GLOBAL FINANCIAL INTEGRITY

April 15, 2015

The Honorable Orrin Hatch
Chairman, Committee on Finance
United States Senate

The Honorable Ron Wyden
Ranking Member, Committee on Finance
United States Senate

Via email: International@finance.senate.gov

Re: Senate Finance Committee, Bipartisan Working Group on International Tax

Dear Senators Hatch, Wyden, and Staff:

We welcome your initiative to convene bipartisan working groups to discuss potential reforms of the U.S. tax laws and appreciate the opportunity to provide input for these proceedings. We firmly agree on the need for extensive reform of this broken system, and we believe the goal of making our tax code "simpler, fairer, and more efficient" is an admirable one. Our comments, however, focus broadly on an additional perspective that we believe the working groups and your committee should utilize when considering proposals for reform—namely, the effects of U.S. tax laws on capital allocation and movement worldwide. The global nature of the U.S. economy and the large number of multinational companies ("MNCs") headquartered in the U.S.—almost twice as many Fortune 500 companies are based in the U.S. than in any other country—mean that any change to the U.S. international tax system will be global in its impact.

Our organization, Global Financial Integrity, studies illicit financial flows and capital flight from developing countries, which by our calculations drained $991.2 billion in 2012, and $6.6 trillion between 2003 and 2012, from these countries' economies. The drivers of these flows are varied and complex, but one major component is the desire to avoid paying taxes. While the amount of capital flight we have found is almost unfathomable—many times the amount of official development assistance these countries receive from other nations—the official trade data that our research is based on does not even capture many abusive transfer pricing transactions or capital flight from developed countries, suggesting the cost of tax evasion and avoidance to the global economy may be much higher.

While discussions of tax reform proposals often center on the incentives for U.S.-based MNCs to move jobs and investment out of the U.S., this is only part of the issue. The truly problematic incentives created by current law are those for MNCs to shift profits and capital to unproductive subsidiaries in tax haven countries, often merely on paper, whereby they can retain the income, untaxed, indefinitely. These incentives drain the U.S. economy and deprive the U.S. government of crucial revenue—but they also have the same effects in many other countries, from which MNCs are able to recharacterize and shift profits into tax havens, avoiding taxes on both sides. While the U.S. has

1100 17th Street, NW, Suite 505 | Washington, DC | 20036 | USA
Tel. +1 (202) 293-0740 | Fax. +1 (202) 293-1720 | www.gfintegrity.org

President: Raymond Baker **Managing Director**: Tom Cardamone

Board: Lord Daniel Brennan (Chair), Dr. Rafael Espada (Vice Chair), Dr. Lester A. Myers (Secretary-Treasurer), Dr. Thomas Pogge, Raymond Baker

no responsibility to enforce or enable enforcement of foreign tax laws, our tax system should at least not enable our corporate citizens to subvert those laws.

Any effective tax reform package must begin with the premise of eliminating the principle of deferral. By allowing MNCs to avoid tax on foreign income until it is repatriated, deferral creates the largest and perhaps most devastating of the tax system's perverse incentives, leading MNCs to recharacterize income as foreign whenever possible and hold it offshore indefinitely (the so-called "lock out effect") in hopes that they may be able to repatriate it at a much lower tax rate later through recharacterization or a "tax holiday." The same accounting gimmicks that are used to extract U.S. income and "invest" it overseas can be used to avoid taxes on income in other countries as well, and thus with deferral American MNCs are able to move capital around the world freely and completely untaxed. Adding to the list of counterproductive incentives, the income is typically booked in a tax haven and can be used as collateral for the companies to borrow against back in the U.S.

Members of both parties have offered multiple reform proposals that would tax U.S. corporate income earned overseas immediately upon accrual. However, we are concerned that these proposals tend to establish lower tax rates for foreign earnings, which would be unlikely to diminish the incentive to shift profits to jurisdictions where they would still be taxed at lower overall rates, or not taxed at all, than if they were immediately repatriated. Since profit-shifting transactions are relatively costless and multinational corporations have already shown their willingness to hold hundreds of billions of dollars offshore to avoid paying U.S. taxes, limiting deferral rather than eliminating it would likely only generate moderate tax revenue for the U.S. at best—it would not actually halt illicit flows from the U.S. and developing countries.

The discussion draft also does little to ameliorate the opacity of large MNCs' global structures and financial arrangements, the source of much of the complexity in the international tax system and the reason tax authorities must often "play catch up" on the latest clever tax schemes. We have advocated for a long time that MNCs should publicly disclose basic financial information on a country-by-country basis—at least their revenues, profits, taxes paid, and employment figures for each country in which they operate. The IRS already collects this information and more through tax forms for controlled foreign corporations (CFC)—taxpayers must provide full, GAAP-compliant balance sheets and income statements for each CFC via Form 5471. Unfortunately, despite decades of collection such information, multiple administrations have failed to analyze this critical data to identify gaps in U.S. tax laws that result in the warehousing of cash offshore.

Requiring MNCs to disclose excerpts or summaries of this information publicly would have many benefits, however. Academics could use the data to analyze global trends in capital allocation and study weaknesses in the global tax regime. Civil society organizations and journalists could highlight anomalies and raise questions about MNCs' operations in certain countries. Congress would benefit immeasurably from having such a wide range of citizens identifying problems in the tax code and crafting innovative solutions. Foreign tax authorities could monitor large movements of funds out of certain countries and use the information to spur further investigations. There is growing political momentum behind proposals for country-by-country reporting, and the OECD has already developed a country-by-country reporting template that have been approved by G20 country governments, including the U.S. Extending such provisions to all MNCs would be relatively painless, as the companies already compile such information for tax purposes.

Issues of corporate tax avoidance are currently at the forefront of international public perception and policy discussion, as recent years' G8 and G20 processes, the OECD BEPS project, and protests around the world indicate. We urge you to keep this in mind, and retain an international perspective while working for international tax reform in the U.S. Please let us know any ways in which we may contribute or assist with the process.

Sincerely,

Heather A. Lowe
Legal Counsel and Director of Government Affairs

Joshua Simmons
Policy Counsel