Testimony
Of
Stephen E. Shay
Professor of Practice
Harvard Law School

U.S. Senate Committee on Finance
Hearing on Building a Competitive U.S. International Tax System

March 17, 2015 10:00 a.m.

Chairman Hatch, Ranking Member Wyden, and Members of the Committee, it is a pleasure to appear before you today to discuss the subject of how to build a competitive U.S. international tax system. I am a Professor of Practice at Harvard Law School. I practiced international tax law as a partner at Ropes & Gray for over 2 decades and have served twice in the Treasury Department – the first time in the Reagan Administration throughout the process leading to the Tax Reform Act of 1986 and the second time as Deputy Assistant Secretary for International Tax Affairs in the first term of the Obama Administration.

I. Executive Summary

The major points I would like to make follow:

- A competitive tax system is one that is able to fund effectively public goods, such as education, basic research, infrastructure, income security transfers and defense, which support a high standard of living for all Americans.
- The income tax is an important counterweight to increasing inequality in income and wealth in America. The Committee should focus on tax reform policies that preserve and increase the income tax base, including the corporate tax base, to be able to maintain a politically acceptable progressive rate structure.
- There is no normative policy justification for advantaging international business income of multinational corporations (MNCs) beyond allowing a credit for foreign income taxes. Evidence suggests that the U.S. taxes U.S. MNCs' foreign business income too little and not too much. The evidence does not support a claim that U.S. MNCs are non-competitive as a consequence of U.S. international tax rules.
- I recommend the Committee consider the following reforms to improve taxation of international business income. These reforms could be adopted as part of or independently of a broader business tax reform:

- Adopt a minimum tax on U.S. MNCs foreign business income that is an advance payment against full U.S. tax when earnings are distributed from the foreign business.
- Strengthen U.S. corporate residence and earnings stripping rules.
- Reduce the U.S. tax advantages for portfolio investment in foreign stock over domestic stock.

II. Background Assumptions

The following are background assumptions that provide the context for the policies I recommend in this testimony.

- Even after taking account of recent spending limitations and revenue increases, the U.S. will continue to run a deficit, which is projected to expand in budget out years.
- Absent policy changes, the distribution of income and wealth in the U.S. will continue to shift toward the wealthy and the social and economic significance of income and wealth inequality will grow over time.
- Although global economic integration will continue, the global economy will expand as a result of increased population, investment and trade among the current actors (i.e., the emergence in recent decades of China, India and Brazil as major new economic participants will not be replicated). There will be further expansion of the reach and efficiency of wireless and electronic communications and increased reliance on the internet as a means of commerce.
- The effects of globalization in eroding national tax systems (including income and consumption taxes) will continue, but how far and how fast, and whether international tax systems can respond in a mutually cooperative and beneficial way, is uncertain.
- The U.S. will continue to rely on the personal income tax for the largest portion of its revenue. The U.S. income tax system will continue to rely on a partially-integrated corporate tax to protect the U.S. personal income tax base and to collect revenue from U.S. tax-exempt and foreign shareholders.
- Cross-border investment will continue to be dominated by MNCs and intercompany transfer pricing will be based on separate accounting.

III. Policy Benchmarks

A competitive income tax system. A well-functioning U.S. tax system should provide revenue for the public goods that support high-wage jobs, innovation, productive investment, income security for those in need and personal security from domestic and international threats. A competitive income tax system would have a broad base and a progressive rate structure that retains public support through apportioning tax burdens according to ability to pay. A well-designed tax system should be capable of fulfilling revenue needs, including unforeseen needs of war or other emergency, through simple and transparent adjustments to tax rates.

We should stop using the tax system as a back door tool to regulate the size of government and to make non-transparent de facto public expenditures for specific industries or interest groups. In all but a few cases, spending and appropriation are the appropriate mechanisms to address these issues openly and transparently. The collateral damage to the most efficient revenue raising system in the world from its use as a political football has been substantial.

Role of the income tax. For over 100 years, the income tax has played a key role in developed countries in achieving a fairer distribution of the costs of public goods among national populations.[1] The central feature of an income tax is to measure individuals' worldwide income, from labor and capital, and to tax individuals based on their ability to pay measured by total income. The United States, which relies more heavily on the income tax to raise revenue than most other countries, taxes the worldwide income of U.S. resident individuals including imposing tax on worldwide income of domestic corporations. Taxing U.S. MNCs foreign business income is important to achieve the desired ability-to-pay objectives of the U.S. Federal income tax.[2]

Factual paradigms underlying international tax rules have changed. International tax rules were formulated in a time when it could be assumed that income from business carried on through a foreign subsidiary in another country where goods and services were sold (the source country) would be taxed at rates comparable to the rates in the country of residence of the MNC. It was customary to organize a foreign subsidiary in each country where business was conducted in a bilateral relationship between the MNC residence country and each source country where business was conducted.

[1] *See* Thomas Piketty, CAPITAL IN THE 21ST CENTURY, 498 – 502 (Harvard Belknap 2013) (emphasizing the role of economic shocks from the World Wars in adoption of high progressive rates).

[2] There is dispute among economists regarding the extent to which corporate tax is borne by shareholders or by labor. Nonetheless, the Staff of the Joint Committee on Taxation and the U.S. Treasury allocate over 75 percent (75%) of the burden of the U.S. corporate tax to shareholders. *See* Staff of Joint Comm. on Taxation, *Modeling the Distribution of Taxes On Business Income*, at 4-5, 30 (JCX 14-13; 2013). Based on Federal Reserve data, at the end of the third quarter of 2014, approximately 16 percent (16%) of the equity in U.S. corporations (not just U.S. MNCs) was reported as owned by foreign residents leaving 84% to be owned by U.S. residents. *See* Board of Governors of the Federal Reserve System, *Financial Accounts Guide*, Table L.213 Corporate Equities, available at http://www.federalreserve.gov/releases/z1/current/z1r-4.pdf. Professor Sanchirico has questioned the ability to identify beneficial ownership of equities as a result of limitations in existing data sources and disclosures. See, Chris William Sanchirico, *As American as Apple Inc.: International Tax and Ownership Nationality*, 68 Tax L. Rev. (forthcoming). The issues Professor Sanchirico raises are important and the exact percentage of U.S. beneficial ownership of U.S. equities in fact is unclear. Moreover, even in the Federal Reserve data U.S. ownership has been trending slowly down in recent years, though it remains to be seen whether this will continue. Based on what we know, it nonetheless is likely that a fairly high percentage of shares in U.S. corporations is owned by U.S. residents.

The premise that a foreign subsidiary pays a tax comparable to a U.S. tax today is not just wrong, but very wrong for most U.S. MNC foreign subsidiary earnings. Based on 2006 tax return data, 45.9 percent (45.9%) of earnings of foreign subsidiaries that reported positive income and some foreign tax were taxed at a foreign effective rate of *less than* 10 percent (10%).[3] Such low foreign effective rates are not fully explained by lower foreign corporate tax rates in major U.S. trading partner countries, but also reflect ongoing MNC structuring to minimize tax by source and residence countries. Today, most international tax structures employ intermediary legal entities that do not bear a meaningful corporate tax because they are located in countries that facilitate very low effective tax rates on the income.[4]

The importance of taxing foreign business income. Taxing income earned abroad is necessary to prevent the simplest form of avoidance of U.S. residence taxing jurisdiction.[5] Aggregate and firm level financial data evidence substantial U.S. tax base erosion under current law.[6] As one firm level example, the staff of the Senate Permanent Subcommittee on Investigations found that Microsoft transferred rights to software developed in the United States to a subsidiary operating in Puerto Rico so that digital and physical copies could be made for sale to customers in the United States. In fiscal year 2011, Microsoft's Puerto Rican subsidiary booked over $4 billion of operating income for financial statement purposes and paid under 1 percent in tax (after paying $1.9 billion in cost sharing payments).[7] This income shifting from the United States is in the face of current transfer pricing regulations and Subpart F rules. As the Microsoft example demonstrates, one reason to tax foreign business income is to protect the U.S. tax base from erosion with respect to sales to U.S. customers.

---

[3] Harry Grubert and Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, 66 NAT. TAX J. 671, Table 3 at 699 (Sept. 2013). 53.9 percent (53.9%) of these foreign subsidiaries' income was taxed at a foreign effective rate of 15 percent (15%) or less and less than one quarter of these foreign subsidiaries' income was taxed at an effective foreign rate of 30 percent (30%) or more. *Id.*

[4] *See, e.g.*, Staff of Joint Comm. on Taxation, *Present Law And Background Related To Possible Income Shifting And Transfer Pricing*, at 122–127 (JCX 37-10; 2010) (In each of the six case studies, taxpayers use numerous intermediary legal entities to effect their tax avoidance strategies.); Leslie Wayne, Kelly Carr, Marina Walker Guevara, Mar Cabra & Michael Hudson, *Leaked Documents Expose Global Companies' Secret Tax Deals in Luxembourg*, INT'L CONSORTIUM OF INVESTIGATIVE JOURNALISTS (Nov. 5, 2014, 4:00 PM), available at http://www.icij.org/project/luxembourg-leaks/leaked-documents-expose-globalcompanies-secret-tax-deals-luxembourg (Luxembourg tax rulings for U.S. and non-U.S. MNE structures show multiple layers of companies).

[5] Daniel Shaviro, FIXING U.S. INTERNATIONAL TAX RULES 20-21 (Oxford 2014). Taxing worldwide income of U.S. citizens and residents has been upheld by the Supreme Court since the earliest days of the income tax. *Cook v. Tait*, 265 U.S. 47 (1924).

[6] *See* Harry Grubert, *Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized*, 65 NAT'L TAX J. 247 (2012).

[7] *See* U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Government Affairs, HEARING ON OFFSHORE PROFIT SHIFTING AND THE U.S. TAX CODE, Exhibit 1, Memorandum from Chairman Carl Levin and Senator Tom Coburn to Subcommittee Members, *Offshore Profit Shifting and the Internal Revenue Code*, 20-22 (Sept. 20, 2012) (hereinafter cited as "Levin and Coburn, *Memorandum on Microsoft and HP*") at http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code (last visited May 30, 2013). The Puerto Rican subsidiary had 177 employees whose compensation averaged $44,000. Intangible rights with respect to the software lay behind the Puerto Rican operation's claim to 47% of the operating profit on the U.S. sales.

There also is a need to protect the U.S. tax base in respect of sales to foreign customers. The pricing of U.S. intermediate goods and services with respect to sales to a foreign subsidiary, as well as the foreign subsidiary's non-U.S. sales, are subject to the same risk of U.S. tax base erosion. Even in cases where the foreign subsidiary is selling to another foreign subsidiary, a low level of tax on the income attracts profit-shifting investment because of the higher after-tax return and our transfer pricing rules are not capable of defending large effective tax rate differences. The combination of low-tax intermediary entities in countries enabling tax avoidance, transfer pricing and a range of other tax planning techniques are largely responsible for very low effective rates of tax on foreign income.

MNC competitiveness, lockout and dividend exemption. There is dispute whether U.S. MNCs are in fact tax disadvantaged under current law in relation to MNCs from other countries. The better case can be made that U.S. MNCs are advantaged, not disadvantaged.[8] It also has been argued that the large retentions of offshore earnings by U.S. MNCs' foreign subsidiaries are an important reason, if not the primary reason, to shift to a territorial tax system.[9] I respectfully disagree that the evidence we have supports that conclusion.[10] Adverse effects of offshore retentions on U.S. economic activity are very unclear and do not lead to a conclusion we should relieve foreign business income from taxation. Offshore earnings retentions could as readily be addressed with full current taxation of foreign business income. The minimum tax proposal I outline below also would relieve some pressure on repatriating offshore earnings.

Foreign parent MNC's U.S. tax advantages. Foreign parent MNCs use debt and other earnings stripping techniques (that generally are not available to U.S. MNCs) to reduce U.S. tax on U.S. economic activity.[11] Indeed, this tax avoidance opportunity has encouraged U.S. MNCs to shift their corporate residence outside the United States.[12] A clear policy objective should be to

---

[8] *See* J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption*, 59 EMORY L.J. 79, 85 (2009) (combination of deferral, defective source rules, foreign tax credits, weak transfer pricing and current use of branch losses give U.S. MNEs a net tax advantage over exemption country competitors); Edward D. Kleinbard, "'Competitiveness' Has Nothing to Do With It," 144 TAX NOTES 1055 (Sept. 1, 2014). The Administration's minimum tax proposal is estimated by Treasury to raise $206 billion over FY 2016-2025, but it would lose $103 billion from extending the active finance exception to Subpart F and other taxpayer favorable changes, for a net revenue gain of roughly $103 billion (before taking account of $268 billion from a one-time tax on pre-effective date earnings). The Camp proposal for a 95 percent (95%) dividend exemption was estimated to lose $212 billion for the period 2014-2023, but its Subpart F reforms would raise $116 billion over the same period for a net revenue loss of $96 billion over the period. With $170 billion of revenue from a one-time tax on pre-effective date earnings, however, the Camp proposal would levy in the budget period roughly $70 billion in additional tax on U.S. MNCs (compared with the Administration's roughly $371 billion). While there are questions about revenue effects beyond the budget period, these proposals arguably could be interpreted as representing an emerging consensus that U.S. MNCs should pay more tax on foreign income with the only remaining issues being how much more, how rules should be designed and what the revenue should be spent on.

[9] Republican Staff, Committee on Finance, United States Senate, TAX REFORM FOR 2015 AND BEYOND 254 (Dec. 2014).

[10] *See* Stephen E. Shay, *The Truthiness of 'Lockout': A Review of What We Know*, 146 TAX NOTES 1493 (Mar. 16, 2015).

neutralize a foreign parent MNC's advantage from using earnings stripping (which need not wait for passage of new legislation).

U.S. resident's foreign portfolio stock tax advantages. In addition to corporate tax reforms, it is important to re-examine individual shareholder level portfolio income taxation. If an objective is to protect the U.S. individual income tax base, U.S. individuals' portfolio investments in a foreign corporation should not be advantaged, as often is the case today, over a portfolio investment in a domestic corporation carrying on exactly the same global business. Today a U.S. individual portfolio shareholder in a foreign corporation bearing a low or no foreign corporate tax on foreign business income is more favorably taxed than the shareholder would be investing in the same business conducted through a domestic corporation. In a range of cases, this encourages individual and tax-exempt ownership of foreign rather than domestic equities and may indirectly contribute to shifting of corporate tax residence outside the United States. The taxation of dividends and gains from foreign portfolio equity investments should be reviewed and reformed under any of the international tax reform proposals.

IV. Policy Proposals

The preceding discussion leads me to recommend that the Committee consider the following proposals or areas for reform. Each of these ideas would address a current problem and would be helpful whether or not part of a more fundamental tax reform, but each also would work well as part of a broader reform.

Improve taxation of foreign business income

If the corporate rate were reduced materially, the first best choice would be to follow the Wyden-Coats proposal and tax foreign subsidiary earnings currently, in which case deductions allocable to foreign subsidiary earnings should be allowed in full.[13] I am skeptical that a lower corporate

---

[11] *See* J. Clifton Fleming, Robert J. Peroni and Stephen E. Shay, *Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytical Framework*, (forthcoming at 93 N. C. Law Rev. 101 (2015) (hereinafter "Fleming, Peroni and Shay, *Cross-Border Earnings Stripping*").

[12] Stephen E. Shay, *Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations*, 144 TAX NOTES 473, 479 (2014); U.S. Treasury Dep't, EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 21–22 (2007); Willard B. Taylor, Letter to the Editor, *A Comment on Eric Solomon's Article on Corporate Inversions*, 137 TAX NOTES 105, 105 (2012).

[13] The Administration and Chairman Camp have each proposed a form of minimum tax combined with a form of dividend exemption. An important difference between the proposals from a revenue perspective is the Administration's limitation of interest deductions allocable to foreign subsidiary earnings eligible for a reduced rate of tax. The Administration and Camp proposals also vary in other important details but share the attribute of allowing foreign income to be exempt from U.S. tax so long as it is subject to an effective rate of tax that is less than the U.S. rate. The effects of the Administration minimum tax are not easy to discern without a specific proposal, including a specific corporate tax rate, particularly because the Administration proposal incorporates an allowance for corporate equity (ACE). Both the Camp and Administration proposals adopt design choices that, in quite different ways, directly or indirectly target MNCs that possess intangibles. My experience as a tax planner leads me to be skeptical of targeting income categories, such as intangibles, or adopting special relief provisions like the

tax rate will be achieved in this Congress, yet I think it is very important to address U.S. MNCs base erosion and profit shifting. Accordingly, I suggest as a second best approach an advance minimum tax on foreign business income that could be adopted today or as part of a broader reform.

Under an advance minimum tax, a United States shareholder in a controlled foreign corporation (CFC) would be required to include in income (under the Code's Subpart F rules) the portion of the CFC's earnings that would result in a residual U.S. tax sufficient to achieve the target minimum effective tax rate on the CFC's current year earnings. The target minimum effective tax rate would be based on a percentage of the of the U.S corporate rate, so that it would adapt to changes in the U.S. corporate tax rate.[14] Deductions incurred by U.S. affiliates allocable to the CFC's earnings only would be allowed to the extent the CFC's earnings were actually or deemed distributed. For example, if the actual and deemed distributions caused 35% of the CFC's earnings to be distributed, then 35% of the deductions allocable to the CFC's income would be allowed and the remaining 65% would be suspended until the remaining earnings were distributed.

The earnings deemed distributed would be treated as previously taxed as under current law and would be available for distribution without a further U.S. tax (which would reduce pressure on earnings held abroad). An advance minimum tax structured in this way could be readily adapted under the current infrastructure of U.S. international tax rules and could replace existing Subpart F income categories, including those for foreign base company sales and services income. This proposal could be implemented without waiting for a broader tax reform and without relying on a material reduction to the final corporate tax rate.[15]

ACE, which experience in Belgium suggests can difficult to design to achieve intended objectives. *See* Ernesto Zangari, *Addressing the Debt Bias: A Comparison between the Belgian and the Italian ACE Systems* (Working Paper No. 44, European Commission Taxation Papers), available at *http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_44.pdf*. The U.S. experience with the Section 199 deduction for manufacturing activity provides another cautionary example of a misguided effort to target an ill-defined category. I suggest instead adopting a design for taxing foreign business income that is broader and does not exempt, as the Administration's ACE approach would, the primary layer of income from capital. With my co-authors Professors Fleming and Peroni, I have extensively critiqued a prior version of the Camp proposal and many of those observations remain relevant to the final proposal as well as to elements of the Administration proposal. Stephen E. Shay, J. Clifton Fleming, Jr. and Robert J. Peroni, *Territoriality in Search of Principles and Revenue: Camp and Enzi*, 141 Tax Notes 173 (Oct. 14, 2013) (hereinafter Shay, Fleming and Peroni, *Territoriality in Search of Principles*).

[14] The Obama Administration proposal for a final minimum tax would apply if a foreign effective rate is less than 22.35 percent (22.35%). If the Obama Administration is seeking to achieve a 28 percent (28%) corporate tax rate, a minimum effective tax rate of 22.35 percent (22.35%) would be approximately 80 percent (80%) of the domestic corporate tax rate. If the corporate tax rate remained 35 percent (35%), however, the minimum effective tax rate would be approximately 64 percent (64%) of the domestic tax rate.

[15] I also would be very concerned if the Administration's minimum tax proposal were "cherry-picked" and, for example, the deduction disallowance rule were not adopted or the minimum tax rate were reduced by even a few percent. Maintaining a full residual U.S. tax mitigates the substantial tax base risks of such changes in the course of the legislative process.

Strengthen corporate residence and U.S. source taxation rules

If taxation of foreign income is reformed, there will be greater pressure on U.S. corporations to change corporate residence. It is important to reconsider existing corporate residence rules beyond cases involving expatriating entities. The United States should consider broadening its definition of a resident corporation to provide that a foreign corporation would be U.S. tax resident if it satisfied either a shareholder residency test or the presently controlling place of incorporation test. I acknowledge that there currently are limitations on identifying ultimate owners of stock in publicly-traded companies, but identity of shareholders' or their tax residence already is used under the Code and it is feasible to increase the ability of corporations to learn shareholder identity information through reporting or other means. Importantly, linking corporate residence to greater than 50% control by U.S. tax residents would align corporate residence with the primary reason the U.S. seeks to impose a corporate tax which is to tax resident shareholders. There are important details to be worked out in designing a shareholder residence test, but I strongly encourage the Committee to pursue this avenue.

The first and most direct way to strengthen U.S. source taxation generally is through improved earnings stripping rules.[16] This has been the focus of the Treasury Department and I do not address details here except to emphasize that, unless addressed, U.S. MNCs will continue to attempt to shift corporate residence to take advantage of the U.S. tax reduction opportunities from earnings stripping.

Reduce U.S. tax advantages for portfolio investment in foreign over domestic stock

Under current U.S. tax law, a U.S. portfolio stock investor can earn a higher after-tax return on foreign business income earned through a foreign corporation than through a domestic corporation. In order not to favor a foreign corporation over a U.S. corporation in relation to foreign business income, at a minimum, foreign dividends should not qualify for a lower tax rate allowed for "qualified dividend income," or QDI, to the extent that the foreign corporate level effective tax rate is materially lower than the U.S. corporate tax rate.[17] In addition, the preferential capital gains rate (if retained) should be denied for stock gain attributable to the foreign corporation's non-U.S. earnings.[18]

---

[16] *See* Fleming, Peroni and Shay, *Cross-Border Earnings Stripping*, *supra* note 11.

[17] *See* Shay, Fleming and Peroni, *Territoriality in Search of Principles*, supra note * [13], at 163-165; *see also* A.B.A. Tax Sec. Task Force on International Tax Reform, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 698-699 (2006) (calling for reconsideration of the scope of QDI treatment for a dividend from a foreign corporation); *see also* Michael J. Graetz and Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 361 (2013).

[18] In addition, with respect to corporate managers of expatriated companies, if foreign taxes are imposed at lower rates than U.S. taxes, Section 457A-type restrictions on compensation deferrals could be extended to all cases where the deferred amounts are not subject to a corporate tax equivalent to the U.S. corporate tax.

A more fundamental alternative would be to determine the portfolio shareholder level U.S. tax on foreign earnings distributed from a foreign corporation in two parts. The first part would be a tax equal to the tax that would be paid on the foreign earnings if they were subject to domestic corporate tax including allowing foreign corporate-level taxes as a credit. This equalizing tax would be imposed on tax-exempt as well as taxable shareholders just as would occur in a domestic corporation. It is strange indeed to advantage investment by U.S. tax-exempts in foreign over U.S. corporations but that is the case today in relation to foreign corporations subject to low effective rates of tax.

The distributed earnings (reduced by that amount of tax as though it were a corporate-level tax), then would be subject to the normal U.S. tax rules for that dividend income.[19] The same mechanism could be applied to gains on the sale of foreign stock to the extent of untaxed deferred earnings.[20] This would mitigate the advantage to a U.S. portfolio shareholder of earning foreign income through a foreign corporation not subject to U.S. corporate level tax.

These modifications of shareholder taxation would bear on the corporate residence decision, particularly by domestic corporations that have a substantial U.S. shareholder base and may consider expatriation, not just in terms of the tax in connection with an expatriation, but in relation to ongoing shareholders. More generally, we need to scrutinize all of our international rules more closely to see where we may inadvertently be favoring non-U.S. over U.S. economic activity.

IV. Conclusion

International business income is but a part of the larger mosaic that comprises the U.S. economy. There is no normative reason to privilege foreign business income beyond allowing a credit for foreign income taxes. If any group of taxpayers does not bear its share of tax, others must make up the difference sooner or, if the deficit is debt-financed, later. The efforts of former Chairmen Camp and Baucus to lower tax rates in a revenue neutral tax reform illustrates the necessity of maintaining and expanding the tax base, including foreign business income of U.S. MNCs. Dynamic scoring will not alter this fundamental reality.

---

[19] The surrogate for a corporate level tax would apply to a U.S. portfolio shareholder that is a U.S. tax-exempt organization, just as a U.S. corporate level tax would apply in relation to earnings of a domestic corporation. The taxing structure described is used in current law I.R.C. §962, which permits an individual U.S. shareholder in a CFC to elect to take a credit for a foreign corporate tax against the U.S. tax on a Subpart F inclusion, but conditions the election on (i) the shareholder being subject to a notional U.S. corporate level tax against which the foreign corporate tax is credited, and (ii) the shareholder being subject to normal U.S. tax when the earnings are actually distributed (though reduced by any additional tax paid under (i)). The Section 962 election is rarely used under current law. A U.S. portfolio shareholder owning less than 10 percent (10%) by voting power of the foreign corporation could be allowed to rely on the foreign corporation's published financial statements to make reasonable estimates of retained earnings and foreign taxes. In the absence of such information, gain would be attributed to earnings.

[20] A similar deemed corporate level tax is used as a limitation on the tax of an individual U.S. shareholder on dividend treatment of stock sale gain under Section 1248. See I.R.C. §1248(b).

In no area of business are tax planning skills more acute and heavily deployed to take advantage of exceptions, special deductions and lower effective rates than in relation to earning cross-border business income. My recommendation is to tax foreign business income broadly and allow a credit for foreign income taxes. It always is possible to relieve a tax rule; it is very difficult in our system to make a tax rule tougher. I encourage you not to gamble with dividend exemption or an ACE deduction when there are more established and less risky ways to address the actual problems.

I would be pleased to answer any questions the Committee might have.