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**Before the United States Senate Committee on Finance  
Hearing on Building a Competitive U.S. International Tax System**

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Chairman Hatch, Ranking Member Wyden, and Members of the Committee, it is an honor to appear before you today to discuss the very important topic of international tax reform.

I am a Professor in the Economics Department and Dean of Social and Behavioral Sciences at the School of Arts and Sciences of Rutgers University. During various leaves from Rutgers University, I have served as Special Advisor to the Joint Committee on Taxation, Chief Economist for the President's Advisory Panel on Federal Tax Reform in 2005, and Director of the Urban-Brookings Tax Policy Center. In each of these positions, I have advocated the compelling case for tax reform, evaluated the economic consequences of different tax reforms, and studied the implementation issues and transition costs associated with various reforms. My primary area of expertise is international tax policy.

Under our current system, all income of U.S. corporations is subject to U.S. corporate income tax whether it is earned at home or abroad. This "worldwide" or "residence" approach is used by only a handful of advanced countries. All other G-7 countries and all but six other OECD countries (Chile, Ireland, Israel, Mexico, Poland, South Korea) have adopted systems that exempt some (or all) active foreign earnings of resident multinational corporations (MNCs) from home country taxation. These countries are commonly referred to as having "territorial" tax systems. It is more accurate, however, to call this approach a "dividend exemption" system since the removal of home country tax liabilities on active foreign income is typically accomplished by exempting dividend remittances from foreign affiliates to home country parent corporations from tax. In contrast, the United States defers taxation of foreign affiliates' active income until it is distributed as a dividend, but then taxes the income at its full corporate rate and allows a credit for foreign taxes paid on the earnings.

I believe there is broad agreement among policy makers and companies that our current system for taxing the income earned abroad by U.S. corporations is very complex and induces inefficient behavioral responses. The system provides incentives to invest in tangible and intangible capital in some locations instead of others, to engage in costly strategies to avoid U.S. taxes on foreign dividends, and to shift reported income from high- to low-tax locations by using inappropriate transfer prices or paying inadequate royalties. Where the tax burden under U.S. rules exceeds what could be achieved through a non-U.S. parent structure, pressure exists to change the parent corporation's domicile to a foreign jurisdiction.

Many in the United States are calling for reform of our system for taxing international income and support moving to a territorial tax system. I recently worked with Stephen Shay of

Harvard Law School and Eric Toder of the Urban-Brookings Tax Policy Center on a report that explores other countries' experiences with territorial tax systems.<sup>1</sup> We examined the approaches and experience of four countries --- Germany and Australia --- both of which have long-standing territorial systems and the UK and Japan --- both of which within the last six years enacted territorial systems by exempting from home country taxation either all or 95 percent of the dividends their resident MNCs receive from their foreign affiliates. We examined the factors that drove the policy choices of these four countries and put forward some lessons we believe the United States can take away from their experiences. In my testimony today, I highlight six conclusions from this work that I believe are important for policy makers in the United States as they contemplate reform of our international tax system. I also briefly discuss the benefits of adopting a reform that would remove the U.S. tax due upon repatriation of foreign profits and impose a minimum tax on foreign income.

**1. The classification of tax systems as “worldwide” or “territorial” oversimplifies and does not do justice to the variety of hybrid approaches taken in different countries.**

In practice, when exceptions and anti-abuse rules are taken into account, the difference in corporate tax policy between the United States and other advanced economies is nowhere near as stark as the labels “worldwide” and “territorial” suggest. The details of a system are more important than which broad definitional category is applied to a particular system.

All tax systems are hybrid systems that tax at reduced effective rates some foreign business income. Under the current U.S. “worldwide” system, MNCs are allowed to defer tax on most income earned in their foreign subsidiaries until that income is repatriated as a dividend to the U.S. parent company and are provided a liberal credit for foreign income taxes paid. As a result of deferral and the foreign tax credit, the United States collects little tax on the dividends its MNCs receive from their foreign affiliates.<sup>2</sup> Under the prior “worldwide” UK and Japanese systems, in which they also deferred tax on foreign affiliate earnings, their MNCs could bring back foreign earnings through related party loans without it being treated as a taxable repatriation. Most “territorial” countries impose tax on some foreign-source income as accrued in order to protect their domestic corporate tax base. In any assessment of international tax policy, as in so much else in taxation, the devil is in the details.

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<sup>1</sup> Rosanne Altshuler, Stephen E. Shay, and Eric J. Toder, "Lessons the United States Can Learn from Other Countries' Territorial Systems for Taxing Income of Multinational Corporations," *Urban-Brookings Tax Policy Center Research Paper*, January 21, 2015, <http://www.taxpolicycenter.org/UploadedPDF/2000077-lessons-the-us-can-learn-from-other-countries.pdf>.

<sup>2</sup> Because of deferral, the foreign tax credit, and the electivity of operating through a foreign branch, the United States does not collect much corporate tax in any form on foreign income earned from operating directly in another country. In recent work using U.S. Treasury tax data, Harry Grubert and I estimate that the United States collected \$32 billion of revenue on all categories of corporate foreign source income in 2006. This amount was approximately nine percent of 2006 corporate tax revenues but less than four percent of all foreign-source income of U.S. MNCs (including profits deferred abroad, but before allocated parent expense). U.S. taxes paid on repatriated dividends accounted for a very small portion of this revenue. The remainder came from taxes on royalties, portfolio income, export income and income from foreign branches. See, Harry Grubert and Rosanne Altshuler, “Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax,” *National Tax Journal*, September 2013, 66(3), 671-712.

**2. The circumstances that have caused other countries to maintain or introduce territorial systems do not necessarily apply to the United States. Therefore, others' experiences do not necessarily dictate that the United States should follow the same path.**

The countries we studied (Australia, Germany, Japan and the UK) differed greatly in the extent to which they weighed conflicting policy concerns, such as effects on domestic investment, residence decisions of MNCs, tax avoidance through profit shifting, the burden of the tax due upon repatriation of foreign profits, and taxation of inbound investments. Countries also differed as to their levels of concern about potential budgetary effects of corporate tax policy changes. We were somewhat surprised to discover that the policy decisions of the countries we studied do not appear to have been based on analysis of how foreign source income was effectively being taxed. In other words, the changes do not seem to have been driven by analysis of administrative data and seem, instead, to have been driven by anecdotal evidence to the extent decisions were “evidence based”.

**3. The tax policies of countries with dividend exemption systems have been greatly influenced by their separate individual circumstances.**

As a net capital importing country, Australia's main goal for its corporate tax has been to collect taxes from foreign corporate investors. There is less concern with treatment of outbound investment by Australian companies. Australia has an imputation system, which allows domestic, but not foreign shareholders, to claim credits for domestic but not foreign corporate taxes paid by Australian companies. This in part may reduce tax avoidance by Australian companies through shifting profits overseas, because Australian shareholders are not allowed credits if domestic corporate taxes have not been paid.

Germany adopted their dividend exemption system many years ago in order to foster foreign investment by German companies. Other European Union (EU) countries also had exemption systems, which influenced German practice. German anti-avoidance rules appear to be more effective than most in limiting profit shifting by German-based companies, except to the extent that these rules are limited to conform to EU rules.<sup>3</sup>

Japan adopted an exemption system in 2009 to make its companies more competitive and encourage them to bring back accrued overseas profits to Japan. The Japanese also believed that exemption would be simpler to administer than the system they had in place. A notable feature of the Japanese tax environment is a compliant international tax planning culture. Advisers report that Japanese MNCs are not aggressive tax planners. Accordingly, the Japanese government was not concerned that eliminating taxes on repatriated dividends would encourage income shifting and base erosion behavior by their MNCs. Japan did not enact any new anti-avoidance rules to accompany the switch to a territorial system and did not adopt a transition tax on repatriations from pre-effective date profits.

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<sup>3</sup> Germany is concerned about avoidance of German tax on inbound investment, which their rules to limit tax avoidance by German-resident companies cannot combat. There is a concern that this gives foreign companies a competitive advantage over domestic-based firms in the German market.

The United Kingdom went to a territorial tax system in 2010 and lowered their top corporate tax rate to 21 percent. It also enacted “patent box” legislation that reduced the tax rate on intangible income to 10 percent. Like Japan, the United Kingdom applied their new dividend exemption system to distributions of foreign earnings prior to the effective date. But the UK moves had much different motivations than the Japanese reforms. The United Kingdom was mainly concerned with losing corporate headquarters. This was facilitated by a number of factors including the proximity of the United Kingdom to other countries (Ireland, Luxembourg) with lower corporate tax rates and territorial systems, and the absence of any anti-inversion rules in the United Kingdom (and EU restrictions against adopting such rules). The United Kingdom was less concerned about tax avoidance and had close to the equivalence of an exemption system before the change because of rules that allowed their MNCs to return borrowed funds to their shareholders without paying the repatriation tax. In addition to tax competition from European countries for corporate headquarters, the decision of the United Kingdom to adopt dividend exemption seems to have been driven by requirements to satisfy European Court of Justice case law interpreting EU treaties and the recession brought on by the 2008 financial global crisis.

**4. The burden of the tax due upon repatriation of foreign earnings may be a lot higher in the United States than it was in the United Kingdom and Japan before they adopted dividend exemption systems.**

Deferral of U.S. tax allows foreign business income of U.S. MNCs to be taxed at a lower effective rate than it would be if it were earned in the United States. When combined with financial accounting rules that effectively treat deferred earnings as permanently exempt, deferral creates a “lockout” effect with associated efficiency costs. Corporations will engage in inefficient behavior --- they will take actions that they would not find attractive were it not for the tax --- to avoid the tax due upon repatriation and the associated reduction in after-tax book income. For example, a parent corporation that wants to invest in a project in the United States, distribute dividends to shareholders or buy back its shares may borrow at home instead of remitting foreign profits in order to extend the deferral of U.S tax on foreign earnings. This maneuver allows the U.S. parent to defer the U.S. corporate tax, but raises the cost of capital for domestic uses.

The burden of the tax on foreign subsidiary dividends is a key issue for understanding both the benefits and detriments of moving to a dividend exemption system and how the current system differs from dividend exemption.<sup>4</sup> The burden of the tax includes both the actual tax paid upon repatriation and the implicit costs of deferring income which likely increase as retentions abroad grow. These implicit costs include, for example, the cost of using parent debt to finance domestic projects as a substitute for foreign profits (which will increase as debt on the parent's balance sheet expands), payments to tax planners, foregone domestic investment opportunities and foreign acquisitions that may not have been undertaken in the absence of the tax.

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<sup>4</sup> Pressure from U.S. MNCs arguing that the burden was costly to their business operations and a desire by Congress to induce U.S. MNCs to reinvest accrued foreign profits in the United States resulted in a “repatriation tax holiday” in 2005. Not surprisingly, pressure for a similar tax holiday surfaced not long after the holiday expired and has continued.

In a recent paper, Harry Grubert of the U.S. Treasury Department and I used data from the U.S. Treasury tax files to derive an estimate of the cost of deferring foreign income that takes into account the growing stock of profits retained abroad.<sup>5,6</sup> This implicit cost can be thought of as the amount a company would be willing to pay to have the repatriation tax on an extra dollar of foreign earnings removed. Our work suggests that the implicit cost of the tax on foreign profits for a highly profitable company is about five to seven percentage points today. This burden is higher than previous estimates and increases as deferrals accumulate abroad.

As mentioned above, the United Kingdom and Japan allowed corporations to move foreign profits from affiliates to parents without any home country tax via subsidiary loans to or investment in parent corporations.<sup>7</sup> In those countries, it seems that it was relatively easy for parent corporations to access foreign profits without paying home country tax. The U.S. tax code, however, would treat such loans or investments as distributions with respect to stock and subject them to U.S. tax to the extent of un-repatriated earnings.

I am not aware of any estimates of the burden of repatriation taxes in the United Kingdom or Japan, but my understanding of their systems suggests that the burden of the tax on foreign dividends in those countries was much smaller than it is in the United States. For this reason, their decisions to eliminate the tax on active foreign earnings offer relatively little direct guidance for resolving the disagreement in the United States over the optimal approach to reducing this key burden of the current system.

**5. The fact that the United States raises relatively little corporate tax revenue as a share of GDP than other countries while having the highest statutory corporate rate in the OECD has multiple explanations and does not necessarily suggest that U.S.-based companies in any given industry are more aggressive at income-shifting than foreign-based companies.**

According to the OECD Tax Database, only Germany had a lower ratio of corporate receipts to GDP than the United States in 2012 (the most recent year reported).<sup>8</sup> This ratio was 1.8 percent for Germany, 2.5 percent for the United States, 2.7 percent for the UK, 3.7 percent for Japan and 5.2 percent for Australia. The United States had the second highest corporate rate at 39.1 percent (including subnational taxes) among the five countries in 2012 with Japan at the top at 39.5 percent. Germany and Australia had rates of 30.2 and 30 percent, respectively, and

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<sup>5</sup> See, Harry Grubert and Rosanne Altshuler, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," *National Tax Journal*, September 2013, 66(3), 671-712.

<sup>6</sup> A recent analysis reported in Bloomberg News estimates the stock of profits held abroad by U.S. companies at \$2.1 trillion. See <http://www.bloomberg.com/news/articles/2015-03-04/u-s-companies-are-stashing-2-1-trillion-overseas-to-avoid-taxes>.

<sup>7</sup> Section 956 of the Internal Revenue Code prevents companies from avoiding home country taxation while implicitly receiving the benefits of the foreign earnings of their controlled foreign affiliates through loans or investments in U.S. property by treating these transactions as constructive dividends. I am not aware of these types of rules being in place in any other OECD country.

<sup>8</sup> OECD, *Revenue Statistics 2014*, 2014, OECD Publishing, Paris, [http://www.oecd-ilibrary.org/taxation/revenue-statistics-2014\\_rev\\_stats-2014-en-fr](http://www.oecd-ilibrary.org/taxation/revenue-statistics-2014_rev_stats-2014-en-fr).

the United Kingdom had a rate 24 percent. (Since 2012, the Japanese rate has fallen to 37 percent and the rate in the United Kingdom has been reduced to 21 percent.)

One reason the United States raises little corporate revenue as a share of GDP with a relatively high corporate tax rate is that a relatively large share of business activity in the United States comes from firms that do not pay corporate income tax. We estimate that the United States among the five countries has the lowest share of business profits that comes from companies that are subject to a corporate profits tax (34 percent). Germany appears also to have a relatively low share of business profits subject to the corporate tax (45 percent). In contrast, very large shares of business profits in Japan (87 percent), Australia (82 percent), and the United Kingdom (80 percent) are subject to their country's corporate income tax.<sup>9</sup>

A second reason that the United States raises relatively little revenue as a share of GDP from corporate taxes in spite of its high statutory corporate rate is the extent of tax preferences it allows in relation to business income. Based on estimates and projections reported by the U.S. Office of Management and Budget, we calculate that corporate tax expenditures, excluding international provisions, will reduce U.S. corporate tax receipts by about 15 percent between fiscal years 2015 and 2019.<sup>10</sup> Including international provisions would raise this figure to 23 percent, but the major international tax expenditure, deferral, is less generous than the exemption of foreign-source income in the tax laws of the four comparison countries. While the domestic tax preferences reduce the effective U.S. corporate rate below the statutory rate, the effective corporate rate is also lower than the statutory rate in most other OECD countries, although less so. The ratio of the effective rate to statutory rates is slightly lower in the United States than it is for the four comparison countries.<sup>11</sup>

To what extent does income shifting explain the comparatively low level of corporate receipts as a share of GDP relative to the high U.S. statutory rate? The United States does have relatively large high-tech and pharmaceutical sectors, which are the ones mostly likely to have a large share of their capital in the form intangible assets that are easy to shift to entities in low-tax jurisdictions. While there is evidence of income shifting by U.S. companies, there are insufficient comparable data on companies from other countries to conclude that U.S. companies are more or less aggressive than their peer competitors from other countries.<sup>12</sup>

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<sup>9</sup> For further information and figures see Rosanne Altshuler, Stephen E. Shay, and Eric J. Toder, "Lessons the United States Can Learn from Other Countries' Territorial Systems for Taxing Income of Multinational Corporations," *Urban-Brookings Tax Policy Center Research Paper*, January 21, 2015, <http://www.taxpolicycenter.org/UploadedPDF/2000077-lessons-the-us-can-learn-from-other-countries.pdf>.

<sup>10</sup> U.S. Office of Management and Budget, *Analytical Perspectives: Budget of the United States Government, Fiscal Year 2015*, 2014, Table 14.2: 210-215.

<sup>11</sup> See Kevin A. Hassett and Aparna Mathur, "Report Card on Effective Corporate Tax Rates: U.S. Gets an F," American Enterprise Institute, February 9, 2011.

<sup>12</sup> For the most rigorous evidence of income shifting of U.S. multinational corporations, see Harry Grubert, "Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales are Being Globalized," *National Tax Journal*, June 2012. Grubert demonstrates using Treasury tax data that the differential between U.S. and foreign effective tax rates has a significant effect on the share of U.S. multinational income abroad and that this effect works primarily through changes in domestic and foreign profit margins and not through the location of sales.

## **6. The ability of the U.S. to retain higher corporate tax rates and tougher rules on foreign income is declining.**

The United States is subject to many of the same pressures facing other countries that have lowered corporate tax rates and have eliminated taxation of repatriated dividends. The United States faces growing competition as an investment location versus jurisdictions with lower corporate tax rates. U.S.-based MNCs face growing competition from MNCs based in countries with exemption systems.<sup>13</sup>

The advantages of foreign residence have increased incentives for some U.S.-based firms to “re-domicile” as foreign-based firms. The rising costs of repatriations as U.S. firms accumulate more cash overseas and foreign corporate income tax rates decline, combined with the ability of expatriated firms to circumvent taxes that would otherwise be payable on repatriations from accrued assets in U.S. controlled foreign subsidiaries puts increased pressure on firms to consider giving up U.S. residence.<sup>14</sup> And foreign-residence makes it easier for corporations to strip income out of the United States through earnings stripping techniques involving interest and royalties.<sup>15</sup>

The U.S. market is large and has enough unique productive resources that companies will invest here (albeit somewhat less) even if U.S. corporate rates are higher than elsewhere. The United States has some of the world’s leading MNCs with unique assets in certain areas (e.g., high-tech, finance, and retailing). But as the economic differences between the United States and other countries narrow and the United States share of world output declines, the ability of the United States to sustain “U.S. tax exceptionalism” will decline.

## **Conclusion**

In the last two decades differences between the United States and other countries' tax systems have widened. The United States is now the only major country that imposes a home country tax on foreign business income when it is returned to home country parents. And there are other ways that the United States has become more different that are also important: the United States is the only country that does not employ a VAT to raise revenues; statutory and effective tax rates around the world have continued to decline relative to U.S. rates, sharpening the “competitiveness” issue; and the share of business income in the United States that is taxed at the corporate level has been declining since the 1980s and today is less than 40 percent, while in most other countries business income is typically subject to corporate income tax. At the same time, emerging economies have acquired importance in international tax policy discussions and generally have adopted the perspective of a host country seeking to attract inbound investment.

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<sup>13</sup> No country, however, has a pure territorial system. Countries with territorial tax systems have adopted rules to prevent abuse and protect the corporate tax base and one must take these provisions into account when comparing the “competitiveness”, for example, of different systems. At least on the surface, however, it does appear that other countries anti-abuse rules are not more robust than U.S. rules (Brian J. Arnold, “A Comparative Perspective on the U.S. Controlled Foreign Corporation Rules,” *Tax Law Review*, Spring 2012).

<sup>14</sup> Edward D. Kleinbard, “Competitiveness Has Nothing to Do with It,” *Tax Notes*, September 1, 2014.

<sup>15</sup> Stephen E. Shay 2014. “Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations,” *Tax Notes*, July 28, 2014.

Accumulating evidence that MNCs are shifting more of their reported income to very low-tax countries is driving discussion of reform around the world and the OECD has initiated a Base Erosion and Profit Shifting project (BEPS) to develop coordinated actions to prevent the erosion of the corporate tax base.

There is no question that the global tax environment has changed greatly and will continue to do so. One of the lessons of my study with Stephen Shay and Eric Toder is that the United States need not follow others tax policies. But that does not mean that our reform process should be done in a vacuum. It is fundamental to understand the forces that have shaped the reforms of our competitors and recognize that while our economies are different we do, indeed, face many of the same pressures.

In a recent paper, Harry Grubert and I evaluated a variety of reforms and proposed one that makes improvements along a number of behavioral margins that are distorted under the current tax system.<sup>16</sup> We would start by eliminating the lockout effect by exempting all foreign earnings sent home via dividends from U.S. tax. This reduces wasteful tax planning and simplifies the system. Then we would impose a minimum tax of, say, 15 percent on foreign income. As a result, companies would lose some of the tax benefits they enjoy from placing valuable intellectual property like patents in tax havens and from other methods of income shifting. If companies continue to route income to havens, at least the U.S. would collect some revenue.

Our reform would restore some sanity to the system. For example, investments in low-tax countries are now effectively subsidized due to the opportunities for income shifting they create. Under our minimum tax reform these investments would face positive U.S. effective tax rates. The minimum tax could be imposed on a per country basis but it could also be on an overall basis which would be much simpler. As an alternative to an active business test, the tax could effectively exempt the normal profits companies earn on their investments abroad by allowing them to deduct their capital costs. That way the tax would apply only to foreign profits above the normal cost of capital and companies would not be discouraged from taking advantage of profitable opportunities abroad. Only “super” profits above the normal return --- typically generated from intellectual property--- that are most easily shifted would be subject to the minimum tax. There are other options. But my analysis with Harry Grubert suggests that combining a minimum tax with dividend exemption can make improvements across many dimensions including the lockout effect, income shifting, the choice of location and complexity.

I applaud the Senate Committee on Finance for holding this hearing on building a competitive U.S. international tax system and urge the Committee to tackle the challenge of reforming our system.

Thank you. I would be happy to answer any questions you may have.

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<sup>16</sup> Harry Grubert and Rosanne Altshuler, “Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax,” *National Tax Journal*, September 2013, 66(3), 671-712.