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SENATE FINANCE COMMITTEE HEARING
ON INTERNATIONAL TAX: OECD BEPS & STATE AID

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Chairman Hatch, Ranking Member Wyden, and distinguished members of the Committee, I appreciate the opportunity to appear this afternoon as the Committee considers the OECD's project on "base erosion and profit shifting" and the European Commission's inquiries into "State Aid." I'd like to compliment the Committee for holding today's hearing. The subject is of considerable import to the U.S. tax base and tax administration. In addition to having 20 years of experience with various accounting and law firms advising businesses on tax matters, from January 2010 until July of 2014, I had the honor of serving as the Deputy Commissioner (International) in the Large Business and International division at the Internal Revenue Service. In that position, I was responsible for the IRS's international enforcement programs and served as the U.S. competent authority under our bilateral tax conventions. As competent authority, my team and I represented the United States on all cross-border matters pertaining to dispute resolution, treaty interpretation, and information exchange. From 1995 to 2000, I also had the honor of serving as the Associate Chief Counsel (International) at the IRS, where my team and I were responsible for all legal matters pertaining to U.S. international tax laws and tax treaties. The effect of the BEPS project on tax administration will be the focus of my testimony.

Currently, I am a tax Principal at PricewaterhouseCoopers LLP in the firm's Washington National Tax Services practice. I appear here today, however, on my own behalf and not on behalf of PwC or any client of the firm. Therefore, the views that I express are entirely my own.

The subject of today's hearing – BEPS and State Aid – is both broad and complex. The OECD BEPS project has called for numerous changes to the laws and policies guiding the taxation of multinational businesses. In my view, however, the most important effect of the BEPS project in the near term is likely to be on international tax enforcement activities around the world, and this, in turn, will create a serious challenge for both U.S.-based multinational businesses and the U.S. government. Further, I believe this more practical impact on international enforcement may well cause an erosion of the U.S. tax base. I will focus my testimony on the reasons for this view.

Before I begin, I'd like to offer my compliments to Mr. Stack and his team at the Treasury Department. The BEPS project seemed threatening of U.S. interests from the start, and Mr. Stack's diligent efforts to bring balance and wisdom to the project are greatly appreciated.

I'll begin by observing that the scope of the BEPS project and the timetable set for completing the work were extraordinarily ambitious. In addition, the OECD invited participation by non-OECD member countries that brought new points of view to the table. As a consequence, it isn't surprising that the papers issued on October 5th of this year do not reflect a true global consensus on many of the difficult issues that were evaluated. The papers achieve consensus in some respects by merely providing governments with options to address the issues in question. In other respects, they draw conclusions based on new concepts that are ambiguous and that could be read to mean any number of things to countries seeking to enlarge their tax bases. In still other respects, the work is unfinished. In addition, many of the recommendations coming out of the project will need to be implemented by each country through changes in law, regulations, or treaties, and these haven't happened yet. So in important ways,

we just don't know what the new policies will be in each country. Despite its accomplishments, the BEPS project has created significant ambiguities and considerable uncertainty.

Creating uncertainty regarding how tax compliance will be measured in a particular area is not necessarily a poor way for governments to proceed if the effort is targeted at specific practices that clearly should be ended. In other words, governments can and often do create ambiguity about how a particular law will work going forward as a means of addressing specific situations where the intent of current law is clearly being circumvented. If BEPS were focused on ending a specific kind of abusive tax planning, then perhaps the uncertainty the project has created would be less objectionable, and companies would be advised to react by moving out of the identified structures before the new standards crystalize.

The problem, though, is that the October 5th papers are not aimed at what might be fairly referred to as abusive. Rather, the papers will have the effect of broadening the collective corporate tax base and providing countries with new ways to claim a bigger share of that corporate base. The papers also break down the previously accepted view that each corporate entity in an affiliated multinational group should be regarded as a separate taxpayer that is taxed based on the risks it takes, the assets it owns, and the functions it performs. In this regard, the papers edge toward the concept that a multinational group should be viewed as an integrated whole. The risk is that the multinational group's profits will be divided among the countries in which it conducts business not based on the arm's-length principle that has guided international taxation for decades, but based on what each government perceives to be the value contributed by the part of the enterprise operating within its borders.

I don't intend to explore these policy changes today. Rather, I want to focus on the implications of setting forth broad and ambiguous concepts without taking the time to work through the ambiguities, which is essential to proper implementation and administration of the concepts. In my estimation, it is inevitable that countries will begin to assert these new concepts through enforcement actions, guided by their own interpretations and with their own revenue collection interests in mind. Indeed, this is already happening around the world. I hear stories from clients about it nearly every day. Unlike IRS agents, examining agents in other countries often are driven by particular revenue collection metrics, and the BEPS project has for them has established new goals. In the best of circumstances, it is a challenge for taxing authorities to administer policy nuances and act with caution when rules are unclear; and if examining agents are told they're not collecting enough revenue, we should expect that they will construe ambiguity in their own favor.

As a result, many are predicting that the BEPS project will lead to far more aggressive tax enforcement efforts targeted at multinational companies, many of which are headquartered in the United States. Further, because the BEPS project provides concepts that can be used to expand the revenue base of almost any country, the resulting threat is widespread double taxation. Allow me to explain the double taxation threat because it's critical. When an examining agent adjusts the profits of a multinational business, the adjustment can, and often does, mean the adjusted profits could be taxed twice – once by the country making the adjustment and once by the country in which the profits were originally reported. In my view, increased instances of double, or even multiple, taxation is an unintended but very real threat flowing from the BEPS reports.

The U.S. network of tax treaties is, of course, designed to eliminate double taxation so as not to impede cross-border business, and all countries agree that double taxation is wrong as matter of policy. But when double taxation is created by one country's enforcement action, it isn't automatically eliminated

by a rule in a treaty. Rather, the case is presented by the taxpayer to the designated competent authorities of the two jurisdictions involved, and those competent authorities seek to arrive at a principle-based settlement to ensure that the profits of the business are taxed only once. But this so-called mutual agreement procedure is far from easy to conduct. As I mentioned at the outset, I had the honor to serve as the U.S. competent authority for a number of years and feel the need to convey to this body why I am so worried about the BEPS project from that perspective.

At the competent authority negotiating table, the country that makes the adjustment has the greater leverage. That country is in a position to enforce its determination at will, and in some cases the tax has already been collected and the country can be quite reluctant to negotiate in good faith. The other country – the one where the profits were originally reported – can only attempt to convince the adjusting country to withdraw or reduce the adjustment by pointing to well-established international principles. This can be a difficult under normal circumstances, but where the underlying principles are unclear, the effort may well be a losing one.

If we were to roll back the clock to the 1990s, we would find that the United States was the first, and for a while the only, country in the world attempting to police income shifting through transfer pricing audits. As a result, the cases in front of competent authorities at the time were largely the result of IRS-proposed adjustments to increase profits reported in the United States. Since then, the situation has changed dramatically. When I left my position, in July of 2014, well over 80 percent of the mutual agreement cases in inventory were the result of foreign-initiated adjustments on U.S.-based companies; and this, even though U.S. companies typically do not attempt to shift profits to the United States from foreign countries where tax rates generally are lower. Regardless, foreign tax authorities increasingly have been seeking to tax profits reported and taxed in the United States and it can be difficult for the U.S. competent authority to convince the other government to accede to the taxpayer's reported position – even by pointing to principles that are well-established. In my estimation, in the post-BEPS world, this challenge will grow exponentially. The risk is that, with ambiguous new principles, governments will be even less willing to concede their adjustments despite another government's objection.

In the near term, there is little that can be done to ameliorate the enforcement problem I describe. Eliminating the ambiguities in the BEPS papers will take a long period of time, and in the meantime, the rhetoric that has driven the BEPS project will continue to affect how taxing authorities administer the law. While there was a need to examine the international rules to ensure consensus, I believe rhetoric to the effect that *governments must do something about BEPS quickly* negatively impacted the goal of achieving the consensus that is needed. In the near term, experience suggests that what governments will do quickly is seek to collect more revenue through enforcement actions against foreign-based businesses. Without clear principles to guide these enforcement actions, the result will be more disputes that will be more difficult to resolve.

In the meantime, two things can be done. One is to ensure the IRS competent authority is equipped to handle the increased challenges that lie ahead. The second is to reform the U.S. international tax rules. Making rapid changes in U.S. policy, however, will not, in my view, reverse the enforcement problem. Lowering the U.S. corporate tax rate and reforming our international system is critical. But even if such changes are made, other taxing authorities will be looking to tax a bigger share of a bigger pie, and that will not be stopped through U.S. legislative change.

In summary, major multinational companies all around the world likely will face the problems I am describing. While there seems to be a target unfairly painted on the backs of U.S. companies, taxing authorities will seek to tax a larger share of global profits by pursuing what Senator Russell Long referred to as “that fellow behind the tree.” That fellow will include foreign-based multinational companies as well as those based here in the United States. There is, however, an important difference between U.S. companies and foreign companies in this respect. As we all know, the United States has a worldwide system with credits provided for foreign taxes paid, not a so-called “exemption” or “territorial system.” This means that we allow a tax credit against U.S. taxes on income for foreign taxes imposed on that same income, including those imposed through foreign audits without a principled basis. So if the U.S. competent authority does not have the resources to handle the tsunami of new double tax cases predicted by many, or if the IRS cannot successfully convince foreign governments that their adjustments are wrong by pointing to well-established principles, U.S. companies generally won’t bear the resulting double taxation. Instead, companies will be entitled to take a credit for the adjusted foreign taxes in the United States and the U.S. tax base will be eroded as a result.

Chairman Hatch, Ranking Member Wyden, and other distinguished members of the Committee. I thank you again for the opportunity to be here today, and I would be happy to answer any questions you may have.