to generate economic income. IRS data suggest the effective tax rates of U.S. subsidiaries are similar to and vary in largely the same ways as those of all corporations, which generally relate to the state of the U.S. economy.

Figure 1



U.S. subsidiary interest payments have declined sharply and are a lower percentage of total receipts than those of all U.S. companies

Interest deductions reported by U.S. subsidiaries spiked in the mid-2000s as both foreign direct investment and interest rates increased. Following 2007, U.S. subsidiary interest paid declined sharply both in absolute terms (Figure 2) and as a percentage of total receipts (Figure 8). U.S. subsidiary interest as a percentage of receipts was below and closely tracked that of all U.S. corporations (Figure 3).

[3] Effective tax rates are generally considered to be taxes paid as a percentage of economic income. Because federal tax returns provide no measure of economic income, total assets is one measure used as an indicator of the ability or potential to earn economic income.

Figure 2

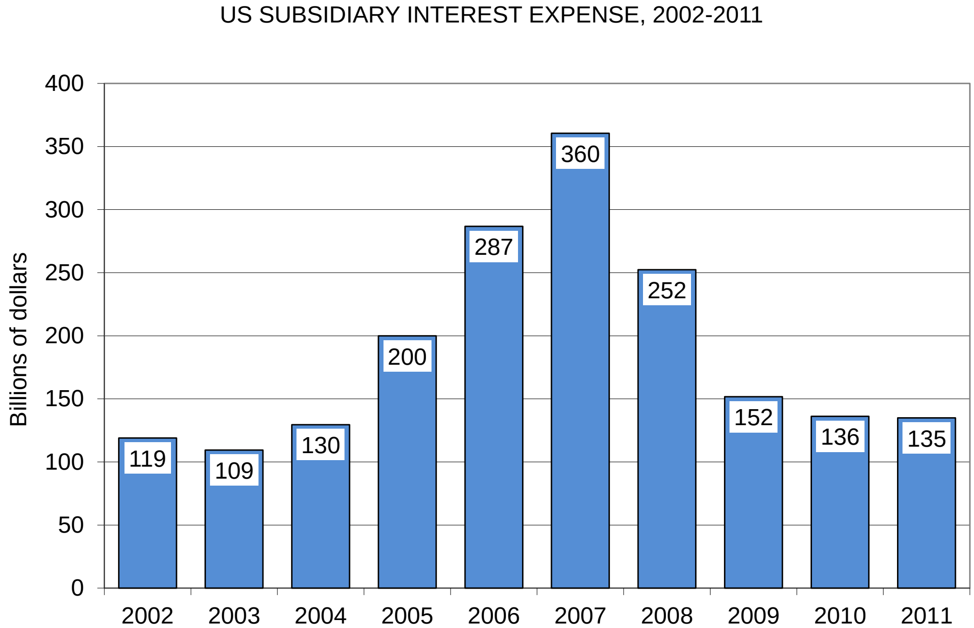
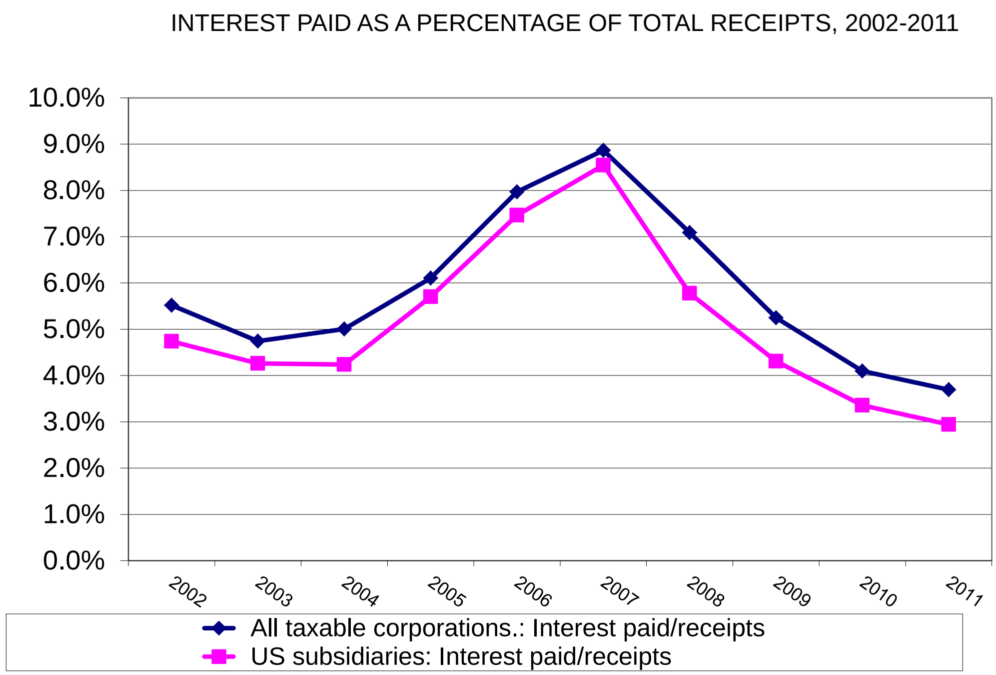


Figure 3



U.S. subsidiary long-term debt has declined as a share of assets and is similar to that of all taxable corporations

Over the most recent ten years, trends in the long-term debt of U.S. subsidiaries generally have reflected economic conditions, increasing during periods of economic weakness and decreasing with economic recovery. Over the past 10 years, long-term debt as a percentage of assets peaked in 2003 at 17.6 percent and has declined to 14.2 percent in 2011. These same U.S. subsidiary data may be compared with the long-term debt of all taxable U.S. corporations. While U.S.

subsidiary debt is generally a similar share of total assets in 2007 through 2009, the debt of all U.S. companies increased significantly to 19.4 percent 2010 and 18.8 percent in 2011 (see Figure 4), while U.S. subsidiary debt declined to 15.1 percent and 14.2 percent, respectively.

Figure 4

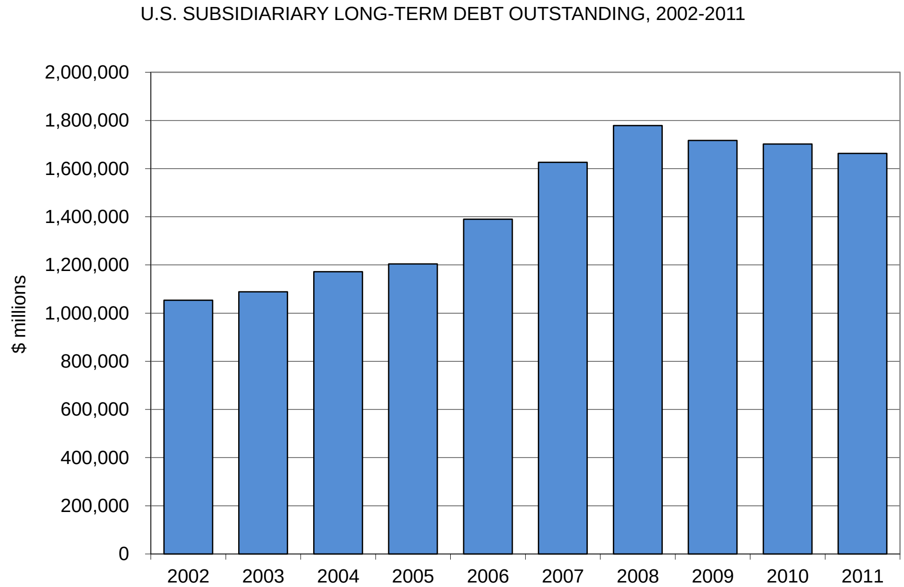
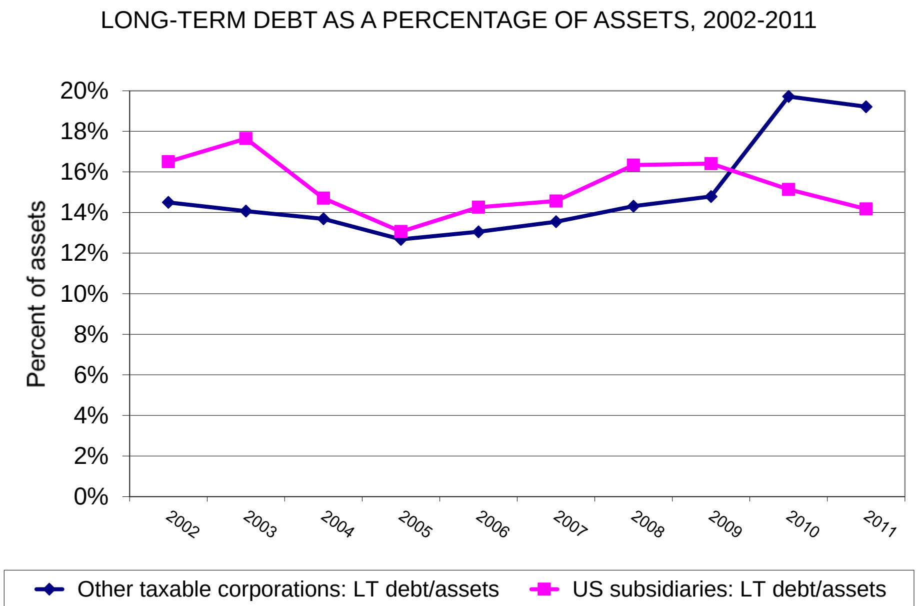


Figure 5



D. Conclusions

Recent IRS data on U.S. subsidiaries' debt levels, interest income and expense, and tax payments, both in the aggregate and in comparison with those of all U.S. taxable corporations, show no evidence of a significant or growing earnings stripping problem and provide no justification for changes to current limitations.