Testimony
of
Mihir A. Desai
Miuzho Financial Group Professor of Finance
Professor of Law
Harvard University

before the

U.S. Senate Committee on Finance
July 22, 2014 10:00 a.m.

Chairman Wyden, Ranking Member Hatch, and Members of the Committee, it is a pleasure to appear before you today to discuss international tax reform. I am a Professor of Finance at Harvard Business School, a Professor of Law at Harvard Law School and a Research Associate of the National Bureau of Economic Research.

Recent merger transactions highlight long-simmering problems in the U.S. corporate tax, particularly with respect to its international provisions. My comments attempt to outline briefly the origins of these transactions, the range of alternative solutions, guidelines for evaluating alternative reforms and some reforms that should be avoided.

1. The last twelve months have witnessed a remarkable wave of merger transactions that facilitate the expatriation of U.S. corporations. Such transactions reflect the effects of policies and of the changing structure of multinational firms. From a policy perspective, the transactions highlight the increasing costs of employing a) a worldwide tax regime when most other large capital exporting countries no longer maintain such regimes and b) a corporate tax rate that stands well above rates employed by other OECD countries. From a firm point of view, the transactions highlight a) the increased mobility of activity in today's economy, b) the growing "decentering" of firms whereby headquarter locations have been split up and reallocated across the world, and c) the growing importance of non-U.S. markets for U.S. firms. Rather than questioning the loyalties of executives, it is critical to understand these underlying structural and secular forces. [See references 1, 2, 3, and 4]

2. While these transactions naturally attract growing attention, inversions are merely the most visible manifestation of these developments. In addition to inversions, these forces are giving rise to a) incorporation decisions by entrepreneurs that anticipate the burdens of being a U.S. corporation, b) merger patterns that reflect the penalties of being domiciled in the U.S and the importance of offshore cash for U.S. corporations, c) investment patterns by U.S. and foreign companies, d) profit-shifting activities that are not value-creating and e) the consequent, negative impact of all of these distortions on the U.S. labor force. While it is tempting to limit attention to the more sensational effects and characterize them as tax-avoiding paper-shuffling, this would effectively be missing the forest for the trees. [See references 1, 2, 4 and 7]

3. Reforms should be focused exclusively on advancing U.S. welfare with particular attention on reforms that will improve American wages. These goals are mistakenly thought to be achieved by limiting the foreign activities of U.S. firms as foreign activities can be viewed as diverting economic activity away from the U.S. In fact, the evidence suggests the opposite as firms expand globally, they also expand domestically. Indeed, American welfare can be advanced by ensuring that investments in the U.S and abroad are owned by the most productive owner and that American firms flourish abroad, a goal advanced by the territorial regime that has now been adopted by most comparable countries. While the developments described above have crystallized the case for international tax reform with an increasing attention on switching to a territorial regime, there is still tremendous variation in proposals for territorial regimes. Some proposals, including those with an alternative minimum tax on foreign profits, are tantamount to a backdoor worldwide regime with even more complexity than today's system. Revenue considerations should figure largely in tax reform today but should be accorded secondary status in this setting given the very limited revenue provided by current international tax rules and the remarkable complexity and distortions required to secure any such revenue. Additionally, it is not clear that policies should prioritize revenue considerations in other countries. [See references 2, 5, and 6]

4. More broadly, the corporate tax is ripe for reform. In addition to international reforms and a rate reduction, reform should address the two other major developments in the corporate tax arena: a) the growing prominence of non-C corporate business income, and b) the disjunction between profits reported to capital markets and to tax authorities. A useful blueprint for reform would include a) moving to a territorial regime unencumbered by excessive complexity, b) a considerably lower tax rate in the range of 18-20%, c) better alignment of book and tax reporting of corporate profits and d) by some taxation of non-C corporation business income. This combination of reforms has the potential of addressing significant changes in the global economy in a revenue-neutral way that will advance U.S. welfare. More fundamental reforms, including those that replace a corporate tax with a consumption tax, are preferred if feasible. [See Reference 1]

5. Legislation that is narrowly focused on preventing inversions or specific transactions runs the risk of being counterproductive. These transactions are nested in a broader set of corporate decisions, leading to several unintended consequences. For example, rules that increase the required size of a foreign target to ensure the tax benefits of an inversion can deter these transactions but can also lead to more substantive transactions. More substantive transactions are likely to involve the loss of U.S. activity as American firms will be paired with larger foreign acquirers that demand the relocation of more activity abroad, including headquarters functions. Similarly, specific regulations targeted at inverted firms may also lead to foreign firms leading such transactions to avoid those regulations. While it is tempting to address specific transactions in advance, or in lieu, of broader reform, it is useful to recall that the last wave of anti-inversion legislation likely spurred these more significant, recent transactions and reduced the prospect of reform in these intervening years. [See References 4 and 7]

Members of the Committee, I admire your foresight in addressing these issues. These highly visible manifestations of the structural problems in the corporate tax provide a significant opportunity for genuine reform. I'd be delighted to answer any questions.

References:

1. Desai, Mihir. "A Better Way to Tax U.S. Businesses." *Harvard Business Review* 90, nos. 7-8 (July–August 2012): 135–139.

2. Desai, Mihir A. "Securing Jobs or the New Protectionism?" *Tax Notes* 123 no. 3 (July 2009): 315.

3. Desai, Mihir A. "The Decentering of the Global Firm." *World Economy* 32, no. 9 (September 2009): 1271–1290.

4. Desai, Mihir, and Dhammika Dharmapala. "Do Strong Fences Make Strong Neighbors?" *National Tax Journal* 63 (December 2010): 723–740.

5. Desai, Mihir A., C. Fritz Foley, and James R. Hines Jr. "Domestic Effects of the Foreign Activities of U.S. Multinationals." *American Economic Journal: Economic Policy* 1, no. 1 (February 2009): 181–203.

6. Desai, Mihir A., and James R. Hines Jr. "Evaluating International Tax Reform." *National Tax Journal* 56, no. 3 (September 2003): 409–440.

7. Desai, Mihir A., and James R. Hines Jr. "Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions." *National Tax Journal* 55, no. 3 (September 2002): 409–440.