Testimony of Philip R. West

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Committee on Finance

Tax Reform Options: International Issues
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Chairman Baucus, Ranking Member Hatch, and distinguished Members of the Committee:

My name is Philip R. West. I am a partner with the law firm of Steptoe & Johnson LLP and lead the firm's tax practice. I have been practicing tax law for over twenty-five years, predominantly in the international tax area. Although I have spent most of my career in private practice, I served as the Treasury Department's International Tax Counsel from 1997 to 2000, I started my career in tax enforcement at the Justice Department, and I served as a law clerk to the Honorable Judge Carolyn Miller Parr of the United States Tax Court. My testimony today is a product of my experiences in government as well as my experiences advising large and medium-sized businesses, but I appear before you on my own behalf and not on behalf of my firm or any client.

International Tax Reform Generally

Near the end of my tenure at the Treasury Department, a wise man said to me: "There is no objective truth in international tax policy. Ultimately, the choices are political." Having lived through years of polarizing arguments about corporate and international tax reform and after considering various arguments from all perspectives, I have come to the view that no one group—whether liberal or conservative; whether business leaders, labor unions, or think tanks; academics, economists, or practitioners—has a monopoly on thoughtful ideas for tax reform.

It has been twenty-five years since the United States was last able to achieve fundamental tax reform. Since then, we have seen periods of sustained discussion and hope for reform, but then retrenchment, as the usual players on all sides continue to take what appear to be pre-determined roles and dig themselves deeper and deeper into positions from which they cannot (or will not) back out. At the same time, the United States' tax code, including its corporate and international rules, has become more out of step with the rest of the world and in need of comprehensive reform.

So how can we advance the debate and achieve fundamental tax reform in the twenty-first century? I believe there are a number of critical components. First, an acknowledgement that there is no clear right or wrong answer, that people come to the debate with competing policy orientations, and that we all may have to sacrifice some sacred cows. In addition, we should consider both (a) empirical research, in particular (if possible) with respect to the macroeconomic effect of alternative policies on domestic job and economic growth, and (b) real-world experiences of those who are responsible for paying taxes and complying with the system. I believe that, with these components, Congress can achieve pragmatic comprehensive tax

reform that encourages economic growth in the United States, helps our corporations compete in overseas markets, and promotes fiscal sustainability.

A Framework for Evaluating International Tax Reform Options

There are five criteria that are often used to evaluate tax rules:

- Revenue
- Equity, or Fairness
- Economic Efficiency
- Competitiveness, and
- Simplicity

There is widespread agreement that our international tax rules do not score well when measured against these criteria. Although I recognize that Congress is faced with an extremely difficult task when grappling with our international tax rules, and should not be faulted for the laws we currently have, I am confident that we can do better.

Revenue and Simplicity

A tax system that raises little revenue but imposes high compliance costs is a bad tax system. Our international tax system does both—it imposes little tax on foreign earned income, but taxpayers face high levels of complexity and incur high compliance costs to reach that result. Moreover, the IRS devotes significant and increasing resources to auditing and enforcing the international tax rules despite the modest revenue raised even after those resources have been expended.

The larger point, perhaps, is that corporate revenues overall are a relatively modest percentage of total collected revenue, ranging from around 12 to 15 percent in the past ten years, and comprising 8.9 percent of collected revenue in 2010, the most recent year for which data are available. This figure might suggest to some that corporations should be paying more tax, but what I find most significant about the data is that they show that changes to the corporate income tax system will not have a significant impact on our serious budget problems, at least without unprecedented and probably unsustainable corporate tax increases. In fact, for the reasons discussed below, I believe there is a stronger case that the corporate tax burden should be reduced, although I understand the political difficulties that might be associated with such a result.

Equity (Fairness) and Competitiveness

C Corporation Taxation Generally

When considering equity or fairness, the issue is whether those who are similarly situated have similar tax burdens. Under the tax rules, otherwise similarly-situated U.S. businesses may have vastly different tax burdens depending on their form. In general, only incorporated entities (specifically those referred to as "C" corporations under the tax code) pay tax. Other business entities, including partnerships, LLCs, S corporations, mutual funds like regulated investment companies and offshore funds, and real estate investment trusts, generally do not pay tax. Rather, their owners generally pay tax on the earnings of these vehicles.

Over 90% of U.S. businesses operate in non-taxable (pass-through) form, earning almost half of the nation's business income. The vast majority of the other half of the nation's business income is earned by large publicly traded entities. So with only minor exceptions, business income is earned by either non-taxable entities or publicly traded entities. One question for policy makers is whether this public trading status warrants such significantly different tax treatment. My view is that it does not.[1]

C Corporation Taxation of Foreign Income

Starting from this observation, that there is no compelling justification for treating publicly traded U.S. corporations so differently than other businesses, we should next inquire whether U.S. multinational corporations are treated inequitably compared to foreign multinational corporations. In my view the answer is yes, but it is a more complex question.

First, tax rates are but one part of a complex web of costs and other burdens that factor into competitiveness, and the United States consistently ranks high in terms of overall competitiveness. Second, although the statutory tax rates of other countries may be lower, the data is thin regarding effective tax rates of U.S. corporations compared to corporations based in other countries. Perhaps the most comprehensive study found broadly comparable rates on average, but that study produced results comparing large pools of companies differentiated by geography, and there seems to be ample anecdotal evidence that important U.S. corporations have higher effective tax rates than their foreign competitors.

Third, even if overall tax burdens (i.e., on both U.S. and foreign earnings) are higher for U.S. companies, the tax burdens on only foreign earnings may not be. And although there has

[1] A related point: although we speak of corporations as taxpayers, corporations pass on their tax burdens so that the incidence of the corporate tax falls on others such as shareholders and employees. Just how much of the incidence falls on shareholders and how much on employees is a matter of debate, but the extent to which the literature estimates that the corporate tax is borne by labor appears to be increasing. As I understand the economics, this follows in part from the fact that the world is becoming increasingly globalized. To the extent that labor bears the burden of the corporate income tax, we should be considering the potentially adverse impact of that tax on job creation and wages.

been some work concluding that the U.S. rules for taxing foreign income are more restrictive than those of our competitors, comparisons among countries on that score are complex, requiring not only an analysis of foreign tax rules, but also an analysis of how those rules apply in practice. Despite these limitations, it seems clear that the United States has very limited company for its tax system. It is almost a cliché now, and known even to those who formerly had only the most passing familiarity with international tax, that the United States has one of the highest corporate tax rates in the OECD. Further, very few other countries formally eschew exemption of foreign earnings (although in practice, the U.S. system can operate similarly to and sometimes more advantageously than a formal exemption system).

And finally, even though U.S. tax rates may be higher than in other countries, it can be deceptive to compare tax rates in countries like the United States that provide significant services to tax rates in other countries that provide far fewer services. On the other hand, imposing worldwide taxation on an entity simply because it has filed its organizational documents in the United States does not seem logical. (A "managed and controlled" test would be less arbitrary, but could do more harm than good considering that (a) the corporate inversions it might otherwise stop have already been stopped by other legislation, (b) historic U.S. tax policy for offshore funds that might be caught by the rule has been to encourage them to have U.S. management and investments, and it is not clear why this policy should change, and (c) a managed and controlled test could adversely affect the ability of large non-U.S. based multinationals to locate their managerial talent in the U.S.)

Economic Efficiency

Exactly six months ago today, this committee held a hearing at which eminent economists such as Alan Auerbach discussed economic inefficiencies of the corporate income tax generally. In the international realm, discussion of the economic inefficiencies of the corporate income tax has been a history of dueling efficiency ideologies: capital export neutrality and capital import neutrality (with national neutrality and capital ownership neutrality also being less well established neutralities on opposite sides of the debate). Under rules embodying capital export neutrality, foreign business operations of a U.S. corporation are not taxed more lightly than U.S. business operations. Therefore, those rules are said to promote efficient deployment of capital because they remove tax as an incentive to move abroad. Under rules embodying capital import neutrality, foreign business operations of a U.S. corporation are not taxed more heavily than similar foreign business operations of a non-U.S. corporation. Those rules are said to promote efficient deployment of capital because they remove tax as a disincentive to invest abroad.

Michael Graetz and Jim Hines, among others, have questioned the utility of this framework for viewing the issue. One problem I have with it is that it presupposes a degree of influence in the business decision-making process that most of my Tax Director clients would envy. Although in some cases companies may decide for tax purposes whether they will locate a movable business inside or outside the United States, it is more common that companies decide how much they can afford to pay to fund a foreign opportunity that is not logical to be conducted in the United States for business reasons. In a world in which foreign business opportunities are growing faster than domestic business opportunities, this is only going to become more common.

And in such a world, the competitiveness argument in favor of capital import neutrality gains force and the historic presumption in favor of capital export neutrality loses force.

Specific Recommendation: Territoriality

It is another cliché that the government cannot create enough jobs to pull us out of a recession; it is the private sector that must do so. In that context, the question arises why corporations are not creating jobs now, when they seem to have enough retained earnings to spend and expand. The answer in my view lies in the corporate analogue to consumer confidence. The greater the confidence that a company's hiring will not lead to overcapacity, the greater its willingness to hire. And where there cannot be a lot of confidence that the economy will be very strong very soon, we should err on the side of providing incentives and creating an environment that is business-friendly. And in the international tax context, one way to do so would be to move further towards a territorial tax system.

Impact of Territoriality on U.S. Jobs and the Deficit

Will territoriality push jobs abroad? And will it increase our deficit?

First, most tax planning involves shifting income abroad, not shifting jobs abroad. Job location decisions are made primarily for non-tax reasons. When tax is a factor, it is primarily because the U.S. tax is higher than the tax elsewhere. Admittedly, this is because our system today allows U.S. corporations to effectively exempt from U.S. tax through long term deferral the income generated from their foreign workers. Unless we repeal those rules, however, which would put us even further away from our trading partners, we will not change the incentives to shift jobs abroad by moving to a more formally territorial system. What such a move can do, however, is simplify compliance (although it may well put more pressure on source and transfer pricing rules), and create a more business-friendly environment. And repealing our current system of tax deferral would, in my opinion, adversely affect a multinational's appetite for taking on the risk of hiring additional workers in an uncertain economic climate. Therefore, moving to a territorial system is not likely to adversely affect U.S. job creation, while repeal of deferral might.

Will moving to a territorial system increase the deficit? Shifting to a territorial system can raise or lose revenue depending on the system's design. But a system that reduces tax burdens, and therefore loses revenue, would incentivize corporations to hire, while a system that increases tax and raises revenue would not. Would this be terrible for the deficit? First, I agree with those who favor stimulus now, and disagree that austerity is the right answer for a recession economy. And second, if there is no political appetite for a tax reform that loses revenue, there are numerous offsets that could be found, including an increase in individual tax rates, especially on higher income earners. Compared to historic standards, our individual tax rates today are low, and raising them would move our tax system closer to those of the historically most successful foreign economies, which have a high individual rate and a low corporate rate. Therefore, moving to a territorial system does not have to increase the deficit and, if it does, we should be willing to live with that in the short term.

Select Inbound and Individual International Tax Issues

We mentioned above the subject of U.S. exceptionalism in international tax, and I would be remiss not to mention two aspects of our system, one historic and one recent, that put the United States at the high water mark of exceptionalism. These are (1) our system of taxing citizens on their worldwide income irrespective of whether they reside here, and (2) FATCA, or the Foreign Account Tax Compliance Act provisions of the 2010 HIRE Act.

The United States taxes not only domestic corporations on a worldwide basis, but it also taxes its citizens on a worldwide basis, even if they do not live here, even if they have never lived here, and even if they have no connections to the U.S. at all other than a passport, have no underlying U.S. tax liability, and are honestly unaware of their obligation to file a U.S. return. While it certainly can be argued that U.S. tax compliance is a small price to pay for a U.S. passport, it is probably the case that the vast majority of non-resident citizens fall into that category of persons who have no U.S. tax liability but nevertheless have to file U.S. tax returns. And simply giving up U.S. citizenship often cannot be done without creating adverse tax consequences. Therefore, with the IRS making great strides in focusing its resources where they can do the most good, it may be time for the United States to re-examine its tax rules for non-resident citizens.

In doing so, the United States cannot encourage high-income tax evaders, which was the guiding objective of FATCA. FATCA, however, is imposing compliance costs of over a hundred million dollars for each of many institution, even where there is little likelihood that the affected institution has or will encourage tax evasion. And in a cruel irony, little of this money is going to be spent in the United States to create U.S. jobs. Rather, it will be spent abroad, creating jobs there.

Conclusion

Our corporate and international tax rules need reform to encourage both U.S. economic growth and to help U.S. companies compete in the global market. Although the United States is an attractive investment environment on many fronts, with a strong legal and regulatory framework, infrastructure, economic stability, and skilled workforce, our tax code does not encourage companies to grow in the United States for several reasons:

- First, the U.S. corporate tax rate is significantly higher than the rates of our trading partners. As foreign markets and labor have become just as important to companies as U.S. markets and labor, it becomes increasingly difficult for the United States to justify such a high corporate tax rate.

- Second, the tax code is complex, with various tax incentives that have high compliance costs, are often a source of companies' disputes with the IRS, and may benefit some industries over others.

- Third, the frequent use of expiring tax provisions, as well as the complexity of the tax code, creates uncertainty for taxpayers. For example, although the United States

offers a tax credit for research and development, the credit is enacted on a temporary basis only. When evaluating potential future investments in the United States, businesses must assume that the credit will expire as scheduled. Thus, when they compare the potential return from an investment in the United States with the potential return from a non-U.S. investment, the potential return from the U.S. investment will not include the potential benefit of the R&D credit, which may make the foreign investment more attractive.

Our tax code also appears to be a detriment in the global success of U.S. companies. Although there is no clear empirical evidence of the extent to which U.S.-based multinationals are at a competitive disadvantage as a result of the current U.S. international tax system, there is substantial anecdotal evidence.

The global economy has changed significantly since the United States' international tax rules were last reformed in 1962. Our international tax rules were adopted when the United States was the dominant world economy and the major market for U.S. companies. Although the United States remains an important force in the global economy, significant growth is occurring outside the United States. Non-U.S. markets are critical to the growth of U.S. businesses. Yet, as markets have changed, our international tax rules have not.

Because the United States' international tax rules have not been adapted to the global economy, our rules look fundamentally different than those of our trading partners. For example, the United States taxes its corporations on a worldwide basis, including taxing foreign source income generated by foreign subsidiaries when that income is repatriated to the United States. This feature of the United States international tax system is more similar to that of developing countries than those of the United States' major trading partners, many of which exempt foreign-earned income.

So how should the United States reform its corporate and international tax rules? I have suggested lowering the corporate tax rate and exempting from taxation a large portion of, but not all, the dividends of active earnings from foreign corporations to U.S. shareholders. The portion of the dividends that would continue to be taxed, say 5-10% of the dividends, would be a proxy for disallowed deductions of expenses incurred in connection with the earning of the otherwise-exempt foreign income. To avoid negative revenue consequences, a number of offsets could be on the table, such as the reduction of tax expenditures, imposition of the corporate tax on all entities with corporate characteristics, and the potential adoption of a value-added tax. The ultimate decision regarding offsets is obviously highly political, but we should not fail at reform because it is too politically difficult to broaden the tax base.

Thank you. I look forward to answering your questions.