Testimony before the Committee on Finance

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Statement
of
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I. INTRODUCTION

Mr. Chairman, ranking Senator Wyden, and members of this distinguished committee, it is an honor to participate in these hearings on business tax reform.[1] I have been a tax practitioner specializing in international taxation for twenty years. I have authored or co-authored over 100 articles on domestic and international taxation, including one focusing on the merits of corporate integration.[2] I have co-authored one treatise focusing on U.S. corporations doing business abroad. I also had the privilege for a brief period during my career to assist the Islamic Republic of Afghanistan with various legal issues including tax regulation and sovereign debt restructuring in Kabul. I am here today in my own capacity and not on behalf of my firm. My views do not represent those of any client or other organization.

II. BUSINESSES ARE MOBILE AND SEEK THE LOWEST TAX JURISDICTIONS TO PRODUCE THEIR PRODUCTS AND SERVICES

Given that my practice tends to focus on U.S.-based publicly traded multinationals organized as corporations, my testimony focuses on businesses doing business in corporate form. As this Committee is well aware, corporations, and the businesses they conduct, are highly mobile. Innovation will make them even more mobile. This Committee has already witnessed the way the Internet has transformed the sale of software, music and videos. One can imagine that, in the decades to come, many companies we think

[1] Unless otherwise noted, all Code, section and Treas. Reg. § references are to the United States Internal Revenue Code of 1986, as amended, or regulations issued pursuant thereto.

[2] The article on integration is *A Taxing History: Why Corporate Tax Policy Needs to Come Full Circle and Once Again Reflect the Reality of the Individual as Taxpayer*, 94 Taxes 93 (March 2016).

of today as manufacturing "tangible" products will simply design the product (presumably in multiple locations), store the digital designs on servers owned by a 3rd party maintained in multiple locations, and sell the "product" via digital download over the Internet to a consumer anywhere in the world who happens to have a 3-D printer in their home or office who can then "print" the product. In this environment, it simply does not matter whether you are a "U.S.-based" or "non-U.S.-based" multinational. Nor does it matter if the "manufacturing" and "marketing" staff are physically proximate to the customer.

While these changes are happening, corporate managers are incentivized to reduce costs. U.S. federal, state and foreign taxes are a cost. They are no different from raw material costs or labor costs. U.S. federal corporate income taxes are, in fact, one of the most significant costs U.S. based multinationals have to reduce. To put it in perspective, a corporation's treasury function may spend significant time and energy to reduce a company's borrowing cost by 30 basis points. Yet, a multinational's decision to invert or produce products outside of the U.S. can save up to 3500 basis points in U.S. federal taxes alone on the profit derived from that activity.

So long as tax costs are imposed on corporations and reflected on income statements that, in turn, impact the compensation of corporate managers, those managers will be under incredible pressure to reduce those costs. It is, after all, their job.

III. THE PERILS OF RETAINING OUR CURRENT SYSTEM

As this Committee is well aware, our current tax structure incentivizes corporate managers to produce products or services offshore instead of the U.S. even though, on a pre-federal tax basis, that may not be the most efficient place to produce. The U.S. tax system incentives corporate managers to migrate intangibles to offshore jurisdictions. It then incentivizes those corporations to use those offshore funds to acquire more assets offshore rather than repatriate them to the U.S. (the so-called "lockout effect"). The U.S. system also incentivizes corporations to invert. Although recent attempts have been made to curtail

inversions, the U.S. government cannot prevent corporations from simply being acquired by larger foreign corporations headquartered in countries with more favorable tax regimes.

IV. IF YOU CAN'T BEAT THEM, JOIN THEM

One approach would be to retain the current U.S. corporate tax structure but lower the corporate tax rate and develop an innovation box regime. These changes would make the U.S. more attractive relative to its peers.

The difficulty with this approach is that it is unclear how much this will truly impact the incentives of corporate managers. The U.S. federal corporate income tax will still show up on corporate income statements. Corporate managers will still be tasked with reducing that line item. Congress can make it harder to invert, but it cannot prevent companies from being acquired, and it cannot prevent tomorrow's breakthrough company from being formed offshore today.

Thus, if the current corporate tax system is retained, the U.S. will be forced via tax competition to make other changes, like a territorial system, that put it on par with other countries. Yet, any territorial system that is designed to be appealing enough to make the U.S. competitive will likely enhance (rather than reduce) the incentive companies already have to own intangibles and produce their products and services offshore.

Most importantly, however, other countries will not simply stand pat. Any reform that makes the U.S. look better to corporate managers making investment decisions will almost certainly be countered by other countries that will make their corporate regimes even more attractive *vis-à-vis* the U.S. than they currently are. The Organization for Economic Cooperation and Development's ("OECD's") and G-20's base erosion and profit shifting ("BEPS") initiative attempts to put some additional guardrails around the manner in which many countries and the U.S. compete with one other. Yet, not all countries are OECD or G-20 members. Not all issues are governed by the OECD guidelines. The member countries have broad discretion about how they interpret the OECD guidelines that do apply. Moreover, it is not clear

how the OECD can ensure compliance by those G-20 countries that are not OECD members. Last, but not least, even the OECD guidelines do not prevent countries from simply lowering their tax rates across the board.

The bottom line is that it is not easy to eliminate (or even reduce) tax competition. If it were easy to eliminate tax-competition, the members of the European Union would already have their consolidated corporate tax base, and the States within the United States would have done something similar long ago.

V. INTEGRATION PROVIDES A BETTER PATH FORWARD

A far better approach is to revamp the current corporate tax system so that the corporate tax burden is shifted away from the corporation (which is highly mobile) to the Shareholders (who are not).[3] The goal should be to design a system that allows corporate managers of U.S.-based multinationals to manage their business, as much as possible, on a pre-U.S. federal tax basis.

Starting in 1936, the U.S. tax system has explicitly sought two (2) levels of tax on corporate profits - one at the corporate level and again at the shareholder level. Since then, there have been multiple attempts to eliminate this "double-taxation" of corporate profits through various "integration" approaches that have been studied and analyzed over the years. I discuss the merits of these systems briefly below in reference to their impact on corporate manager incentives.

A. The Limits of An Imputation Credit Approach

One integration approach is to enact a shareholder imputation credit similar to that used in Australia and New Zealand. In this approach, corporations continue to pay tax, but domestic shareholders are allowed to credit those taxes against their own tax liability that they would otherwise have on the dividend. This has the effect of reducing or eliminating the second level of tax on corporate profits.

[3] I use a defined term here, because obviously "shareholders" could, in turn, be U.S. or foreign corporations or non-resident aliens etc… By Shareholders I mean to include U.S. individuals, tax-deferred accounts of those individuals, and U.S. tax-exempt entities. Foreign individuals and entities will have to be addressed through a withholding tax mechanism, with due consideration of any treaty concerns.

Some have argued that a shareholder imputation credit would reduce the incentive corporate managers have to migrate intangibles abroad and produce products and services abroad. The argument is that since the shareholder credit is only available with respect to distributions of profits that have been subjected to home-country taxation, corporate managers will have less incentive to avoid paying those home-country taxes.

There are a number of responses to this argument.

First, the extent to which the imputation credit is even helpful or relevant depends on the corporation's shareholder base. Australia, for example, allows dividends sourced from foreign (i.e., non-Australian) profits to be paid to non-Australian shareholders without withholding tax, regardless whether the income has been subjected to Australian tax and regardless whether a treaty applies. Moreover, non-Australians do not receive any imputation credit. Thus, if the shareholder base is largely non-Australian, a corporate manager has no desire to pay Australian corporate tax in order to pass along a shareholder imputation credit. There is no upside for them. One could argue that the U.S. does not necessarily have to have the same system as Australia and could, for example, impose a withholding tax on distributions of foreign untaxed earnings to non-domestic shareholders. The U.S.'s flexibility is constrained by tax-competition, however. This leads to my next point below.

Second, the corporate tax is still reflected on the income statements of the multinational. Thus, corporate managers will still be incentivized (all other things being equal) to locate in jurisdictions that have other attractive features beyond simply a shareholder imputation credit. The U.S. will be compelled by tax competition to have similar features or lose investment. Perhaps the most significant example is a taxpayer favorable territorial system.[4] In this regard, it is important to point out that Australia effectively has a territorial system. Moreover, as noted above, Australia allows those repatriated profits from CFCs that have not been subjected to Australian tax to be distributed to non-Australians without any

[4] As the Committee is aware, there are a wide variety of "territorial" systems. Some systems exempt virtually all types of profits from the entire home country corporate tax, whereas others only exempt certain types of profits from most (but not all) home country corporate tax.

withholding tax. Thus, this Committee should not assume that moving to a shareholder imputation credit approach will somehow reduce the pressure on Congress to enact other features, such as a territorial system, that further incentivize intangibles migration and offshore production. The U.S. will still have to engage in tax-competition with other countries, even if it enacts a shareholder imputation credit.

Third, corporate managers would only be incentivized to pay home-country tax during those periods when the company is paying dividends. Even then, they would only be incentivized to pay that amount of home-country taxes that are sufficient to support the dividends paid.

Fourth, it does not reduce the incentive corporate managers currently have to finance their business operations with debt.

B. Other Integration Approaches Would Change Incentives for the Better but Possess Serious Administrative Issues

Other integration approaches would completely shift the burden of the corporate tax on to the shareholder. These approaches would have the advantage of allowing corporate managers to plan entirely on a pre-tax basis. They would also focus the imposition of the business tax on individuals or U.S. tax exempt entities that are far less mobile than multinational corporations.

For example, one approach, which is only applicable for publicly traded corporations, involves eliminating the corporate income tax entirely and forcing shareholders of publicly traded companies to mark their shares to market (an "MTM" approach). Another approach involves treating all corporations like partnerships (a "pass-through" approach).

Both approaches involve significant administrative issues, however. For example, it is not at all clear how an MTM approach would be collected on a MTM basis (or even a realization basis) from non-resident aliens and foreign corporations if the U.S. issuer's stock is traded between two foreign persons on

a foreign exchange. Similarly, the difficulty of allocating income of publicly traded entities on a pass-through basis has been addressed in a number of studies on integration.

C. The DPD Represents a More Administrable Integration Approach that Also Favorably Impacts Corporate Manager Incentives

An administrable integration approach that would also have a more positive impact on corporate manager incentives than the shareholder imputation credit is the so-called "dividends paid deduction" or "DPD" being considered by this Committee. The DPD has been considered by Congress over the years (starting at least as early as 1946) as a method for eliminating the double-taxation of corporate profits.

Unlike the shareholder imputation credit, however, the DPD does more than mitigate double-taxation. It should reduce (albeit not eliminate) the incentive that corporate managers have to make investments on a post-U.S. federal income tax basis. This, then, reduces the need for the U.S. federal government to engage in tax competition with other countries to have the best suite of tax features for multinationals.

First, the DPD ought to reduce (albeit not eliminate) the tax incentive that U.S.-based multinationals have to produce products or services offshore. I say "reduce" because it is still possible that a corporation would have taxable income in excess of "free" cash flow (the cash flow existing after reinvestment in the business) that cannot be eliminated on a present basis through a DPD.[5]

EXAMPLE: USCO, a publicly traded U.S. multinational needs to decide whether to build a plant in the U.S. or offshore. The pre-tax projections of cash flow and taxable income are as follows:

	2017	2018	2019	2020	2021
Revenue	$0	$30	$100	$105	$111
COGS	$0	($18)	($30)	($30)	($30)
Operating Expenses	$0	($10)	($10)	($10)	($10)
Depreciation	($10)	($12)	($16)	($20)	($24)

[5] Most businesses (and investments made by those businesses) move through different stages during which they have different income and cash flow profiles. *See e.g.*, Donald L Lester; John A Parnell; Shawn Carraher, *Organizational Life Cycle: A Five-Stage Empirical Scale*, 11 International Journal of Organizational Analysis 339 (2003).

Taxable Income	($10)	($10)	$44	$45	$47
Cash Flow From Operations	$0	$2	$60	$65	$71
CAPEX	($100)	($20)	($40)	($40)	($40)
"Free Cash Flow"[6]	($100)	($18)	$20	$25	$31

Beginning in 2019, the net operating loss carryforwards will have been used, and taxable income will be generated, but there will not be enough "free" cash flow to pay a sufficiently large dividend to wipe out the entire corporate tax through a DPD. Depending on the U.S. corporate rate, the foreign tax rate and the length of time taxable income is expected to exceed free cash flow, USCO may still conceivably have an incentive to engage in deferral. Nevertheless, the differential between the U.S. and foreign tax rate would have to be significant, and the time frame during which taxable income exceeds cash flow would also have to be lengthy for the prospect of deferral to motivate offshore production.

Second, the DPD should substantially reduce the so-called "lock out" effect that currently plagues many U.S.-based multinationals, without necessitating a switch to a territorial regime.[7] Presently, if earnings are retained offshore, and not repatriated, no U.S. tax is paid and no tax is accrued on the U.S. financial statements.[8] This creates a tremendous incentive to keep cash in non-productive passive investments, reinvest cash offshore, and borrow in the U.S. to fund dividends and stock buy-backs. With a DPD, to the extent that the repatriated cash will be used to pay dividends,[9] there is no federal tax reason for the multinational to keep cash offshore.[10]

Third, the DPD would either substantially reduce (or possibly even eliminate) the preference that currently exists in the U.S. tax system for debt financing corporate operations. The precise extent to which parity is achieved, however, depends on a number of specific policy choices that Congress will

[6] I am assuming the negative free cash flow is funded either by issuing equity or debt.

[7] To be clear, enactment of a DPD does not preclude the enactment of some form of territorial regime.

[8] The financial statement presentation is driven by Accounting Principles Board Standard 23 which has since been codified as ASC 740-10-25-3.

[9] I address stock buy-backs below.

[10] The corporate taxpayer would still be incentivized to keep cash offshore if the cash is being brought back to repay principal on debt (which would not be deductible) or invest in assets with long class lives that will depreciate slowly.

have to make if it proceeds with a DPD. I address this issue specifically in the remainder of my written testimony.

VI. THE IMPACT OF A DPD ON DEBT-EQUITY PARITY

The Committee is keenly interested in the extent to which allowing corporations a DPD would eliminate the preference for debt financing in the United States. The tax law did not always favor debt over equity financing as much as it does today. In fact, there is little to suggest that the current preference for debt financing was ever fully considered as an affirmative policy choice by Congress. Instead, the advantage of using debt financing instead of equity financing waxed and waned in the first decades of the 20th Century based on interest deductibility limitations and corporate and individual rates. It was only when Congress chose to impose two levels of tax on corporate profits in 1936 and the only limit on the sheer amount of debt a corporation could issue was established by common law that the tax preference for debt was firmly established. Again, this does not appear to be a considered policy decision taken by Congress, but instead is a state of affairs that evolved over time based on other changes in the Code.

The importance of the distinction is illustrated in stark relief with the issuance of the proposed section 385 regulations. As this Committee will likely hear from others over the coming months, the new proposed section 385 regulations will have a profoundly negative impact on ordinary non-tax motivated transactions and investment in this country. Thus, it would be good for the government and the taxpayer community if the tax treatment of debt and equity were brought into greater balance, thereby obviating the need for punitive rules, like the proposed section 385 regulations, that hinder legitimate economic activity such as cash-pooling, acquisitions of foreign companies that will not be compliant with section 385 and post-closing integration.

Clearly, allowing a DPD will eliminate the biggest tax difference between debt and equity financing. Yet, there are a lot of second and third order effects that this Committee should consider in connection with granting a DPD. The Committee should consider how far it wants to tip the scales in favor of equity financing.

One threshold issue, for example, is the "base" out of which the DPD may be claimed. A "dividend" represents property distributed out of a corporation's earnings and profits ("E&P") which will not necessarily be the same as a corporation's "taxable income". A basic example would be interest on a tax-exempt bond, which would be included in E&P but not included in taxable income. Interest expense reduces a corporation's earnings and profits ("E&P") but may only be deducted against taxable income. Thus, a decision will need to be made as to whether a distribution of property creates a DPD if it is made out of E&P[11] or whether it will be limited to distributions made out of "taxable income". This will then have certain cascading effects which I refer to below.

There are also more bespoke issues that are unique to specific holders and specific issuers. In the interest of simplification, Congress should also reconsider a number of anti-abuse provisions the Code contains that will cease to have a rationale once a DPD is enacted. The DPD could also impact many common reorganization transactions. I try to highlight some of those effects the Committee should consider below.

A. Issues from a Holder's Perspective

Different holders will have different concerns with respect to the DPD proposal depending on their status and how the rule is crafted.

1. U.S. Shareholder Perspective

U.S. individuals, domestic corporations and tax-exempt entities will have different concerns with respect to the DPD proposal than foreign investors. We address domestic taxpayers below.

a. Individual Holders

It is useful to think in terms of tax base, rate and timing.

[11] To the extent the DPD exceeds taxable income it would then presumably create a net operating loss that could be carried backwards or forwards.

Tax Base

The DPD should not impact or create a "base" difference between debt and equity. In terms of the tax base, under current law, the rules governing debt (including but not limited to contingent debt) and the rules governing equity both allow for the tax-free return of invested capital/principal and the inclusion in gross income of return on that capital/principal. Thus, it is really the rate at which that income is taxed and the time when it is taxed that have to be considered in determining how far a DPD would tilt the scales in favor of equity financing.

Tax Rate

Normally, interest deducted by a corporation is included in the taxable income of individuals at ordinary income rates. Yet, individuals currently enjoy a favorable tax rate on dividends paid by domestic corporations under section 1(h)(11) if they hold the shares of the issuer for a sufficient period of time. If the DPD is enacted and there is no change to the foregoing preference, there will be an incentive (all other things being equal) for holders to own debt-like equity as opposed to equity-like debt.[12]

One additional issue the Committee will need to address is the tax treatment of redemptions taxed under section 302(a). If the Committee wants the DPD to mitigate the current "lock-out" effect for CFC earnings, the Committee will have to consider whether the DPD applies to share repurchases governed by section 302(a) as well as property distributions governed by section 301. This is because many companies use their free cash flow to buy back stock, not just pay dividends. Stock buy-backs from public shareholders are often governed by section 302(a) of the Code (governing sale-type redemptions), not section 302(d) and section 301 (governing dividend-equivalent redemptions). If the redemption is governed by section 302(a), section 312(n)(7) currently limits the amount of the E&P reduction to those earnings attributable to the shares that were redeemed. Yet, despite the E&P reduction, the shareholder recognizes "gain" (not ordinary income) equal to the dividend minus his/her basis.

[12] Congress has historically been concerned abut equity-like debt, rather than debt-like equity. *See e.g.*, §§163(l) and 279.

> EXAMPLE: In 2016, A, a U.S. citizen invested $1 in USCO, a publicly traded corporation in an initial public offering for 1% of USCO's shares. A then sold those shares to B, a U.S. citizen, for $4 in 2017. In 2022, USCO has $1,000 of E&P. USCO has a stock buy-back program where it periodically goes out into the market and redeems shares from those shareholders who choose to tender their shares. In 2022, B tenders all of his shares in USCO for $10.[13]

Under current law, USCO would reduce its E&P by $10 (1% x $1,000) and not receive a deduction. A would recognize a gain of $3 in 2017, but the gain would be "capital" in nature. B would recognize gain of $6 ($10 minus $4) and, again, the gain would be "capital" in nature. If a DPD were enacted and drafted so that it applied to share-buy backs, the issuer would presumably get an ordinary deduction of $10, assuming E&P equaled taxable income.[14] USCO's preference for debt financing would thus be reduced. The rates applicable to A and B's income, however, will be more favorable than they would be had A loaned money for a contingent debt instrument and sold it to B who then had it redeemed by USCO.[15] Thus, A and B would now have a tax preference for equity financing under this scenario.

Timing

Holders of instruments with original issue discount ("OID") and contingent debt instruments have to recognize income over the term of the instrument even if they do not necessarily receive cash. A holder of an equity instrument only recognizes income when there is a realization event, like a dividend or a redemption.

Unlike the rate difference described above, however, this distinction is merited by the different economic terms between debt and equity. As the Committee is aware, "debt" and "equity" lie on either ends of a continuum with repayment of principal and yield on "debt" being more certain than with "equity". Thus, allowing holders of "equity" to defer income recognition does not automatically mean

[13] The example assumes that USCO received $100 of initial equity capital, earned another $1,000, but nevertheless is only worth $1,000, which suggests USCO has $100 of assets on its balance sheet that have depreciated in value but USCO has not been able to deduct them for tax purposes.

[14] I am assuming for purposes of this example that the Committee would only permit a DPD for amounts paid out of E&P to the extent the earnings were reflected in taxable income and would not permit a deduction for E&P generated from untaxed earnings like municipal bond income, etc…

[15] Had A loaned the money to USCO for a contingent debt instrument, at least a portion of A's income would be "ordinary" income that it accrued on a constant accrual basis until it sold the instrument to B. Similarly, at least a portion of B's income would be ordinary income that he accrued on a constant accrual basis prior to having the instrument redeemed.

that holders will prefer equity over debt. To be "equity" in the first instance, the payments on the instrument would typically have to be more uncertain than those of a debt instrument, and so allowing holders to defer taxation until there is a realization event would seem appropriate.

b. Corporate Holders

There is no capital gains rate differential for corporations. But corporations do receive a dividends received deduction with respect to dividends from other corporations.[16] Presumably, if a DPD were enacted, the dividends received deduction would be removed. If so, that would bring the treatment of equity financing more in line with debt financing for corporate holders.

c. U.S. Tax-Exempt Entities

Subject to some exceptions, interest and dividends received by a tax-exempt entity are not considered Unrelated Business Taxable Income ("UBTI"). Yet, corporate tax is paid on the earnings out which corporate dividends are paid, whereas, corporate tax is not paid on interest payments made to tax-exempt entities. Thus, the tax-exempt investor gets an exclusion with debt or equity financing but only debt financing generates a corporate tax deduction.

If Congress were to enact a DPD and retain the current treatment of dividends, the DPD would equalize the treatment of debt and equity for tax-exempt entities. Yet, it would also result in lost revenue, as no business tax would be paid on earnings that were paid to tax-exempts as dividends or interest. In this Committee's May 17th hearing, it heard about the tremendous growth in ownership of U.S. corporations by tax-exempt shareholders. Thus, the revenue loss would likely be significant.

If, instead, Congress were to cause dividends from domestic corporations (but not interest) to be UBTI (in order to compensate for the lost corporate tax revenue), then U.S. tax-exempt entities would presumably prefer offering debt financing. This is because even if yields on equity were adjusted to

[16] §§243, 245, 246 and 246A.

reflect the treatment of dividends as UBTI, tax-exempt entities cannot earn an unlimited amount of UBTI without endangering their tax-exempt status.[17] Thus, one approach would be to impose tax on dividends and interest paid by domestic corporations to tax-exempt entities, but not count those dividend and interest payments against the tax-exempt entity in determining its tax-exempt status.

During this Committee's May 17th hearing, there was significant discussion about the impact that a withholding tax on dividends would have on retirement savings accounts, such as 401(k) plans. I would offer a couple of thoughts in this regard.[18] First, page 4 of Ms. Miller's testimony assumes that withdrawals from a 401(k) plan would still be taxable even if the withdrawal is made from income that has already been subjected to withholding tax. This may be true, but need not necessarily be true. There are a lot of correlative changes this Committee needs to consider when enacting a DPD, and the taxation of amounts withdrawn from a 401(k) that have already borne shareholder level tax may be one of those changes. Possibilities would include exempting that income from tax when withdrawn or providing a refundable credit for the taxes that have been paid on that income when the income is withdrawn by the taxpayer. Second, like all taxpayers, 401(k) plan participants will adjust to any new tax system. They can shift their investment preferences (if given a sufficient transition period) from dividend paying stocks to growth stocks that are reinvesting all of their cash flow in the business.[19]

I would suggest that the real issue for tax-exempts, including but not limited to retirement accounts, is the possibility that a DPD would usher in a withholding tax on interest. Right now, as noted above, a U.S. corporation's interest payment to a tax-exempt entity is not subject to any business tax. The question for this Committee is whether that is the appropriate answer from a policy perspective.

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[17] Similarly, if both interest and dividends paid by domestic corporations were included in UBTI, one could see some tax-exempt entities preferring investments in non-dividend paying stocks or foreign entities to limit their overall amount of UBTI.

[18] I do not address whether, in fact, 401(k) plan participants are ***already*** bearing the corporate income tax through lower stock prices and dividends. This is because making that argument first requires the determination as to whether shareholders are currently bearing the economic burden of the corporate income tax, something that tax professionals have been arguing about for a very long time.

[19] Admittedly, this is easier for a younger individual who has a much longer investment horizon than an older plan participant who has transitioned his or her portfolio to income generating securities.

2. Foreign Shareholder's Perspective

As the committee is aware, the U.S. imposes a 30% withholding tax on U.S. source interest and dividend payments, but the U.S. has largely relinquished taxing jurisdiction on interest payments through its treaty network. In contrast, most U.S. tax treaties do not fully eliminate the withholding tax on dividends. The ones that do only do so for significant (80%+) shareholders who satisfy an enhanced limitations on benefits test. In addition, certain types of debt extended from unrelated parties can qualify for the "portfolio interest exemption"[20] and escape U.S. withholding tax without resorting to a treaty. These differences favor debt financing over equity financing.

Presumably, if Congress enacts a DPD it will have to revisit the treatment of dividend withholding taxes under applicable treaties in order to offset the revenue loss that would otherwise occur. This, in turn, will likely require a similar reassessment of how interest is withheld upon. After all, if Congress enacts a DPD, but fails to equalize the manner in which interest and dividends are withheld upon, foreign persons will still have a significant preference for offering debt financing vs. equity financing. [21]

B. Issuer's Perspective

A corporate issuer's ability to derive an interest deduction for debt financing is obviously a significant tax advantage over equity financing. Yet, there are a number of places in the Code where an interest deduction is either limited or has a negative corollary effect. Each provision has its own rationale and this Committee will have to consider whether the rationale for the provision applies equally to a DPD.

1. Limitations on Interest Deductibility

The amount of interest deduction a corporate taxpayer may deduct in any given year with respect to debt issued to, or guaranteed by, a foreign related party is limited by section 163(j). Whether this limit

[20] *See* §881(c) and Treas. Reg. §1.871-14(g).

[21] I address the treaty override issues associated with a DPD more fully in my article cited above.

also applies to a DPD would likely depend greatly on how Congress chooses to resolve the withholding tax issue mentioned above. For example, if dividends subject to a DPD are subject to full withholding, there may not be any reason to subject them to the section 163(j) limitation.

Some interest expense must be capitalized.[22] If similar rules are not provided for the DPD, all other things being equal, an issuer may have a preference for equity financing over debt financing.

Interest on debt used to fund tax-exempt income is not deductible under section 265. That does not automatically mean a similar rule is required for a DPD. Given that the income generated from the investment is not taxable, a subsequent distribution of that income would presumably not be entitled a deduction.[23] Hence, it is not clear that the DPD arising from equity used to finance a tax-exempt investment would have to be subject to section 265.

The interest deduction with respect to related party debt is deferred until "paid" under sections 267(a)(2) and (3). This Committee will have to consider whether it is appropriate to, for example, allow a corporate taxpayer to receive a DPD by simply issuing its own note to the shareholder, or whether payment in cash or other property will be required to crystalize the deduction.[24]

2. Correlative Effects

Interest deductions have a number of unfavorable correlative effects to U.S. corporations. The question is which of these correlative effects should apply equally to a DPD.

[22] *See* §263A(f).

[23] I am assuming that the DPD would be limited to distributions out of taxed earnings and would not allow a deduction for income that had been subject to a preference. But if that is incorrect, then that could cause the Committee to consider whether section 265 should also apply to deny a portion of the DPD.

[24] There is already significant case law that determines whether a corporation's issuance of an obligation is sufficient to cause a "dividend" to have been "paid". Compare, *Moser v. Commissioner*, 914 F.2d 1040 (8th Cir. 1990) and *Estate of McWhorter v. Commissioner*, 69 T.C. 650, *aff'd without opinion*, 590 F2.d 340 (8th Cir. 1978)

For example, U.S. corporations have to apportion interest expense to U.S. and foreign sources in order to compute their foreign tax credit limitation.[25] Any interest apportioned to foreign sources reduces the U.S. corporation's foreign tax credit limitation and its ability to claim foreign tax credits. The underlying theory is that money is fungible and if the taxpayer chooses to finance the business by having a U.S. corporation issue debt (instead of having its foreign subsidiaries issue the debt) then the interest expense should be apportioned. Presumably the DPD would also have to be apportioned under the same theory.

Corporations also have to apportion interest expense to gross income from activities that do, and activities that do not, qualify for the section 199 domestic production deduction. Presumably, the DPD would be similarly apportioned.

A similar issue will arise for foreign corporations that generate effectively connected income. If a foreign corporation generates effectively connected income, the Code has rules that apportion its interest expenses to that effectively connected income and ensure that proper withholding tax is charged.[26] Moreover, since 2004, the U.S. has exempted dividends paid by foreign corporations with significant effectively connected income from U.S. withholding tax.[27] If a DPD were enacted, decisions would have to be made as to whether the DPD would be deductible against effectively connected income. If it is, a decision will have to be made as to how it is apportioned and withheld upon when distributed.

C. Enactment of a DPD will Remove the Rationale for a Number of the Code's Anti-Abuse Provisions

There are a whole host of Code provisions that were enacted to prevent corporate taxpayers from issuing instruments that were characterized as debt under the common law, but nevertheless contained "equity-like" features. The underlying rationale for these provisions as that an interest deduction should

[25] §864(e) and Treas. Reg. §1.861-9T.

[26] §884(f).

[27] §871(i)(2)(D) enacted in §409(a) of The American Jobs Creation Act of 2004.

not be permitted for instruments that were sufficiently "equity-like". If Congress were to enact a DPD, however, the rationale for these provisions presumably disappears. In the interest of simplifying the Code, Congress may consider removing these provisions. I list some examples below.

Section 163(l) prohibits deductions on debt where a substantial portion of the principal or interest is payable in equity. Section 279, similarly, limits deductions with respect to debt issued in acquisitions that have certain equity-like features. Interestingly, section 279 was enacted at the same time as section 385 in 1969,[28] when Congress sought to better define the distinction between debt and equity. Presumably, the rationale for sections 163(l) and 279 would fall away if Congress were to enact a DPD. If so, Congress should consider repealing them.

Other examples are less clear-cut. For example, the applicable high yield debt obligation ("AHYDO") rules in section 163(e)(5) were enacted as an anti-abuse provision. Yet, unlike sections 163(l) and 279, it is not as obvious that the rationale for the AHYDO rules would fall away with a DPD. On the one hand, Congress enacted the AHYDO rules because they believed that high-yield instruments with significant deferred payments were very equity-like. In that sense, enactment of a DPD would eliminate the rationale for the AHYDO rules. Yet, the AHYDO rules also prevent a corporation from claiming a deduction for original issue discount accrued long before it is paid. That rationale would appear to remain intact even after the enactment of a DPD.

D. The DPD may Impact Other Common Reorganization Transactions

As a threshold matter, the Code contains rules governing the movement and allocation of accumulated E&P in corporate reorganizations.[29] The rules do not address the movement and allocation of accumulated taxable income. Thus, if the DPD is only allowed for a payment out of accumulated

[28] *See* An Act to Reform the Income Tax Laws, P.L. 91-172, §411(a), 83 Stat. 487, 604-05 (1969).

[29] §381 (governing tax-free liquidations and non-divisive asset reorganizations); and Treas. Reg. §1.312-10 (in the case of divisive transactions).

taxable income (rather than E&P), companies will need rules to track and allocate their accumulated taxable income which they currently do not have.

In addition, the enactment of the DPD may impact the ability and desire of corporations to engage in divisive transactions. Under the Code, when a corporation distributes appreciated property (including stock of a subsidiary) to its shareholders, a tax is imposed at the distributing corporate level and at the shareholder level. Section 355 provides an exception to this rule in certain specific fact patterns many of which require the taxpayer to analyze the preceding five years of shareholder and business activity. If section 355 applies, no gain is recognized at the corporate or shareholder level.

It is unlikely that the enactment of a DPD will incentivize corporations to engage in divisive transactions that do not satisfy the rigorous requirements of section 355. This is because the DPD will only eliminate the corporate-level gain, not the shareholder level income event. Moreover, the government will not allow distributing corporations to "withhold" on shares of a controlled subsidiary. Thus, if the distribution is taxable and withholding is required, the distributing corporation would have to come up with additional cash to pay over to the government. This would create an additional taxable event to the shareholders.[30] Thus, corporations will still need to satisfy the requirements of section 355 to do divisive transactions.

The question is whether it must comply with all of the requirements of section 355. It is possible that a divisive transaction can qualify for section 355, but corporate level tax can nevertheless be triggered under, for example, sections 355(d) and (e).

> EXAMPLE: USCO is a U.S. publicly traded corporation that wholly owns all of the stock of USSUB, a domestic subsidiary. USCO has a $10 tax basis in USSUB. USSUB is worth $100. USCO distributes all of the stock in USSUB to its shareholders in a transaction that satisfies section 355 in 2017. Later, in 2017, an unrelated

[30] *See Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) and *Enoch v. Commissioner*, 57 T.C. 781 (1972) (acq. in part).

corporation ("XYZCO") acquires all of the stock of USSUB in a transaction that runs afoul of section 355(e). The distribution remains tax-deferred to the shareholders, but USCO must recognize a $90 gain.

Presumably, a DPD would be denied in the foregoing example or else USCO would be somewhat ambivalent about complying with section 355(e).

VII. CONCLUSION

Thank you again for the opportunity to testify on tax reform and corporate integration. I am happy to answer any questions.