S. HRG. 114–389

INTERNATIONAL TAX: OECD BEPS AND EU STATE AID

HEARING

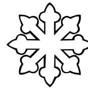
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

DECEMBER 1, 2015



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PUBLISHING OFFICE

22–145—PDF WASHINGTON : 2016

For sale by the Superintendent of Documents, U.S. Government Publishing Office
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CONTENTS

OPENING STATEMENTS

	Page
Hatch, Hon. Orrin G., a U.S. Senator from Utah, chairman, Committee on Finance	1
Wyden, Hon. Ron, a U.S. Senator from Oregon	3

WITNESSES

Stack, Robert B., Deputy Assistant Secretary for International Tax Affairs, Department of the Treasury, Washington, DC	6
Coleman, Dorothy, vice president for tax and domestic economic policy, National Association of Manufacturers, Washington, DC	8
Danilack, Michael, principal, PricewaterhouseCoopers LLP, Washington, DC	10

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Coleman, Dorothy:	
Testimony	8
Prepared statement	33
Responses to questions from committee members	36
Danilack, Michael:	
Testimony	10
Prepared statement	41
Responses to questions from committee members	43
Hatch, Hon. Orrin G.:	
Opening statement	1
Prepared statement	46
Stack, Robert B.:	
Testimony	6
Prepared statement	48
Responses to questions from committee members	54
Wyden, Hon. Ron:	
Opening statement	3

COMMUNICATIONS

Business and Industry Advisory Committee to the OECD	63
Center for Freedom and Prosperity	70
Motion Picture Association of America	75
Tax Innovation Equality (TIE) Coalition	78

INTERNATIONAL TAX: OECD BEPS AND EU STATE AID

TUESDAY, DECEMBER 1, 2015

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:49 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Orrin G. Hatch (chairman of the committee) presiding.

Present: Senators Grassley, Crapo, Thune, Portman, Scott, Wyden, Stabenow, Carper, Cardin, Brown, Bennet, Casey, and Warner.

Also present: Republican Staff: Chris Campbell, Staff Director; Tony Coughlan, Tax Counsel; Eric Oman, Senior Policy Advisor for Tax and Accounting; and Jeff Wrase, Chief Economist. Democratic Staff: Todd Metcalf, Chief Tax Counsel; and Tiffany Smith, Senior Tax Counsel.

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order. I want to welcome everyone here this afternoon and thank you all for attending this important hearing on international taxation, focusing particularly on the Organisation for Economic Co-operation and Development's, or OECD's, project on Base Erosion and Profit Shifting, or BEPS.

The overall discussion about international tax is very timely. Just a couple of weeks ago, we were informed that a major American pharmaceutical company had decided to invert, meaning merging with another drug company with the headquarters in a newly formed corporation to be located in a foreign country.

Of course, this is nothing new. We have been seeing these types of transactions take place for some time. Inversions like these are some of the clearest examples of base erosion, and are largely motivated by tax considerations as American companies determine that they can reduce their overall operating costs if they become foreign corporations.

Given the burdensome and anti-competitive nature of the U.S. tax code, these companies are, unfortunately, not acting irrationally. The administration's response to the wave of inversions has, in my opinion, been very shortsighted, focusing only on the symptoms rather than on the underlying illness.

While the latest guidance from Treasury might very well stem the tide of inversions, it will leave other, potentially more harmful

avenues for tax avoidance—like foreign takeovers—wide open, and perhaps even make them more attractive than they are now. Long story short, any steps we take to address inversions should focus on fixing the shortcomings of the underlying system and make the U.S. a better place for companies to do business.

The BEPS project is another effort aimed at addressing international tax problems and base erosion. But on a more global scale, the purpose of the project was to provide OECD member countries with recommendations for both domestic tax policy changes and amendments to existing tax treaties to address business practices that do result in base erosion.

After several years of discussion, the OECD released its final reports earlier this year, and last month, leaders from the G20 countries endorsed the recommendations. Throughout this process, we have heard concerns from large sectors of the business community that the BEPS project could be used to further undermine our Nation's competitiveness and unfairly subject U.S. companies to greater tax liabilities abroad.

Companies have also been concerned about various reporting requirements that could impose significant compliance costs on American businesses and force them to share highly sensitive, proprietary information with foreign governments. I expect that we will hear about these concerns from the business community and others during today's hearing.

In addition, throughout the BEPS negotiations, I urged the Obama administration to both acknowledge the limits of their authority under the law and to cooperate with Congress on any and all efforts to implement the recommendations. And, while the U.S. was a party to the BEPS negotiations, Congress had neither a seat at the negotiating table nor a meaningful opportunity to weigh in with the administration on the substance of these proposals.

However, it is Congress, and Congress alone, that has the ultimate authority to make changes to the U.S. tax code. And while the Treasury Department does have broad regulatory authority under the law, that power is not without limits.

Even in those areas where authority clearly exists for the administration to promulgate regulations, it is virtually always better if Congress is viewed as a partner in this process, rather than an adversary. And in those instances where the regulatory authority is less clear, congressional involvement and approval is even more important to ensure that policy changes are viewed by the public as legitimate.

Of course, most of this should go without saying. It is, after all, a basic lesson in government, and I do not think anyone here is in need of a civics refresher course from me. However, I think it also goes without saying that the current administration has not always viewed Congress as a necessary or even important part of its efforts to develop and implement policy changes.

So I think it is, at the very least, helpful to offer a brief reminder to everyone that Congress has a role to play on these issues that cannot be overlooked. That is another set of concerns that I expect we will discuss during this hearing.

We have a representative from Treasury here today, so I am looking forward to getting a better sense of what elements of the

BEPS recommendations the administration believes it can implement unilaterally and where they believe congressional action will be necessary.

I also want to note that I have asked the Government Accountability Office to provide its own analysis on the BEPS recommendations, taking into account all of the complex elements, both domestic and global, that are implicated with these types of policy changes. And I expect their work will take some time, but gathering this type of information is, in my view, an essential part of our overall evaluation of the BEPS project.

There are other topics that I expect will come up today, including a discussion of so-called "state aid" remedies and recent activities in the eurozone that to me look like attempts to impose retroactive taxation on multinational enterprises, including a number of U.S.-based companies.

Speaking more broadly, I just want to say that when it comes to international tax issues, I hope we can all have the same goals in mind. I would hope that we all want to improve conditions for American businesses, and I would hope that we would all want to make our country more competitive on the world stage.

And to that end, I would hope that we all want to improve the overall health of the U.S. economy. That is why all of us are here today—or at least it should be. Any regulations promulgated by this administration to prevent businesses from moving offshore should have these goals in mind.

At the same time, while international efforts to align tax systems are worth exploring, we should not be negotiating agreements that undermine our own interests for the sake of some supposedly higher or nobler cause. The interests of the United States, our own economy, our own workers, and our own job creators, should be our sole focus.

So, throughout the day's discussion, whether we are talking about BEPS, inversions, or any other international tax issues, I am most interested in hearing views as to how various policies and proposals will or will not serve our Nation's interests and advance these important goals.

Long story short, we have quite a bit to talk about today, and we have a distinguished panel of witnesses who should be able to shed some light on these complicated issues. So I look forward to their testimony.*

With that, I will turn to Senator Wyden for his opening remarks.

[The prepared statement of Chairman Hatch appears in the appendix.]

OPENING STATEMENT OF HON. RON WYDEN, A U.S. SENATOR FROM OREGON

Senator WYDEN. Thank you very much, Mr. Chairman, and, Mr. Chairman, thank you for holding this hearing. I think you describe it very appropriately in saying that it is especially timely.

And the reality, colleagues, is that the inversion virus is growing. The inversion virus is mutating, and nothing could prove that more

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*For more information, *see also,* "Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project," Joint Committee on Taxaton staff report, November 30, 2015 (JCX–139–15), *https://www.jct.gov/publications.html?func=startdown&id=4853.*

clearly than what we saw just a few days ago, with Pfizer merging with Allergan and moving its headquarters overseas in pursuit of a lower tax bill.

Now, we are doing some checking, but I believe this is the biggest inversion to date. This is the biggest one on record—and we will have the recorder note that Mr. Stack nodded his head, quietly, yes. So I think that that gives me some added validation.

But kidding aside, the point is, the Pfizer move is clear proof of what everybody in this room knows, and that is that the American tax code is a broken, dysfunctional mess, and it is a drag on the American economy.

So we are now coming together for the third time in 18 months to examine the need for international tax reform. In that time, the Treasury Department has taken multiple steps to slow the spread of the inversion virus, but there is only so much that the Treasury Department can do to quarantine the problem. We are going to need comprehensive tax reform.

And while the broken tax code sits in place, something of an antiquated monument to a different economic era, essentially the sand shifts around it, and more and more of the country's tax base erodes into this kind of international sea of harmful tax practices and ruinous competition.

And my guess is, until the Congress has the political will to do what has to be done, these inversions are going to continue. And my guess is the Pfizer inversion will not be the last, and it will not be the largest. And foreign governments are going to continue to use our obsolete tax code against our country by agreeing to give certain companies what amount to sweetheart deals to locate within their borders.

Now, as matters have just continued to spin out of control, the largest economies in the world, through the G20 and the OECD, came together for a very significant tax policy project known as the Base Erosion and Profit Shifting discussion. And what they sought to do is come up with—and this is really their singular goal: to make it harder to game the system.

Now, when it comes to these kinds of proposals, there are some big questions that you have to get into right at the outset. And certainly, they are going to take a lot of study by the Congress.

I do want to commend our Treasury witness, Mr. Stack. He has tried very hard to advocate our interests, the American interests, in these discussions. And obviously, as Mr. Stack will tell you, he has had a very steep hill to climb in these discussions, and we appreciate his efforts.

Now, Chairman Hatch mentioned this question of unlawful state aid. What we are really talking about is very aggressive actions taken by the European Commission. And they call it unlawful state aid, but what it really looks like to me is tax-planning strategies that our broken tax code is driving our companies to go out and pursue.

So, from the standpoint of a bottom line, here is mine: if you shudder, colleagues, at these tax-avoidance schemes; if you really get angry about matters like the double Irish with a Dutch sandwich; if you want to crack down on it, you have to be for comprehensive tax reform. If you want to give companies a reason to

invest and grow and headquarter in the United States, the path to reach those goals is major tax reform.

And I do not see our colleague, Senator Coats, with us, but he and I have worked together. I have worked with Senator Gregg. I have worked with Senator Hatch. I want it clear that I think Senators on both sides of the aisle want to move forward on this, and the sooner we get to it, the better.

And, Mr. Chairman, also, an apology at this point. We are beginning the reconciliation on the floor, and I am going to have to be there for my portion of it here in a few minutes. But I just want it clear that I am looking forward to working with you in a bipartisan way and with our colleagues on both sides of the aisle.

The CHAIRMAN. Well, thank you, Senator Wyden. We appreciate it.

Now I would like to take a few minutes to introduce our distinguished panel of witnesses.

First, we will hear from Assistant Secretary Robert Stack, who covers international tax affairs issues in the Office of Tax Policy at the Department of the Treasury. Mr. Stack serves as the U.S. Delegate to the Committee on Fiscal Affairs in the OECD. Mr. Stack has over 26 years of private-sector experience in international tax matters, representing both corporations and individuals. Mr. Stack is a graduate from Georgetown University Law Center, where he was editor-in-chief of the Georgetown Law Journal.

Second, we will hear from Dorothy Coleman, vice president of tax and domestic economic policy at the National Association of Manufacturers, or NAM. Ms. Coleman has served in her current position for more than 15 years, bringing a wealth of knowledge and experience. She has also worked for a major accounting firm and in the tax press. Ms. Coleman received her law degree from Georgetown University Law Center and her bachelor of arts in economics from Manhattanville College in Purchase, NY.

Finally, we will hear from Michael Danilack, a principal at PricewaterhouseCoopers, or PwC. Mr. Danilack currently works in PwC's Washington national tax services practice and focuses specifically on international tax issues. Before joining PwC in 2014, Mr. Danilack served as the Deputy Commissioner in the IRS Large Business and International Division, where he was responsible for all international tax matters for the IRS, including serving as the U.S. competent authority. He also served for 6 years as an assistant to the IRS Commissioner and then as IRS Associate Chief Counsel for International Matters. Mr. Danilack earned a B.A. from the University of Pennsylvania and a J.D., as well as an LL.M., from New York University School of Law.

I want to thank each of these distinguished witnesses for being here today, but more especially for their hard work and dedication, especially as they prepared for this hearing over the Thanksgiving holiday.

Mr. Stack, we will start with you. If you will proceed with your opening statement, we would appreciate it.

OPENING STATEMENT OF ROBERT B. STACK, DEPUTY ASSISTANT SECRETARY FOR INTERNATIONAL TAX AFFAIRS, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. STACK. Thank you, Mr. Chairman. Chairman Hatch, Ranking Member Wyden, and distinguished members of the committee, I appreciate the opportunity to appear today to discuss some key international tax issues, including the recently completed G20 OECD Base Erosion and Profit Shifting, or BEPS, program.

In June 2012 at the G20 Summit in Los Cabos, Mexico, the leaders of the world's largest economies identified the ability of multinational companies to reduce their tax bills by shifting income into low- and no-tax jurisdictions as a significant global concern. They instructed their governments to develop an action plan to address these issues, which was endorsed by the G20 leaders in St. Petersburg in 2013. The project came to fruition this fall with the presentation of the final reports to the G20.

The BEPS project covers 15 separate topics. Some reports, such as those on the digital economy and controlled foreign corporations, are more or less descriptive of the underlying issues and discuss approaches or options that countries might take without demonstrating any agreement among participants on a particular path. Other reports, such as those on interest deductibility and hybrid mixed securities, describe the elements of a common approach that countries might take with respect to those issues.

With respect to transfer pricing, the arm's-length standard was further amplified in connection with issues around funding, risk, and hard-to-value intangibles. Finally, in the areas of preventing treaty shopping, requiring country-by-country reporting, fighting harmful tax practices—including through the exchange of cross-border tax rulings—and improving dispute resolution, countries agreed to a minimum standard.

I believe that the transparency provided by country-by-country reporting that tightens the transfer pricing rules and the agreement to exchange cross-border tax rulings will go a long way to curtail the phenomenon of stateless income that pushed the BEPS program forward. Companies will very likely be reluctant to show on their country-by-country reports substantial amounts of income in low- or no-tax jurisdictions, and the transfer pricing work will better align profits with the functions, assets, and risks that create that profit.

The exchange of rulings on cross-border matters will drive out bad practices and shine sunlight on the practices that remain. The improvement of dispute resolution and the inclusion, where possible, of arbitration will streamline dispute resolution and should thereby reduce instances of double taxation.

So where do we go from here? Well, certain technical work remains for the OECD in 2016 and beyond, and the OECD will turn its attention to implementation and monitoring of the various BEPS deliverables on the action items. More importantly, however, we believe that the best way to foster the G20 goal of supporting global growth is to actively promote the connection between foreign direct investment, growth, and efficient and effective tax administration built on the rule of law. We are working hard to ensure

that issues around effective and fair tax administration around the world are made part of the post-BEPS agenda.

The BEPS project was one manifestation of global concern about international tax issues, and the EU state aid investigations are another. In 2014, the European Commission opened four in-depth investigations to examine whether decisions by tax authorities in Ireland, the Netherlands, and Luxembourg with regard to corporate income tax paid by Apple, Starbucks, Fiat Finance and Trade, and Amazon complied with EU rules on state aid.

On October 21, 2015, the EU Commission announced its conclusions that Luxembourg has granted selective tax advantages to Fiat's financing company, and the Netherlands has granted selective tax advantages to Starbucks Coffee Roasting Company in the Netherlands. U.S. companies are reported to be the subject of still more investigations.

Treasury has followed the state aid cases closely for a number of reasons. First, we are concerned that the EU Commission appears to be disproportionately targeting U.S. companies.

Second, these actions potentially undermine our rights under our tax treaties with European member states. The United States has a network of income tax treaties with the member states and has no income tax treaty with the EU, because income tax is a matter of member-state competence, under EU law.

While these cases are being billed as cases of illegal state subsidies under EU law, or state aid, we are concerned that the EU Commission is, in effect, telling member states how they should have applied their own tax laws over a 10-year period. Plainly, the assertion of such broad power with respect to an income tax matter calls into question the finality of U.S. taxpayers' dealing with member states, as well as the U.S. Government's treaties with member states in the area of income taxation.

Third, the EU Commission is, by all accounts, taking a novel approach to the state aid issue, yet they have chosen to apply this new approach retroactively rather than only prospectively.

While in the Starbucks case, the sums were relatively modest—20 to 30 million euros—they may be substantially larger, perhaps in the billions, in other cases. The retroactive application of a novel interpretation of EU law calls into question the basic fairness of the proceedings.

Fourth, while the IRS and Treasury have not yet analyzed the equally novel foreign tax credit issues raised by the payments that may be required under these cases, it is possible that the settlement payments ultimately could be determined to give rise to creditable foreign taxes. If so, U.S. taxpayers would wind up footing the bill for these state aid settlements when the affected U.S. taxpayers' companies either repatriate amounts voluntarily, or Congress requires a deemed repatriation as a part of tax reform, unless U.S. taxes are paid on the repatriated amounts on account of the higher creditable taxes.

Finally—and this relates to the EU's apparent substantive position in these cases—we are greatly concerned that the EU Commission is reaching out to tax income that no member state had the right to tax under internationally accepted standards.

Let me close with a quick reference to the topic of inversions. As you are aware, the IRS and Treasury last week issued Notice 2015-79 to deter and reduce further the economic benefits of corporate inversions.

Treasury will continue to examine additional ways to reduce the tax benefits of inversions, including through limiting the ability of inverted companies to strip earnings with inter-company debt. However, only legislation can effectively address these issues. To this point, we look forward to working with Congress in a bipartisan manner to protect the U.S. tax base, to address the issue of corporate inversions, and to reform our business tax system.

Let me repeat our appreciation for the committee's interest in these important issues. I would be happy to answer any questions that you may have.

Thank you.

The CHAIRMAN. Thank you, Mr. Stack.

[The prepared statement of Mr. Stack appears in the appendix.]

The CHAIRMAN. We will turn to you now, Ms. Coleman.

OPENING STATEMENT OF DOROTHY COLEMAN, VICE PRESIDENT FOR TAX AND DOMESTIC ECONOMIC POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, DC

Ms. COLEMAN. Chairman Hatch, Ranking Member Wyden, and members of the committee, thank you for the opportunity to testify today about the BEPS project spearheaded by the G20 and the OECD. I appreciate the chance to highlight the NAM's concerns about some of the recommendations in the BEPS project that would impose unnecessary compliance costs on companies, and in some cases force disclosure of sensitive, confidential taxpayer information.

The NAM is the Nation's largest industrial association and voice for more than 12 million women and men who make things in America. Manufacturers know how critically important it is for U.S. companies to be able to invest and compete effectively in a global economy where 95 percent of the world's customers are outside the United States.

The BEPS project included 15 action items, and I would like to focus my comments on Action 13, "Re-examine Transfer Pricing Documentation."

Action 13 adopts a three-tiered approach: a master file to provide a complete picture of a multinational company's global operations, a local file of more detailed information relating to specific inter-company transactions impacting a tax jurisdiction, and a country-by-country report with aggregated financial and tax data.

The country-by-country reports that companies would file with their own country would impose an additional administrative burden on companies. These reports, however, would be submitted to foreign countries under bilateral treaties and information exchange agreements with protections to ensure confidentiality, consistency, and appropriate use of the information by foreign countries. If a country fails to abide by these conditions, the U.S. Treasury has stated its intent to suspend the information exchange. This would

not be the case with the master file, which could be required directly by any country where a company does business.

While both the country-by-country reports and the master file include extremely sensitive information unrelated to actual taxpayer activities in the country requesting the information, the master file does not have the protections of the information exchange process, and thus is not subject to any confidentiality, consistency, or appropriate-use conditions beyond those that may apply locally. Manufacturers also are concerned that the master file requirement would force them to disclose an unprecedented amount of proprietary information about their global operations to foreign governments.

The master file would include organizational charts, consolidated financial statements, and analyses of profit drivers, supply chains, intangibles, and financing—in short, a comprehensive plan that includes every aspect of a company's worldwide business. For privately held companies, the requirements to include a global organizational chart and consolidated financial statements would constitute an unprecedented level of disclosure to foreign governments.

The fact that taxpayers have some level of control over what information is included in the master file does little to address confidentiality concerns, since it is unclear how much flexibility taxpayers actually have to exclude sensitive information. The OECD recommends taxpayers use a prudent business judgment standard to determine the appropriate level of detail to be included in the master file. This standard provides little comfort for taxpayers who want to omit sensitive information and avoid penalties for failing to comply with the filing requirements.

Even though the BEPS recommendations were finalized this fall, confidentiality concerns can and should be addressed during the BEPS implementation phase. Specifically, the NAM believes that Treasury should link master file information to its agreements to provide the country-by-country report to other countries through information exchange.

Thus, we urge Congress to ensure that Treasury enters into agreements with foreign countries specifying that Treasury agrees to provide country-by-country reports for U.S. multinationals only if U.S. multinationals or their subsidiaries are not required to provide master file information to the foreign country, that the foreign country agrees that it will not collect country-by-country reports from U.S. multinationals or their subsidiaries, and that Treasury agrees to provide to the foreign country only the master file information that a U.S. multinational chooses to file with its country-by-country report in order to provide context for its country-by-country data.

Manufacturers believe a fair and transparent tax climate in the United States, including competitive business tax rates and modern international tax rules, will boost standards of living and economic growth worldwide. At the same time, an appropriate balance needs to be struck between transparency and confidentiality of the proprietary information that enables companies to compete and prosper in a global economy.

Thank you for the opportunity to appear before the committee to discuss the NAM's concerns with the master file requirement. This

concludes my testimony, and I would be happy to answer any of your questions.

Thank you.

The CHAIRMAN. Well, thank you so much.

[The prepared statement of Ms. Coleman appears in the appendix.]

The CHAIRMAN. Mr. Danilack, we will take your testimony now.

OPENING STATEMENT OF MICHAEL DANILACK, PRINCIPAL, PRICEWATERHOUSECOOPERS LLP, WASHINGTON, DC

Mr. DANILACK. Chairman Hatch, Ranking Member Wyden, and distinguished members of the committee, I appreciate the opportunity to appear this afternoon as the committee considers BEPS and state aid.

I would like to compliment the committee for holding today's hearing. The subject is of considerable importance to the U.S. tax base and to U.S. tax administration.

As Chairman Hatch mentioned at the outset, currently I am a tax principal at PricewaterhouseCoopers in the Washington national tax services practice, but previously I held a number of international-focused leadership positions at the IRS.

I appear here today, however, on my own behalf and not on behalf of PwC or any client of the firm or certainly not on behalf of the U.S. Government. And therefore, the views I express today are entirely my own.

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

The subject of today's hearing raises numerous legal and policy considerations. 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 I believe will create a serious challenge both for U.S.-based multinational businesses and for the U.S. Government.

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 is not surprising that the papers issued on October 5th of this year do not reflect a clear global consensus on many of the difficult issues that were evaluated. In some respects, the papers merely provide governments with options. In other respects, they draw conclusions based on new concepts that are somewhat ambiguous. In still other respects, the work is unfinished.

So, despite the OECD's accomplishments, so far the BEPS project has created significant ambiguities and considerable uncertainties. Notwithstanding the ambiguities, however, in my estimation it is inevitable that countries will begin to assert the new concepts through enforcement actions guided by their own interpretations and with their own revenue collection goals in mind.

Indeed, this is already happening around the world. I hear stories about it from clients nearly every day.

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, or even multiple taxation.

The U.S. network of tax treaties, of course, is designed to eliminate double taxation, and all countries agree that double taxation is wrong as a matter of policy. But when double taxation is created by one country's enforcement action, it is not automatically eliminated by a rule in the 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. At the competent authority table, the country that makes the adjustment has the greater leverage. Essentially, that country is in a position to enforce its determination at will.

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 difficult under normal circumstances, but where the underlying principles are unclear, the effort may well be a losing one.

A number of things might be done about the problem. One is to ensure that the IRS competent authority is equipped to handle the challenges that lie ahead. A second is to reform the U.S. international tax system.

Lowering the U.S. corporate rate and reforming our international rules are critical, but I note that even if such changes are made, other taxing authorities will be looking to tax a bigger share of a bigger pie.

I also note, in closing, that there seems to be a target unfairly painted on the backs of U.S. companies. Nevertheless, it is likely that taxing authorities will seek to tax a larger share of global profits of all multinational businesses. 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, which may include those imposed through foreign audits. 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 established principles, the U.S. companies generally will not bear the resulting double taxation. Instead, they 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 heard today, and I would be happy to answer any questions you may have.

The CHAIRMAN. Well, thank you so much.

[The prepared statement of Mr. Danilack appears in the appendix.]

The CHAIRMAN. We will turn to Senator Grassley first.

Senator GRASSLEY. Thank you very much for that courtesy, Mr. Chairman.

I have three questions, if I have time, to ask Mr. Stack, but if the other two of you would like to join in, that is all right as well.

Mr. Stack, in a talk that you gave in June on the progress of BEPS, you stated that you had, quote, "been personally shocked and appalled at the lack of attention that clarity and the ability to administer get at the OECD." You further stated, quote, "This was motivated by the fact that tax administrators like having whatever tools they can to go after taxpayers."

So, a question: do you continue to have concerns about the lack of clarity and the ability to administer rules contained in the final BEPS report? If so, should American companies be worried that they will be unfairly targeted by foreign tax administrators taking an I-know-it-when-I-see-it approach to their implementation and enforcement of the recommendations?

Those two questions.

Mr. STACK. Yes, Senator, I stand by those remarks, and I work very closely with the business community and lots of stakeholders in the BEPS work.

I think that the areas that concerned us the most in these negotiations were questions like a looser standard on permanent establishments, and questions like how other countries were going to determine treaty abuse by putting in place what we consider a vague principal purpose test for treaty abuse. And I stand by the remark that I did not find the questions of the importance and clarity and administrability of rules to be a central concern of the negotiators at the OECD.

I would say two things on those particular issues. Because of our reservations on both the PE and the treaty abuse issues, the United States has made it clear that we will not be adopting the permanent establishment rules that were agreed to, unless we get further guarantees on how profits will be attributed once they are put in place. And second, the U.S. has made clear that we will not be putting a principal purpose test in our treaties.

Now, granted, U.S. multinationals operate all around the world, so they are still going to run into these rules, but that was a position that we were able to take on that.

Having said that, there were many areas where I think we were able to push back and get better rules and more clarity because we were insistent. The transfer pricing reports at the end were a lot better than they were in the middle drafts, and so we stayed focused on that.

And the last point I want to make is, we are trying to turn the attention of the OECD next to this very issue, which is, we have written a thousand pages of reports, but what are the guarantees that your auditor in X country is going to understand them and apply them fairly and that people will get a fair shake?

So we think we can pivot now from having written some new rules to try to turn the world's attention to what is fair and efficient tax administration. And that is a heavy lift, but we think it is a very important thing to do for global growth and foreign direct investment.

Senator GRASSLEY. All right. My next question to you is, this project was sold as a means to stave off uncoordinated unilateral action by some countries that would erode international tax certainty and predictability, yet it is unclear that this has been the case.

For instance, the U.K. and Australia have gone forward with so-called diverted profits taxes, and now we have the EU state aid cases, which could be seen as linked to BEPS concerns.

So, Mr. Stack, in your view, will the finalizing of the BEPS project help put an end to unilateral action, or should we be concerned that it has only emboldened countries to take even more aggressive action towards American companies?

Mr. STACK. Thank you, Senator.

Look, I think the unilateral action point is, we will never know, as we sit here, what more unilateral action there would have been if we had not fully engaged in the BEPS project, number one. And I think one of the things I have learned by talking to other governments is that foreign, multinational tax avoidance, often with a focus on U.S. companies, is headline news around the world that very much creates a great deal of political pressure.

So what might have happened if we had not engaged in BEPS is a story we do not know the answer to. Has there been unilateral action? Yes, there has. Are we upset about it in the case of the U.K. tax and the Australian tax and the state aid? Yes we are, and what can we do to manage it is an open question.

We are hopeful that we can use the BEPS reports and monitor the ongoing output to invite countries to pull back from places where they have strayed from what is in the BEPS reports, to come back to the rules that we have now all agreed to.

But I would say, that is very much a work in progress, as working with these countries and their sovereignty in writing their rules is not something we control all that easily.

Senator GRASSLEY. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Well, thank you.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

So we have obviously had, as the kind of cloud over all this, the question of companies inverting because they say they have to lower their tax bills. That is what Pfizer said. The *Wall Street Journal* recently reported that Aon is using earnings stripping to lower its tax bill, and certainly evidence suggests it is not alone.

So, Mr. Stack, on this point, does the Treasury Department have sufficient authority to, in effect, nullify efforts to strip earnings out of the United States?

Mr. STACK. Senator, we continue to look at the earnings stripping questions very closely. We are mindful of the point the chairman made, that there are lines between what can be done administratively and where the Congress needs to act. And it is difficult for me to say point blank, because this work is ongoing at the Treasury, where that line is between what we can do regulatorily and what would require congressional action.

I can say that in the inversion space and the earnings stripping space, Congress could tomorrow limit earnings stripping below

what it is currently in 163(j), but we are still looking at the contours of our authority relative to your authority. And we, as the Secretary said recently, continue to examine these issues.

Senator WYDEN. All right. Let us turn to the question of state aid—and maybe for you, Mr. Stack, and I think probably Mr. Danilack, but any of you who would like to participate.

The EU state aid cases look like, to me, another example of foreign governments targeting American firms. And they are targeting American firms because they would like to expand their tax base.

So I think, based at least on comments I have read in the press, that you all largely share my concerns that these cases could lead to retroactive tax increases. Is that right, Mr. Stack? That is just a "yes" or "no."

Mr. STACK. Yes, sir.

Senator WYDEN. All right. And so we would be talking about retroactive tax increases on American companies that could result in American taxpayers footing the bill through foreign tax credits, which is something we have had for quite some time.

So my concern here is—and the point of the question is—the effects could go far beyond what are just these initial state aid cases.

So, let us see if we can get a reaction. One, are these cases, in your view, Mr. Stack, paving the way for the EU to go after the historical earnings of many more U.S. multinationals?

Mr. STACK. Senator, I only know that there have been reported instances of more U.S. companies being examined. So that would take you in the direction of saying yes, they might go further than the cases we have been looking at. And yes, I do believe that the target is the unrepatriated earnings of our companies that have been deferred from U.S. taxes.

Senator WYDEN. So these cases, then, could have a substantial and direct impact on the U.S. fisc, and consequently American taxpayers?

Mr. STACK. Yes, Senator.

Senator WYDEN. All right. So on this point, what is the Treasury Department's strategy on these issues, and what can the Congress do in that effort?

Mr. STACK. Senator, we have taken measures to be sure that the Commission understands the direct U.S. concerns around our tax treaty network and the potential for these taxes to be borne by American taxpayers. So the first thing we could do, and we have done, is to let the Commission know that we have a stake in these cases. We are not just bystanders.

I think a broader point is, we have also made it clear that the retroactive element of these cases—because it seems clear to me as an observer that the theories being put forth here surprised countries, companies, advisers, auditors. And when you have a new type of ruling that is not foreseen by the community that effectively had no notice, for it to be retroactive strikes me as particularly unfair.

Now, beyond the Treasury Department making clear our view with respect to these issues, since this is a proceeding in another jurisdiction, I do not have some magic bullet for the next things that the Treasury can do, except I will say we did not want to wait for these rulings to be in the books and the money to be paid before we looked up and realized that these issues had arisen.

So I believe we have been very aggressive and forward-leaning in making sure that we are getting ahead of and not being surprised about the direction this is heading.

Senator WYDEN. Let me ask you about this in the context of tax reform, and I think you and I have talked about it down there in the office a few doors down. I really spent years, particularly with Senator Gregg and Senator Coats, putting together bipartisan bills and working with various colleagues on the committee. And Chairman Hatch and I have discussed this at some length.

And we never really had to deal with things like what we are talking about now, the question of EU state aid cases and what the implications are. Now, it looks to me that, given the debate now, most international tax reform plans are going to include revenue from some sort of deemed repatriation of historical foreign earnings as a transition to a new system—really, an exemption-based system.

How is the EU state aid situation going to impact something like a deemed repatriation transition tax? The reason I am asking is, I am telling you as somebody who has spent a lot of time looking at this and working with the bipartisan groups that Chairman Hatch set up as part of tax reform, I think this is really new stuff and pretty ominous.

So what is your thought on that?

Mr. STACK. Thank you, Senator. First I want to lead by being very clear that the Treasury Department, because we are out in front of these cases, we have not done the analysis, the technical analysis that, in fact, these payments constitute taxes and that, in fact, they will be creditable.

Having said that, I think many people in the tax practitioner community and many people who have thought about these issues think that there is a substantial likelihood that they may be creditable.

In that case, if they were to turn out to be creditable taxes, when we do those deemed repatriations, those same companies that are having deemed repatriations will claim a tax credit for the amounts that the Commission has ordered the local governments to impose on them, if one were to conclude that they are taxes and that, in fact, they are creditable taxes.

So that gives us a direct fiscal stake, and I did not think we should wait until that horse is completely out of the barn before letting our interests be known.

Senator WYDEN. Let us do this. I am way over my time. I would like to give you a couple more questions on this general point. Can you get back to us, say, within a couple of weeks on it?

Mr. STACK. Absolutely, Senator.

Senator WYDEN. The question will be, I would like to know what they mean, the EU state aid cases, for our tax treaties. And also, what about the prospect that Europe tries to retroactively impose some sort of back-door tax on what they think are unfair earnings?

So you have a general sense of what I am interested in. We will get that to you. If you can get back to me with your take on that within a couple of weeks, that would be very helpful.

And again, I want to commend you because I know in a very, very difficult forum you have been trying to represent American interests, and I appreciate it.

Thank you, Mr. Chairman.

The CHAIRMAN. Well, thank you, Senator.

Senator Warner?

Senator WARNER. Thank you, Mr. Chairman. And let me first of all say I agree with you and the ranking member that we desperately need to do international tax reform. We need to have an international tax system that allows us to be competitive, with lower rates.

I would point out, though, that one of the challenges we have, and correct me if I am wrong, Mr. Stack, out of the 34 OECD nations, America, which has the most—I will take a combination of both your comments—the most mixed-up, screwed-up tax system of all with, technically on the business side, some of the highest rates in the world, yet you look at what we collect, state, local, and Federal combined, business and personal combined, and we are 32nd out of 34 in terms of percent of GDP. Is that correct, Mr. Stack? Yes. I will get you the written validations.

So we have both the nemesis of the most complicated system around, yet we collect, on a comparative basis, the least revenue. One of the reasons—and again, I appreciate both of you mentioning the challenges around inversions.

As somebody who has been a strong supporter of the benefits of PhRMA for a long time, I am very disappointed by those actions, and particularly disappointed by some of the comments of the CEO there in terms of whatever obligation he feels he has to this country, which has in many ways subsidized the R&D for PhRMA for the whole world, since we pay higher drug prices than the rest of the world, and things like NIH and others that do not seem to go into his calculation.

I guess, Mr. Stack, what I am wondering is—and this kind of goes with what the chairman and the ranking member have said—this may be too early to have some data. But when we are talking about inversions, when we are talking about the BEPS process, which is now driving some of these state aid and other potential actions, when we are seeing the growth in, particularly, Europe, on patent boxes, has anyone calculated at least a ballpark number in terms of amount of lost revenue to our country, in the current year, future years?

How do we factor this in, if we need even more impetus to try to get our tax codes fixed in terms of estimating what is going to happen in terms of both erosion of our base, and even companies that stay within our base, the tax actions that may be taken against them in the OECD?

Mr. STACK. I am not aware, Senator, of the precise figures on where we are headed. I would make a few observations.

In the inverted company cases, I think we know, once the companies are gone, they are not coming back. So that is kind of like a permanent loss.

And second, once——

Senator WARNER. And yet there is—has there been any estimate done by Treasury of over, say, the last 3 to 5 years, of inverted companies, total amounts of revenue lost on a projected basis?

Mr. STACK. Not that I am aware of, Senator, but I will double-check, and if so, I will get back to you.

The second thing that happens is, once the company inverts, it is able to strip revenue out of the United States through interest in a far more generous way than it could have done while it was still domestic.

And again, I will check to see if we have data on what that has been, but I am not aware, off the top of my head. But those are two very palpable issues with respect to inversions, and where we lose our base.

I could speak to other issues in our tax reform, where we want to shore up some of the rules about moving intangible property offshore by U.S. companies, which is another way that we have our base eroded.

In the President's tax reform proposal, we have a series of ways to protect the U.S. base as we lower the tax rate and broaden the base for corporate tax.

Senator WARNER. Mr. Chairman, one thing I would hope, as we look at whatever package that may come around on tax extenders, is that some of the provisions that might be part of an international tax reform package, that we do not make those provisions permanent in the short term now, which frankly would incent companies to keep more earnings offshore.

Some of the proposals being talked about I think will, again, make it even harder for us to get to our ultimate goal, which is an international tax reform system that makes America competitive with lower rates, with less exemptions. I know there is discussion about making some provisions permanent now that I think would dramatically benefit American companies, but would benefit them in the way of keeping those revenues and profits offshore.

My last question—I guess this will be for the whole panel. One of the areas I think the BEPS process resolved or came to some conclusion on—and I love your general comments on this. I have been very concerned about the movement towards the patent boxes, what that regime may do in terms of dramatically lowering corporate tax rates, particularly around high-value intellectual property, with our competitive nations.

Now I understand BEPS has ended up saying there has to be a linkage, a nexus in terms of R&D and patent boxes. How worried should we be about the patent box regimes in the OECD nations?

Very briefly, because my time is out. If each of you would take a crack.

Ms. COLEMAN. Manufacturers have looked at patent box proposals in the United States. In reality, they do not provide that much benefit to the industry across the board. We found the benefits tend to be concentrated in different sectors of the manufacturing industry. So I think patent boxes would probably have a mixed impact on my industry.

Mr. DANILACK. Senator, I would say generally speaking, we should be worried about the nexus requirements, if we are concerned about where the R&D jobs are, at the end of the day.

Because the nexus requirements call for those jobs to be in those jurisdictions where the rates are beneficial. And companies respond to incentives like this and will move jobs in order to obtain the benefits of the tax regimes that are put in place.

Mr. STACK. I will only say briefly, Senator, that I think there has been some broad bipartisan notion that we should do a revenue-neutral, broaden-the-base, and lower-the-rates tax reform. And when you go in the direction of a patent box, you have kind of broken away from that and are creating new special treatment for a particular industry and a particular kind of income that may make it harder to do international tax reform rather than easier.

Senator WARNER. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Casey, you are next.

Senator CASEY. Thank you, Mr. Chairman. And I appreciate the testimony of the panel.

Mr. Stack, I want to start with you in terms of some fundamentals that we try to keep an eye on here, such as wage growth, which is, in my judgment, a several decades long challenge for the country.

We really haven't turned wages in the right direction in several decades—by one estimate this past January, 40 years of wage growth amounting to just 9 percent. In the prior 25 years, 90 percent or 91 percent. So wage growth, economic growth, and just job creation.

When we are looking at those issues and looking at tax issues through that lens, one of the areas of concern would be, in addition to what Congress can do and must do, in your work at Treasury, what can you say that you are doing or the Treasury Department overall is doing to protect those basic U.S. interests when it comes to tax policy, to the tax strategy, and how it ensures that we have the kind of wage and job growth that we want?

Mr. STACK. Thank you, Senator. In the Office of Tax Policy, I think the driver is, we want companies to be able to make decisions for their economic benefits and not decisions necessarily driven by tax incentives or tax regimes.

So to the extent one can remove the tax gimmicks out of economic decision-making and investment, then you do wind up with the jobs in the right places and the factories in the right places.

One way the President has talked about doing that is by lowering the rate so we are more competitive around the world, and to do that, we need to broaden the base. And the minimum tax proposal the President has put forward basically says to companies, if you are operating abroad in a jurisdiction where the tax rate is higher than the minimum, you are going to have the same rate as your competitor. So you can make your investment decisions in that jurisdiction based on that market and the cost of operating and where to put the factory and who to hire, and you are not so worried about having some additional tax when that money comes back home, in which case you wind up with skewed incentives.

So I think our goal is, take the tax out of the equation; let companies make good investment decisions. That should put the factories and the jobs in the places where they are economically needed. And hopefully, at the end of the day, that fuels the kind of growth that you are talking about.

Senator CASEY. Mr. Danilack, or Ms. Coleman, do have any opinions on this question?

Mr. DANILACK. No, sir, I do not have a particular opinion on the question you asked of the Treasury Department.

Senator CASEY. I want to ask as well—I know that Senator Wyden raised the question of the European Union state aid cases and the overall impact because of potential targeting of U.S. companies and what that impact is for American taxpayers.

Mr. Stack, could you kind of walk through that, just in terms of, if a taxpayer were sitting in front of you asking how does this affect me ultimately, or how could it potentially affect that taxpayer?

Mr. STACK. Sure, Senator. When a U.S. company pays a tax in a foreign jurisdiction and then they bring money home, they get a credit for that tax paid in the foreign jurisdiction, up to a certain limit. Now, in the normal case, that means you are actually doing some business in Germany, let us say, and you had some tax, and you brought it home and you got your credit.

In this fact pattern, the EU is coming along and they are saying, oh, we think when you cut your deal with Ireland or Luxembourg or the Netherlands that, in fact, you, company, should have been paying more tax to those jurisdictions.

Now, if we were to determine that those payments are in fact taxes, and were to determine that they are creditable under our rules, now when that money comes home from those countries, in addition to the credit the company got for the tax they originally paid in those jurisdictions, they get an extra credit.

And that credit, to this taxpayer you asked me about, means in effect the U.S. Treasury got less money and in effect made a direct transfer to the European jurisdiction that is getting the ruling from the Commission. So if these turn out to be creditable taxes, it is the U.S. taxpayer who is footing the bill for these EU investigations.

Senator CASEY. So now, you referred to it in your testimony as well. Is there anything you want to add?

Mr. DANILACK. Yes, and I would like to broaden out the particular problem you are asking about, beyond state aid, because the very same profits that the European Commission is having a look at are also being looked at by other jurisdictions around the world.

You will have another country that will see the low tax profits in a jurisdiction like the ones Mr. Stack mentioned, and they are currently already—this is what I am trying to get across—in the enforcement mode, attempting to tax those profits for themselves.

Now, if that happens, and it is happening, those taxes are also going to be creditable taxes in the U.S. So that same pot of profits is going to be subject to taxation, perhaps by multiple countries, and those credits will all come back.

And you will not have the state aid tax credit question if it is another jurisdiction. That is just applying their normal income taxes, attempting to drag those profits into their jurisdictions. And this is happening already with a number of the clients of the firm.

Senator CASEY. I appreciate that. And I know my time is up and over. I do want to say for the record, Mr. Chairman, my father-in-law, John Foppiano, spent a lot of his years as a tax partner at Pricewaterhouse. So that is on the record now. Mr. Danilack, you

do not have to comment, but I wanted to make sure that was part of the record.

Thank you, Mr. Chairman.

The CHAIRMAN. Well, I think every member of this committee ought to be able to brag about his father-in-law once in a while. Senator Portman?

Senator PORTMAN. Having a father-in-law who can do your taxes is quite an advantage. [Laughter.]

Mr. DANILACK. That is right. That is right.

Senator PORTMAN. So I think Senator Casey asked a really good question about jobs and wages, and how do we get past the point in this country where we see not just flat but actually declining wages, higher expenses, the middle-class squeeze. It is very real.

And I think the testimony today has also been very helpful and raised a lot of issues, and I think the answer to it all is pretty obvious, which is tax reform.

I mean, we could do a number of things to get wages up. But every economic study I have seen says the same thing, which is, if you do in fact go with a pro-growth tax reform on the business side, you are going to see the benefit go to the workers. The CBO study that many of you have seen shows 70 percent of the benefit is going to go to higher wages and better benefits. And it is because American firms will be more competitive and they can pay more.

And I just think we are missing the boat. And I hope this has been a wake-up call today for everybody to hear you all talk about the fact that, even if we were not already convinced that we are missing this opportunity to help the people we represent—those workers should be able to have more opportunity for themselves and their families—but now it is getting even worse.

Because everything you have said—and I have looked at your testimony. And also we have had a chance, some of us, to talk about these issues, and if we do not move to do it—we should do it anyway, reform our code to make it more competitive—in effect what will happen is, this is not just in Europe, as you know very well, Mr. Stack, because you have had to sit through probably dozens of meetings on this, this is not just OECD; this is the G20. As Mr. Danilack has said, this is other countries as well. It is global now. They are going to go after these profits.

So, in effect, we are having the worst of all worlds. We have a non-competitive tax code that makes our workers have to compete with one hand tied behind their back, that keeps their wages depressed, and yet we are also seeing now that, because we have not acted, other countries are moving in to try to grab those earnings themselves.

And I just hope that we can figure out a way, on a bipartisan basis, to fix this. And this committee has done a good job, I think, on the hearings. And I think the working group that Chairman Hatch asked us to convene was effective.

Senator Schumer and I do not agree on everything, to say the least, but we did come up with an agreement on this issue, which is a framework to deal with tax reform. And I know there are some controversial parts of it, but I see a lot of consensus as to what we ought to do.

And it does involve, as Mr. Stack has said, lowering the rate, broadening the base, but also, on the international side, moving to this territorial-type system before it is too late.

I just have a couple quick questions, if I might. This nexus requirement that the BEPS project has now blessed, which is to say, if you do have an innovation box or a patent box in your country, you have to actually have the work connected with it.

I assume you believe that is also going to draw additional jobs overseas, because companies that are now taking advantage of moving that intangible income overseas to lower-tax jurisdictions are going to find, gosh, they have to actually send the researchers, the scientists, the infrastructure over there. Is that not true?

Mr. STACK. Not necessarily, Senator. I think—I want to make two points about the work we did at BEPS on the patent box.

First of all, I think we all have to appreciate where we began. We began with countries like the U.K. that said, if you just drop your paper patents into London, you can get a 10-percent rate and you can strip out of all our neighbors at a 25- or 35-percent rate. And the OECD said, wait a second. That is not having any domestic tax policy other than trying to strip income out of your neighbors.

So the work at the OECD—and one premise we have at OECD is, countries can have their own rates and countries can favor some income over others. But what we said was, if you are going to have a separate rate for patent box-type income, it has to be promoting a domestic policy of encouraging research and development. So do some research and development in country.

Now, once you go there, you have to—there are two things. I do not think it is a given in the economic literature that the tax rate of where the research is done is the determining factor of where the research is done. People like to conduct research in the United States because we have universities and communities and synergies of all these great dynamic people we have here, number one.

And number two, remember, if you are going to take your winners at 6.5 percent in Ireland, your income, you are going to have to take your deductions at 6.5 percent on your losers. So it is not a no-brainer for a company to say, I am going where there is a 6.5-percent rate, because they have to make a judgment to give up the 28- or the 35-percent deduction in the U.S. as they do it.

And finally, I do not also think it is a no-brainer that U.S. tax policy should race to the lowest tax rates of any neighbor we have, because that is a very expensive way to proceed, given all of our competing fiscal demands.

So I think the work we did on patent boxes was good, from where we started and got to a better place. And I do not think it is necessarily going to drive U.S. researchers, and the ownership of IP, out of the U.S. overnight.

And I have had an opportunity to discuss some of this with my European counterparts, and a lot of them view their patent boxes as probably more beneficial to some of their small and medium enterprises that can benefit, because they are doing the research there locally. Obviously, that is something we should study and look at as we go forward, but I still think we did good work in that space.

Senator PORTMAN. I am not challenging your work, but I am perplexed by your answer. I do not see how you can say this is good for the United States to have a BEPS project that ends up saying, for those American companies that do research overseas because they can take advantage of a patent box or an innovation box, now there is a nexus that they have to actually not just move, as you say, the paper patents overseas, they have to move the people overseas. How is that good for the United States of America?

Mr. STACK. Well, Congressman, we do not get to tell countries what rates they should have.

Senator PORTMAN. No, I understand that. But I do not see how you can say that is good. I mean, that should make you want to look at our tax code and figure out a way to make our code more competitive.

Mr. STACK. Absolutely.

Senator PORTMAN. Which is the point that Senator Schumer and I made in our report, having talked to a lot of experts, including at least one member of your panel. This is the reality. This is what is happening.

Now, we may not like it, and you are right, other countries have the right to do it, I suppose. But that does not mean that we should sit back and simply not react, because I do think you are going to see an erosion, not just of inversions and foreign takeovers—which, by the way, doubled last year in value as compared to the year before, and this year is on track probably to go up another 70, 80 percent. But I think you are going to see not just the paper patents, but the researchers move overseas. That just seems to me logical.

Mr. STACK. Well, Senator, that is why the President has proposed lowering the rate, broadening the base, and doing a whole host of other things to make us more competitive and pro-growth in the world. And so I was answering, in isolation, the patent box question.

But I fully agree with you: we need to do better at international tax reform to make ourselves more competitive. And on that, there is bipartisan agreement. So I fully agree with you.

Senator PORTMAN. On the—well, my time has expired. I apologize. I see one of my colleagues has now arrived. But I would like to talk to you more at some point about this notion of these retroactive tax increases you talked about, and all three of you talked about, being creditable, and what that means for tax reform.

Because one of the very specific concerns we have obviously is that in our proposal, there is a deemed repatriation. And Treasury agrees with us on that, and obviously that deemed repatriation will be a lot less to be able to pay for moving to a territorial system if there are creditable tax credits against it. And so that is my biggest concern: the impact of this specifically on tax reform.

And just a quick—do you all agree with that as a concern, and is that one reason for us to move quickly?

Mr. STACK. Yes, Senator.

Mr. DANILACK. Yes, Senator, I believe it is something to consider, yes.

Senator PORTMAN. Thank you, Mr. Chairman.

The CHAIRMAN. All right, thank you.

I have deferred my questions, so I think I will ask a couple right now.

Mr. Stack, I appreciate that you discuss the problem of inversions in your testimony. It seems that the decision to invert is driven, for the most part, by the fact that the tax consequences for being a foreign company are much better than being a U.S. company. I think that is coming out here today.

Some of the proposals from the administration, in an effort to combat the problem of intangibles migrating from the U.S., call for a minimum tax on income of foreign subsidiaries of U.S. companies. But I wonder if taxing U.S. companies more heavily on the income of their foreign subsidiaries would create yet more pressure to invert. So combating one type of base erosion and profit shifting—that is, intangible property migration—perhaps would create more pressure for another type of base erosion and profit shifting, and that is inversion.

What are your thoughts on that? And, if Mr. Danilack would like to weigh in as well, I would welcome his thoughts as well.

Mr. STACK. Thank you, Senator. I think that you mentioned our minimum tax, and we think that the President's proposal needs to be looked at in its entirety.

Ways to take pressure off inversions are, number one, to lower our rate, broaden the base, and enact other elements of our proposal like limiting the ability of inverted companies, or all foreign multinationals, to strip interest out of the United States once they invert.

The minimum tax proposal—it surprises me; we get so much focus on the min tax piece. Because in my experience, companies actually do business in jurisdictions with tax rates higher than the minimum tax rate.

And what our proposal says is, if you are in a jurisdiction with a tax rate higher than the minimum tax rate, you get to go there and compete with all the competitors in that jurisdiction and pay the same tax in, let us say Germany, as your competitors in Germany get to pay. And when you repatriate that money, you do not pay any additional tax.

What the minimum tax part of it does is to say, if you are shifting income into very low-tax jurisdictions—and one can always quibble on where the line is. We put it at 19 percent in the budget, but my boss has said that is not divinely inspired. We could pick other numbers. When that happens, it is probably true that there is some shifting going on that is dangerous to the U.S. base, because it is attracting people to put the income offshore.

So one way to think about tax reform and inversions is, lower the rates, broaden the base, put in an entire package of sensible tax rules to take the pressure off inversions, and for that, highlighting the need to get at interest-stripping, I think is critical.

And then, if people are still putting high-value items in low-tax jurisdictions and tax havens, we protect our base by saying we will pick up the tax on that at the minimum rate.

The CHAIRMAN. Well, you also talk about earnings stripping in your testimony. Apparently the ability to engage in earnings stripping creates pressure to invert as well.

And if you agree that U.S. companies invert or become foreign companies because the tax consequences to being foreign are better than the tax consequences of being a U.S. company, then perhaps limitations on earnings stripping reduce the attractiveness to being foreign—that is, reduce the attractiveness of inverting.

Earnings stripping is one factor in the decision to invert. Do you agree with that?

Mr. STACK. Yes, Senator, I do very much.

The CHAIRMAN. And do you think that the OECD BEPS project recommends a more aggressive posture against earnings stripping?

Mr. STACK. Yes it does, Senator.

The CHAIRMAN. All right. Well, Mr. Danilack, I welcome your comments on these two questions that I have asked, if you care to make any.

Mr. DANILACK. I think that each of these questions is interrelated with each of the others. And what you are really looking for is a formula to balance out your tax environment for your U.S. companies with the environment for foreign companies. And ultimately, you want to ensure that a U.S. company is happy to be here and is not interested in being somewhere else because the tax environment for a company abroad is beneficial.

And this involves the U.S. rate. If the rate is lower, there is less incentive to strip. If the rate is high, there is clearly a lot of pressure to strip as much as possible.

So you are essentially asking, what is the right formula for tax reform to ensure that businesses, as Mr. Stack said, make decisions based on economics and not based on taxation? So there is not a real magic answer; it takes a lot of hard work to figure out exactly how to get it right.

The CHAIRMAN. All right.

Well, Senator Carper is next and then Senator Thune.

Senator CARPER. When I walked for the second time into the hearing, I think Senator Portman was asking a question relating to BEPS, U.S. competitiveness, and the tax base, I think, of Mr. Stack. And I do not know that we really heard from the other witnesses on that question. I will just frame it briefly.

While we have been talking a lot about tax reform in this country, other places have actually been doing it, and we have been an observer in that process. But a lot of countries are putting in place patent box regimes in order to offer some lower rates on profits that are derived from intellectual property.

In the context of these patent boxes, the BEPS project is proposing what is called a nexus approach. And I think you were having some discussion with Senator Portman about that.

I would just like to hear from our other two witnesses, just your comments and thoughts in this regard, particularly about the impact you believe a nexus requirement, if it is adopted on a widespread basis, might have both on the U.S. tax base and also the impact it might have on our ability to keep intellectual property and R&D jobs here in the U.S.

Yes, ma'am?

Ms. COLEMAN. I think one way to keep R&D jobs in the United States is to have a permanent R&D credit. And as I mentioned be-

fore, the NAM took a look at the innovation box, and we had a mixed reaction from our members.

In contrast, the NAM has been a strong proponent of a permanent R&D credit. In fact, we are very optimistic about the discussions going on right now. We feel that a permanent R&D credit would keep R&D in the United States.

And when you look across our competitors in the OECD, all of them have much stronger and, in most cases, permanent incentives. As you know, we have an on-again-off-again incentive, which currently is off. So the U.S. credit is not as attractive as incentives in our competitor nations.

So I think a simple solution and something that we could do right away is to make the credit permanent.

Senator CARPER. All right. Thank you.

Mr. DANILACK. I answered the question earlier, before you came in, Senator.

Senator CARPER. What did you say?

Mr. DANILACK. I said generally speaking, I would be concerned about patent box regimes cropping up around the world, especially if they are widespread and especially if the value of those regimes from a tax savings perspective is very high.

I also agree with Mr. Stack's comments earlier that it is not automatically going to be the case that jobs will migrate to these jurisdictions, because it is a complex calculus that a business needs to make.

There are businesses where there is a great deal of risk in R&D, and there are losers. And the deductibility of the expenses—you will have to also take into account the respective tax rates.

So it is like anything else. This is not a one-issue question. You necessarily have to bring in the other issues that are on the table, like what the respective rates are in the jurisdictions in question. If a baseline rate in the U.S. is relatively low, you are obviously going to have less incentives for jobs to migrate to a lower-tax jurisdiction than if the baseline rate is very high.

So I do not have a strong sort of on-off type of view on the threat posed by the nexus requirements. I think generally it is something to really take into account, especially if patent boxes become widespread and very beneficial and nothing is done here in the U.S.

Senator CARPER. All right. Thanks.

If we could talk a minute or so about the time frame for BEPS implementation, and to Mr. Stack, could you give us some reasonable estimate, if you will, as to when other countries will ratify, might ratify, the BEPS multilateral instrument, and will taxpayers be given a reasonable amount of time to create systems to comply?

Mr. STACK. Thank you, Senator.

Because there are 15 different action items, each one relates differently to the question of implementation. With some, for example in digital economy and Controlled Foreign Company rules, there is nothing to do or implement.

If you look at the interest deductibility in hybrids, since they are effectively setting out common approaches for countries, there is no particular expectation of when things might be implemented. So it kind of runs the gamut.

The transfer pricing work in many countries, because it amplifies the arm's-length standard, is kind of automatically absorbed into law.

The two things on the multilateral instrument, that work will be going on this year. They are hoping to have a draft out by the end of the year. It is going to try to embody the different treaty things we have agreed to.

Frankly, I think that is an ambitious schedule. Obviously, we would have to work with the Senate Foreign Relations Committee if we are going to move forward on elements of that. So I think that is still a ways down the road, and we will have plenty of time to work with Congress in terms of implementing that, I would say.

Senator CARPER. Good. Thanks. Thanks to all of you. Much obliged.

Senator THUNE [presiding]. Senator Cardin?

Senator CARDIN. Chairman Thune, it is nice to be with you here.

Let me sort of preface this question. Clearly we are interested in collecting our taxes. To the extent that we do not collect the taxes that are due from a particular entity, everyone else pays a little bit more in taxes. So being able to collect our fair share of taxes allows us to have lower tax rates. That is one reason that we want to make sure that we have a fair tax structure.

There is also the reason of fairness. Everybody should pay their fair amount.

We are clearly concerned about these flagship tax investigations that are taking place that we see targeting American companies. And therefore we obviously want to support the tax treaties that can help us deal with some of these issues to make sure our companies are treated fairly and we do collect our taxes.

And hopefully, we are going to move these tax treaties in a more expedited way than we have over the last 4 or 5 years. All that is very, very important, and we want to gauge our OECD partners to make sure that we have more uniform rules in determining allocations of costs and revenues.

But I want to get to the fundamental issue here and ask you this question: if the business tax rates in the United States were lower than the OECD countries, would we be having these problems? If we, after all, were the low-tax jurisdiction rather than the high-tax jurisdiction, it seems to me the dynamics here would be dramatically different.

And I will give you a chance to answer that question. Senator Thune and I worked on the business reform issues, and I thought we made a lot of progress.

Senator Thune raised a very good issue about the corporate entity, or the business entity you pick, and why that should be neutral rather than what it is today. I agree that is certainly an inequity in our tax code, depending on double taxation issues.

And I raised the fact that the United States, among the OECD countries, has by and large a lower reliance on the governmental sector than they do, so therefore, since our reliance on government revenues is less, we should have lower marginal rates, not higher marginal rates.

Of course the reason is that the United States is stubborn. We have always been. We do things right; the rest of the world does

not. And therefore, for Federal purposes we rely almost solely on income taxes, where they use consumption taxes as well as income taxes.

So my question to you is, if we could reform our tax code—I know a lot of my colleagues have talked about that—to be more in harmony regarding how we collect taxes, as the OECD countries are, so that we would end up with the lowest marginal tax rates among the OECD countries, would it not make some of these discussions a little bit more different and dynamic? It might be just the reverse of the arguments that we are having today on targeting.

Whoever wants—Mr. Stack, you look anxious, and I think you might agree with me, so——

Mr. STACK. Yes, certainly, Senator, if we had lower rates, there is less pressure on stripping out of our jurisdiction.

Now, I would just add that in the case of multinationals, you sometimes get these jurisdictions that sit in the middle where you may not pay tax at all, and so you bring the money home, and that is just something I think there is bipartisan consensus we should be fixing as well.

Senator CARDIN. I would point out that this is not theoretical. I filed the Progressive Consumption Tax Act that incorporates two major provisions that seem to be reasons why we have not been able to advance this in the past.

One is, it is progressive. We do incorporate the current benefits in the income tax code for the Earned Income Tax Credit and the Child Tax Credit, and we do provide rebate payments for recipients so that we are dealing with a more progressive way to collect taxes.

And then second, we put a circuit breaker in the bill to make sure that the revenue growth is not more than we say it is going to be, so we do not grow government, which is another complaint that has been made about consumption taxes, which I think is a legitimate concern, because I expect that the Joint Tax Committee will not score this for the true revenue potential that it will unleash by having more competitive rates.

So I do think this is doable, and I know we spend a lot of time in this committee, and you all spend a lot of time talking about ways that we can protect American companies from discriminatory actions and how we can keep jobs in America and how we can be competitive and how we deal with inversions or deal with how we get the monies that are parked overseas back to the United States. It seems to me that if we dealt with the fundamental problem we have—and that is, America is out of step with our competing countries in how we collect our revenues and the sources of our revenues—that would go a long way to resolving a lot of these issues, and we probably would not have had to have this hearing.

So let us have a hearing on the progressive consumption tax.

Thank you, Mr. Chairman.

Senator THUNE. The Senator from Maryland has done a lot of work and put a lot of effort into examining these issues and coming up with solutions. And he is out there at least advocating reforms to the tax code that would get us away from many of the embedded problems that we have and that have led us to where we are having hearings like this one today to talk about issues that, unfortu-

nately, I think could be solved if we had a more competitive tax code in this country.

So I appreciate his efforts and enjoyed working with him on our working group, and, as he said, we made a lot of good progress. We will see how much of that can be incorporated. And I know in the end he wants to see his concept, his idea, become the law of the land. So we will see if that emerges as one of the top ideas.

But I want to—first off, I think this is an important hearing, because it does have important implications for how American companies do business in Europe and around the globe. And efforts to combat inappropriate tax base erosion, if done incorrectly, could further damage the ability of American companies to compete in the global economy.

And I think, to put it more simply, American businesses deserve fair treatment and due process when it comes to their tax obligations in foreign nations, including from European nations as well as the European Commission.

And I hope today's hearing will send a signal that Congress is paying attention to the actions taken at the OECD in Brussels, and that Congress is not going to stand idly by if these actions are conducted in a way that negatively impacts innovative American companies from doing business abroad.

But I do want to just follow up on one point that the Senator from Maryland was sort of getting at, and that is to say that with the state aid cases, it would appear at least that the EU is taking advantage of America's lack of a competitive international tax system to pursue American companies, to accumulate overseas earnings as a revenue source. Those earnings are only overseas because Congress has failed to reform the U.S. international tax system.

So the question is—this is just a general question—are these cases, at least in large part, really just a symptom of the larger problem of a non-competitive U.S. tax system?

Mr. STACK. Senator, I want to answer with kind of two notes of humility. First, I am not an EU competition lawyer, and second, these cases have not run the gamut over there so that one can read and analyze final cases.

Having said that, we were faced with a choice as to whether to speak up now, before multi-billion-dollar judgments are rendered against our companies, or wait until the decisions were handed down. So we have been raising this issue today.

From my personal observation and study of these cases, it appears to me that the Commission here is attempting to tax income that really, under international standards, does not belong to any member.

My perception is that they are trying to tax the income that they perceive is untaxed because it has been deferred for U.S. tax, and they see it as something that is there for the taking, because our system has let it sit offshore without being taxed.

So that is my perception of the substantive state of those cases. They have a ways to go. I could be wrong, but that is the way I see them today.

Senator THUNE. And, Mr. Stack, do you believe that the Treasury Department—let me ask it this way. Does the Treasury Department believe that the sovereign right of taxation resides with the

individual nations of Europe and their tax departments, or does it reside in Brussels?

Mr. STACK. So my understanding under EU law is that income tax is the right of the member states. Now, having said that, there are a lot of complicated rules in the EU.

For example, you are not allowed to use your income tax to benefit one company over another, or one industry over another, and that is state aid in a very classic case. So there is some complexity of when an income tax could turn into a state subsidy that the EU Commission has every right to rule against.

In these particular cases where they are looking at particular rulings and telling countries that their transfer pricing rules should have been applied this way or that way, from our perspective, that crosses the line from the traditional state aid analysis, as I understand it.

That is novel, as I understand it, and that is why we have been asking for this to be done prospectively and not retroactively. And therefore these issues, the way I understand it, should have been within the purview of the member states and not the Commission. But again, I am not an EU lawyer and certainly not a competition lawyer in the EU.

Senator THUNE. So what recourse does the administration and Congress have to ensure that these state aid investigations are conducted fairly and not just simply another effort to tax or target American high-tech companies?

Mr. STACK. Senator, beyond what we have been doing, which is talking to the Commission, and what you are doing, which is shining a light on them, I do not have a magic bullet for what role we play in another sovereign's internal investigations.

But I do think it is a service to shine a light, talk about these issues openly, and hope that the Commission will see that being fair is better in the long run than perhaps what is about to occur.

Senator THUNE. I want to ask, just for a minute, a question about base erosion and profit-shifting efforts at the OECD. You were recently quoted in the *Financial Times* as saying—and this is a quote: "It is to the great credit of the U.K. that they were able to step back from a patent box widely seen as harmful."

As you may know, there has been much discussion in Congress about the possibility of a patent box, often called an innovation box, as part of tax reform. In fact, it is something that Senator Cardin and I examined in our tax reform working group, as did Senators Portman and Schumer.

Could you elaborate on why you view the U.K. patent box as harmful, and to whom do you view it as harmful? And perhaps maybe follow up with, are there existing patent boxes or patent box proposals that you would find to be beneficial?

Mr. STACK. Sure. Look, the U.K. started out and went around the world and said to companies, come and take your patents and just bring them on to our shores. You did not do any research here. You did not do anything. And when those patents are earning income, we are going to tax that at—I think 10 percent was the rate. And that meant that companies were being invited to strip out of the Germanies, the Frances, the U.S.es, at 25- and 35-percent rates. Watch the income flow into the U.K.

The reason that was harmful is, it appeared to have no other domestic policy purpose than attracting income from other jurisdictions. And really, all of Europe got very, very upset about it.

I gave them credit in that article—because they walked back from it in an agreement with Germany—to realize it was harmful and walk away from it, put that aside.

Now, the U.S. is unique with respect to intellectual property, because I am told that 85 percent of our R&D is already done in this country. We tend to agree that the R&D credit is a superior way to incentivize research.

But in terms of the work we have done at the OECD, programs built around the fact that we might want to reward research done in this country are not something that will probably violate what we have done at the OECD.

So I think the critical thing is, there are many shapes and sizes of what one might think of as a patent box, and so it is hard to speak about them generally. But none of the proposals I have seen for the U.S. involves the same kind of naked tax competition that the original U.K. proposal did, because we are an engine of global research and development, and rewarding our companies for the output of that in whatever way people think best is a fair debate to have, even if the administration, for example, would prefer the credit over an innovation box.

But nothing being proposed here is like what the U.K. had been doing and that they walked back from.

Senator THUNE. This question anybody may respond to. Europe obviously is an important market for American companies, both as a large consumer of American products and a location for U.S. foreign direct investment.

From the perspective of American enterprises looking to do business in Europe, what is likely to be the impact of these state aid investigations if, as expected, they result in prior tax rulings by certain EU member states being overruled by Brussels? Again, there are assumptions we are making here.

And the broader question has to do with what does this do to U.S. companies? Would it make them less likely to invest in Europe if they know that the European Commission is exerting this kind of authority, and are there likely to be more or fewer jobs created in Europe by American businesses as a result of these investigations?

I know these are kind of hypotheticals, but if you could just perhaps elaborate on what the likely outcome is with respect to jobs in that country and to investment by U.S. companies.

Mr. STACK. I will take the first stab. First, I think companies realize that there is this kind of instability, that when all of a sudden there is a new game in town where somebody can look back 10 years over rulings I got from members, I think it creates issues with respect to that kind of investment.

I will point out—and this is one of the unfortunate aspects of state aid, of these investigations—the landscape in Europe is changing. I think it is going to be more difficult to get Luxembourg rulings as we go forward, because of the BEPS work.

I think that there is going to be more attention paid to putting the actual profit where the activities occur. The Irish have already

taken steps to do away with some of the elements that are under investigation with state aid.

So I think a prospective remedy, actually, would work for the EU Commission, work for the companies, and also take the moving landscape in a positive direction in Europe. And so I am not sure that we would see that much more harm down the road in practice from these things, because the landscape is changing there.

Senator THUNE. All right. If anybody else cares to comment, feel free to.

Mr. DANILACK. I would say generally what I would be worried about if I were a company is not so much the specific results and how they might change and what Ireland may do in response and what Luxembourg may do in response, but more generally that what the European Commission actions represent is an erosion of a process by which to achieve tax certainty.

Not all companies are looking to achieve the lowest rate possible. They are looking to achieve a certain degree of certainty. The way companies generally think they should achieve certainty is by working directly with the government and entering into a ruling where that certainty is established.

And I think what the inquiries under state aid have done is called into question whether rulings are good, whether you can go into a country and get a ruling on transfer pricing principles that is widely accepted by the OECD and not have it subsequently challenged retroactively.

So there is a retroactive element. There is the fact that it is a ruling. You are looking for prospective certainty, and that is taken away. And the principles themselves that you thought were the right principles, and governments agreed to, suddenly now are being called into question.

And that type of a dynamic, where you cannot rely on a ruling anymore, is very, very dangerous, not only in Europe, but elsewhere. So, if other governments begin to think that you can tear up a ruling and go back and start all over and come up with a different tax answer, this is just very bad tax administration.

Senator THUNE. Good. All right. Does anybody have anything else for the good of the order? Closing thoughts?

All right. Well, I want to thank our colleagues who have been here, the distinguished panel of witnesses, and all the staff who have worked so hard over the Thanksgiving holiday to prepare for this hearing.

And I would say for the record that any member who wishes to submit statements, they should be submitted by the close of business on Monday, December the 7th.

And I certainly hope that this is something that we will continue to discuss, going forward, on both sides of the aisle as we work on topics related to tax policy in the future.

So thank you very much for being here, and with that, I guess I will adjourn this hearing, even though I do not have a gavel. This hearing is adjourned. Thank you.

[Whereupon, at 4:27 p.m., the hearing was adjourned.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Dorothy Coleman, Vice President for Tax and Domestic Economic Policy, National Association of Manufacturers

Chairman Hatch, Ranking Member Wyden, and members of the committee, thank you for the opportunity to testify today about the Base Erosion and Profit Shifting (BEPS) project spearheaded by the G20 and the Organisation for Economic Co-operation and Development (OECD). I appreciate the chance to highlight on behalf of the National Association of Manufacturers (NAM) our concerns about some of the recommendations in the BEPS project that would impose substantial and unnecessary compliance costs on companies and, in some cases, force disclosure of sensitive, confidential U.S. taxpayer information. These recommendations would create a new set of challenges for manufacturers and stand to harm our competitiveness in an already difficult global economic environment.

The NAM is the nation's largest industrial association and voice for more than 12 million women and men who make things in America. Manufacturing in the United States supports more than 17 million jobs, and in 2014, U.S. manufacturing output reached a record of nearly $2.1 trillion. It is the engine that drives the U.S. economy by creating jobs, opportunity and prosperity. The NAM is committed to achieving a policy agenda that helps manufacturers grow and create jobs. Manufacturing has the biggest multiplier effect of any industry and manufacturers in the United States perform more than three-quarters of all private-sector R&D in the Nation—driving more innovation than any other sector.

Manufacturers know full well how critically important it is for U.S. companies to be able to invest and compete effectively in the global marketplace. Indeed, 95 percent of the world's customers are outside the United States. Investment by U.S. global companies has paid off for the U.S. economy: U.S. global companies employ 35.2 million workers and are responsible for 20 percent of total U.S. private industry employment.[1] Moreover, U.S. companies that invest abroad export more, spend more on U.S. research and development performed by U.S. workers and pay their workers more on average than other companies.

BACKGROUND

In 2012, representatives from the G20 asked the OECD to develop a comprehensive approach to address aggressive global tax planning that resulted in inappropriate corporate tax avoidance. The OECD released its final recommendations in October 2015 and the recommendations were approved by the G20 Finance Ministers on October 9, 2015, and by the G20 Leaders on November 16, 2015.

In July 2013, the OECD released the G20/OECD Base Erosion and Profit Shifting ("BEPS") Action Plan, which provided for 15 actions designed to reach consensus among members for recommended changes in tax policy. The BEPS Action Plan included Action 13, "Re-examine Transfer Pricing Documentation," to develop rules to require multinational companies (MNEs) "to provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template."

On October 5, 2015, the OECD released its final report on Action 13 (along with reports on all 15 BEPS Actions). The OECD identified Action 13 as one of the areas

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[1] Bureau of Economic Analysis, August 2014.

where all countries agreed to consistent implementation. The Action 13 report was virtually identical to an earlier draft (released in September 2015) and previously released implementation guidance (released in February and June 2015). Action 13 adopts a three-tiered approach to achieve transfer pricing documentation: a *master file* containing information to provide a complete picture of the MNE's global operations, including an organizational chart, consolidated financial statements, and analyses of profit drivers, supply chains, intangibles, and financing; a *local file* providing more detailed information relating to specific intercompany transactions of the MNE group impacting the specific tax jurisdiction; and a *country-by-country report (CbCR)* containing aggregated financial and tax data by tax jurisdiction. According to the OECD, the two documents that provide group-wide information—master file and CbCR—are intended to provide governments with information necessary to conduct high-level transfer pricing risk assessment.

The CbCR will only be required of multinational groups with annual consolidated group revenue of at least 750 million Euro in the immediately preceding year. The first CbCRs would be filed for tax years beginning in 2016 with the tax residence country of the parent of the MNE group (*e.g.,* the United States for U.S. MNEs). Other countries could obtain CbCRs through exchange of information processes under bilateral treaties and tax information exchange agreements.

In order to obtain CbCRs, countries must agree to certain conditions related to confidentiality, consistency and appropriate use of the information. In this document, appropriate use is defined as "assessing high level transfer pricing risk" and "other BEPS-related risks." If the tax residence country of the parent company does not collect CbCRs, or has not agreed to provide CbCRs via information exchange, then other countries would be authorized to collect CbCRs directly from subsidiaries in their jurisdictions.

Action 13 includes model legislative language for adopting CbCR requirements and model competent authority agreements for use by governments to implement CbCR exchange. It also provides a detailed framework for confidentiality and data safeguards that need to be in place for countries to receive the CbCR through information exchange.

Under Action 13, the master file and the local file would be collected directly by each local jurisdiction in which the MNE conducts business. Confidentiality, consistency, and appropriate use standards that apply to the CbCR do not explicitly apply to the master file or local file, although participating countries have agreed that the confidentiality and consistent use standards associated with transfer pricing documentation generally "should be taken into account."

POTENTIAL IMPACT OF THE CBCR AND MASTER FILE REQUIREMENTS

The CbCRs on a company's financial and tax data that companies file with their own country could impose a significant, additional administrative burden on companies. These reports however, would be submitted to foreign countries under bilateral treaties and information exchange agreements and thus have protections to ensure confidentiality, consistency and appropriate use of the information by foreign countries.

Unfortunately, this would not be the case with the master file, which could be required directly by any country where a company does business. The master file asks for extremely sensitive information unrelated to actual taxpayer activities in the country requesting the information. In this way, the master file is similar to the CbCR. However, unlike the CbCR, the master file information does not have the confidentiality protections of the information exchange process and is not subject to any confidentiality, consistency, or appropriate use conditions beyond those that may apply locally.

If a country fails to abide by these conditions with respect to the CbCR, Treasury has stated its intent to suspend CbCR information exchange. To the extent this threat is effective in ensuring that other countries maintain confidentiality of CbCRs of U.S. MNEs, it is irrelevant to the master file, which is arguably more intrusive. With respect to maintaining confidentiality of the master file, U.S. MNEs are at the mercy of foreign governments.

Manufacturers are concerned that the master file requirement would force them to disclose an unprecedented amount of proprietary information about their global operations to foreign governments. The master file would include organizational charts, consolidated financial statements and analyses of profit drivers, supply

chains, intangibles, and financing. In short, it would provide a comprehensive plan that includes every aspect of a company's worldwide business.

While a small amount of the required information in the master file may be contained in public filings with the Securities and Exchange Commission (SEC), most of the required information is descriptive in nature and even publicly traded companies will need substantial input from across the business enterprise to recompose the data. Information about global supply chains, for example, can be considered sensitive commercial information that, if disclosed, would be of high value to the MNE's market competitors. For privately held companies, the requirements to include a global organizational chart and consolidated financial statements would constitute an unprecedented level of disclosure to foreign governments. Disclosure, misappropriation, or inappropriate use of this information could be extremely detrimental to the ability of U.S. manufacturers to create value in the United States and global marketplaces.

The fact that taxpayers may have some level of control over what information is included in the master file does little to address confidentiality concerns since it is unclear how much flexibility taxpayers have to exclude sensitive information.

In the Action 13 report, the OECD recommends taxpayers use a "prudent business judgment" standard to determine the "appropriate level of detail" to be included in the master file. Information that is "important," however, cannot be omitted. The OECD considers information to be important "if its omission would affect the reliability of the transfer pricing outcomes."

Manufacturers believe that this standard provides little comfort for taxpayers that want to omit sensitive information *and* avoid penalties for failing to comply with the filing requirements. There is, at best, a questionable nexus between the master file information and transfer pricing outcomes within a particular country under the arm's length standard, since that is the purpose of the local file. For example, a taxpayer could reasonably take the position that omitting a global organizational chart or consolidated financial statements would not "affect the reliability of the transfer pricing outcomes" within any particular jurisdiction, yet be concerned that such omissions would constitute non-compliance.

ADDRESSING CONFIDENTIALITY CONCERNS

Even though the BEPS recommendations were finalized this fall, the NAM strongly believes that taxpayer confidentiality concerns can and should be addressed during the BEPS implementation phase. Specifically, we believe that Treasury should link master file information to its agreements to provide the CbCR to other countries through information exchange. Thus, we urge Congress to ensure that Treasury enters into agreements with foreign countries specifying that:

- Treasury agrees to provide CbCRs for U.S. MNEs only if U.S. MNEs or their subsidiaries are not required to provide master file information to the foreign country;
- The foreign country agrees that it will not collect CbCRs from U.S. MNEs or their subsidiaries; and
- Treasury agrees to provide to the foreign country only the master file information that a U.S. MNE chooses to file with its CbCR in order to provide context for its CbCR data.

CONCLUSION

NAM members recognize the crucial role tax policy plays in the ability of businesses around the world to compete and grow, and we support tax rules that are pro-growth, pro-competitiveness, fair, clear, and predictable. In contrast, the proposed information sharing and disclosure rules included in the BEPS recommendations described above would impose new and unnecessary compliance costs on companies and, in some cases, force disclosure of proprietary business information, creating a new set of challenges for global companies.

In particular, the master file requirement would provide foreign governments with a comprehensive roadmap detailing every aspect of a company's worldwide business. Many manufacturers in the United States with operations overseas would have to comply with this provision, which represents an unacceptable and unprecedented expansion of required proprietary data sharing and a very real competitive threat for some of America's most innovative firms.

Manufacturers are particularly concerned about the lack of safeguards to protect the confidentiality of this very sensitive information in the master file. Unlike the CbCR, the master file is not provided through information exchange and is not subject to any confidentiality, consistency, or appropriate use conditions beyond those that may apply in a local jurisdiction. If a country fails to meet these conditions on CbCRs, Treasury can suspend the information exchange. Unfortunately, this option does not apply to the master file information, which is even more intrusive.

On a positive note, the United States has not announced plans to collect the master file. We urge Treasury officials to go one step further and only provide CbCRs to foreign countries that do not require a master file. At a company's option, Treasury can provide any master file information the company chooses to provide as context for its CbCR data that is provided through information exchange.

When it comes to tax policy, manufacturers believe a fair and transparent tax climate in the United States—including competitive business tax rates and modern international tax rules—will boost standards of living and economic growth worldwide. At the same time, an appropriate balance needs to be struck between transparency and confidentiality of the proprietary information that enables companies to compete and prosper in a global economy.

Questions Submitted for the Record to Dorothy Coleman

Questions Submitted by Hon. Orrin G. Hatch

master file reporting and confidentiality

Question. There are concerns about taxpayer confidentiality in the Master File reports. Treasury officials have suggested that those concerns have been addressed because taxpayers have discretion over what they put in the Master File.

But there must be some limits to that discretion, right? To what extent will companies have discretion over what goes into the master file? Foreign countries may very well ask for items that taxpayers will wish to keep secret, right?

And what are other OECD countries thinking as to the amount of discretion to be allowed here? What recourse does a company have if the foreign tax authority disagrees with the company's judgment and demands sensitive information on audit or imposes a fine for non-compliance?

Could a non-public company exclude from the master file consolidated financial statements or a global organizational chart if in its "prudent business judgment" that information goes beyond the "appropriate level of detail" and does not "affect the reliability of transfer pricing outcomes"?

The Treasury Department has indicated that other countries can collect the Master File directly from multinational corporations, rather than going through the more typical information exchange process whereby foreign governments would ask the U.S. Government for such Master Files on a given taxpayer.

What should the U.S. Government do if a foreign government fails to keep a U.S. multinational corporation's master file confidential? Does that heighten confidentiality concerns? Would there be greater protection of U.S. taxpayer confidentiality if the U.S. Government were the gatekeeper to this information?

Answer. Action 13 of the BEPS Final Report specifically requires countries to adhere to certain confidentiality, consistency, and appropriate use standards in order to obtain country-by-country reports (CbCRs). In the case of the United States, the Treasury Department plans to collect CbCRs from U.S. multinationals and transfer them to other countries through treaty information exchange. Treasury officials have stated that if a foreign tax authority does not comply with these standards, they would suspend transmitting CbCRs to that tax authority. Unfortunately, the master file, which individual countries will require to be provided directly by companies, and would not be covered by the confidentiality, consistency, and appropriate use standards that apply to CbCRs. While countries have agreed that confidentiality "should be taken into account" when it comes to the master file, there are insufficient safeguards to protect against misuse of the information.

We believe that putting this information into the hands of foreign tax authorities, without any clear safeguards to protect confidentiality, could put critical commercial information at substantial risk of public disclosure. At a time of widely reported cor-

porate espionage and high profile data hacks, there is no guarantee that other countries would not inadvertently compromise companies' information, a risk that U.S. businesses should not have to face. Moreover, the EU has stated its ambitions to make CbCRs public. While the information exchange process gives Treasury some leverage to prevent that for U.S. multinationals, no such leverage exists under current law with respect to master file information.

In addition, we disagree with any assertions that companies already include the master file information in filings with the U.S. Securities and Exchange Commission (SEC). Obviously, private companies do not file with the SEC. Thus, requirements to provide foreign tax authorities with a global organizational chart and consolidated financial statements constitute an unprecedented level of disclosure to foreign governments.

The master file also presents problems for publicly traded companies. Since most of the required information is descriptive in nature, it will have to be compiled with substantial input from across the multinational enterprise (MNE) group and some of the information could be considered confidential or proprietary. For example, information about global supply chains could well be considered sensitive commercial information that, if disclosed, would be of high value to the MNE's market competitors, which could include state-owned enterprises.

Moreover, even if there are individual pieces of information that, taken alone, may not be sensitive, the master file requires companies to pull it all together as a "blueprint of the MNE group." Such a "blueprint" could reveal competitively important strategic information that would be valuable to competitors. We also believe that, like the CbCR, the global nature of information required in the master file will lead to more aggressive foreign audits and tax assessments that are inconsistent with international tax norms, and U.S. MNEs are likely to be the primary targets.

Before the BEPS recommendations were approved, companies had the ability to push back on specific information requested by a foreign tax authority during an audit. This is particularly true with respect to global information that has little or no connection with a MNE's operations within a particular country. Before Action 13, this type of global information was generally available only through treaty-based information exchange, and the U.S. competent authority would require the foreign tax authority to demonstrate a clear linkage to a tax determination. Action 13, however makes local filing of master file information part of the international standard, making it much more difficult for U.S. companies to push back on specific information requests.

On numerous occasions, Treasury officials have taken the position that since taxpayers have control over what they include in the master file, confidentiality concerns are manageable. In reality however, the fact that taxpayers have some level of control over what information is included in the master file does little to address confidentiality concerns because, as noted above, it is not clear how much flexibility taxpayers have to exclude sensitive information.

The "prudent business judgment" standard that the Action 13 report recommends taxpayers use to determine the level of information to include in the master file is vague and subjective, and provides little comfort for taxpayers that wish to omit sensitive information and avoid penalties. For example, a taxpayer could reasonably take the position that omitting a global organizational chart or consolidated financial statements would not "affect the reliability of the transfer pricing outcomes" within any particular jurisdiction, yet be concerned that such omissions would constitute non-compliance.

Some Treasury officials and commentators also have suggested that the master file requirement benefits taxpayers because it allows them to put their CbCR data into a narrative context. If this is the case, the master file itself, and the information included, should be optional and part of the CbCR filing to allow companies that want to provide more context for the financial information in the CbCR can do so with the confidentiality protections that come with treaty-based information exchange provided for the CbCR.

The NAM supports legislation—the Bad Exchange Prevention (BEPS) Act (H.R. 4297)—introduced late last year by Rep. Charles Boustany (R–LA) that addresses many of NAM's concerns outlined above. Specifically, H.R. 4297 clearly describes potential abuses of the master file requirements *and* requires the Federal Government to withhold CbCRs from countries abusing master file documentation requirements or failing to keep master file information confidential. Abuses of the master file requirement include requesting trade secrets, group consolidated financial statements

not filed with the SEC, certain attorney-client privileged information, and other information that Treasury determines to be inappropriate. Thus, H.R. 4297 provides Treasury and taxpayers with the same leverage for master file information that now exists for CbCRs—suspension of CbCR exchange. This helps ensure that the Federal Government will protect U.S. businesses from being forced to disclose sensitive and confidential taxpayer information to foreign tax authorities as part of their implementation of Action 13.

COUNTRY-BY-COUNTRY REPORTS

Question. Does the Treasury Department have the authority to issue regulations as called for by the BEPS reports as to country-by-country reporting? If so, how will the country-by-country reports assist the U.S. Government in the collection of U.S. income taxes?

Answer. While manufacturers recognize that there is a compliance burden associated with the CbCRs, we support efforts by the Internal Revenue Service (IRS) and Treasury to issue CbCR guidance so U.S. MNEs can file once with the IRS and have their information confidentially exchanged via tax treaty or tax information exchange agreements with countries that agree with these confidentiality protections. Other countries already have announced that they will require CbCRs and our members have some level of comfort in exchanging information under a standard process that offers data protection. Moreover, if the United States does not collect and remit CbCRs, other countries may require local subsidiaries of U.S. MNEs to file a CbCR in a much less controlled and confidential manner under the "secondary mechanism" laid out in the BEPS report. This approach would be more costly for U.S. MNEs and provide less protection for confidential taxpayer information than if the IRS requires CbC reporting.

QUESTIONS SUBMITTED BY HON. DEAN HELLER

Question. I strongly believe that tax reform, done the right way, can improve our fiscal picture. That said, without comprehensive tax reform, we are left with a crumbling tax code that negatively impacts our American and Nevadan businesses, while our other OECD partners are lowering their corporate tax rates and expanding their tax base. I am deeply concerned that U.S. multinational companies are being targeted and that the administration is not taking steps to defend our U.S. businesses.

Answer. The NAM strongly agrees with you on the need for comprehensive tax reform. NAM members know firsthand that our current tax system is fundamentally flawed and discourages economic growth and U.S. competitiveness. Indeed, a key objective for the association is to create a national tax climate that promotes manufacturing in America and enhances the global competitiveness of manufacturers in the United States. To achieve these goals, we need a comprehensive tax reform plan that both reduces the corporate tax rate to 25 percent or lower and includes lower rates for the nearly two-thirds of manufacturers organized as flow-through entities. We also believe that comprehensive tax reform must include a shift from the current worldwide system of taxation to a modern and competitive international tax system, a permanent and strengthened research and experimentation (R&E) incentive and a strong capital cost-recovery system.

We also feel that while enactment of a pro-growth tax reform plan will strengthen our economy and ensure vibrant economic growth in the future, our economy is suffering because of inaction on tax reform. *A Missed Opportunity: the Economic Cost of Delaying Pro-Business Tax Reform,* a study released by the NAM in January 2015, takes a close look at the economic impact of enacting a five-prong pro-business tax package similar to NAM's priorities and concludes that lack of action on pro-business tax reform is costing the U.S. economy in terms of slower growth in Gross Domestic Product (GDP), investment and employment. In contrast, the report finds that over a 10-year period, a pro-business tax plan would increase GDP over $12 trillion relative to CBO projections, increase investment by over $3.3 trillion and add over 6.5 million jobs to the U.S. economy.

Question. As you know, the OECD BEPS plan generally can't force member governments to do anything they don't want to do. Does BEPS strengthen the EU Commission's hand by providing political cover?

Answer. Yes. From our perspective, the European Commission (EC) appears very committed to the BEPS recommendations. Based on recent news reports, the EC later this month is expected to issue a proposal that will require countries in the

European Union (EU) to adopt the BEPS proposals as legislation. According to a top EC official, the EU could adopt the BEPS recommendations by June 2016. The NAM is extremely concerned that adoption of these recommendations by the EU will force U.S. companies to hand over a significant amount of detailed and, in some cases, confidential business information to foreign tax authorities without safeguards to protect confidentiality or misuse of the information. We also believe that the type of amount of information required under the BEPS recommendations will lead to more aggressive foreign audits and tax assessments, particularly of U.S. multinational companies.

Question. I am deeply concerned with recent reports, as I am sure you are, that these EU state aid cases will lead to retroactive foreign tax increases on U.S. companies. Does it make sense that if the Commission finds that a country has violated its obligations to the EU that the company should be held liable retroactively?

Answer. The NAM shares your concerns and those expressed by Treasury at the hearing about the continuing EU "state aid" cases involving the ex post facto and novel application of non-tax European law to effectuate tax policy changes that lead to retroactive taxation. It is a long-standing position of the NAM that the retroactive imposition or increase of taxes is fundamentally unsound, unfair and punitive.

Question. As you may know, this committee is dedicated to overhauling the tax code. Earlier this year the committee held tax reform hearings analyzing simplicity, fairness, growth and international competitiveness. As this committee discusses overhauling the tax code, including international tax reform, what is the single biggest element that lawmakers can implement to promote pro-growth international competiveness?

Answer. Manufacturers believe that the OECD's focus on global profit shifting highlights the critical need for a comprehensive overhaul of the U.S. tax system to reflect the global marketplace of the 21st century. Indeed, policy makers in the United States should focus on the underlying problems of the U.S. business tax system—the high business tax rates and the double tax burden faced by U.S. global manufacturers and other U.S. multinationals because of our outdated worldwide tax system. Most of our competitor nations—including most of the countries that participated in the BEPS project—have much lower rates and territorial tax systems that only tax income earned within their borders. Consequently, in order to spur economic growth—and additional revenues for Treasury—the focus should be on reforming our outdated tax code by lowering business tax rates and adopting competitive international tax rules. In sum, we need a competitive tax system that makes the U.S. the best place in the world to manufacture and attract foreign direct investment.

Question. I am here to help. How can Congress protect U.S. businesses from being targeted by foreign governments?

Answer. In addition to advancing pro-growth tax-reform as described above, Senate action on pending tax treaties could be very helpful in protecting U.S. businesses from being targeted by foreign governments. Income tax treaties play a critical role in promoting U.S. bilateral trade and investment. In particular, globally competitive tax treaties protect U.S. businesses from double taxation of income earned overseas and reduce U.S. withholding taxes thus encouraging foreign companies to invest in the United States. The NAM supports inclusion in tax treaties dispute resolution procedures for U.S. taxpayers, treaty-partner taxpayers, and the U.S. and foreign taxing authorities to resolve disagreements and to assist in the enforcement of individual countries' tax laws. Unfortunately, no treaties or protocols have been approved since 2010. Currently, treaties with Chile, Switzerland, Hungary, Poland, Luxembourg, and Spain and a protocol to amend a multilateral convention, all are pending in the Senate.

QUESTIONS SUBMITTED BY HON. MICHAEL B. ENZI

Question. The EU state aid cases are targeting multinationals—predominantly U.S. multinationals. Based on its announcement of the first two decisions last month, the Commission believes the investigated countries are providing multinationals unfair competitive advantages over smaller domestic competitors through tax rulings that "do not reflect economic reality." We haven't seen the legal analysis of these cases yet, but if these are the standards that are being applied, do you agree that the decisions should not produce results that actually disadvantage integrated multinationals and that do reflect economic reality?

Answer. While the NAM has not been involved in any specific case, we share Treasury's concerns expressed at the hearing about the continuing EU "state aid" cases involving ex post facto and novel application of non-tax European law to effectuate tax policy changes that lead to retroactive taxation. It is a long-standing position of the NAM that the retroactive imposition or increase of taxes is fundamentally unsound, unfair and punitive.

Question. Isn't the arm's length principle the internationally accepted mechanism that strikes that balance?

Answer. Manufacturers strongly believe that the current arm's length standard—embodied in U.S. tax law and tax treaties—is the appropriate standard for transfer pricing that is designed to, as you put it in your question, "reflect economic reality" of intercompany transactions. Basing intercompany pricing on what unrelated third parties would do under the same or similar circumstances is a fundamental principle of tax policy. The arm's length standard has been, and remains, conceptually sound, relevant and reliable in addressing related party transactions.

Transfer pricing transactions involve at least two jurisdictions and the arm's length standard recognizes the natural "tension" when each jurisdiction is interested in maximizing revenue and discouraging "leakage" from its tax base. In addition, a system of "advance pricing agreements," a mechanism whereby governments agree to pricing arrangements in advance, provides certainty both to the governments and taxpayers. The arm's length standard has been adopted by the Organisation for Economic Co-operation and Development (OECD) and is used by every major industrial nation. We would note that in announcing its appeal of the European Commission's state aid decision in the Netherlands/Starbucks case, the Dutch Minister of Finance said, "the Commission applies its own new criterion for profit calculation, which is incompatible with domestic regulations and the OECD framework."

Moreover, there is a well-developed body of law and regulatory guidance on the standard in the United States. For example, over the years, Treasury has issued numerous regulations and other guidance on issues involving transfers of intangible assets, including inventions, scientific discoveries, patents, designs, trademarks, brand names, and copyrights. In addition, the Internal Revenue Service (IRS) has broad authority to audit intercompany transactions and change the results reported on tax returns, even absent intent to evade or avoid taxes.

Question. Regarding the EU state aid cases: What do these cases mean for our ability to rely on bilateral tax treaties negotiated with European countries if the European Commission can unilaterally change a treaty partner's tax positions through enforcement of EU competition policy?

Answer. The NAM shares Treasury's concerns expressed at the hearing that the state aid cases potentially undermine U.S. rights under our bilateral tax treaties with EU member states.

Question. Does the U.S. have any rights under the treaty to protect U.S. tax interests while ensuring U.S. multinationals are not subject to double taxation because of the EU state aid decisions?

Answer. See answer above.

Question. We've all heard how BEPS threatens the U.S. tax base because its general policy objective is to align taxing rights with value creating activities. While BEPS represents prospective tax policy changes, and the U.S. at least had a seat at the table, the EU state aid cases represent EU assertion of retroactive taxing rights over the historical foreign earnings of U.S. multinationals, with the U.S. Government unable to participate.

Do you view the EU state aid cases as an attempt by the EU to unilaterally and retrospectively attack the "stateless income" issue that the BEPS project was designed to address on a multilateral and prospective basis?

Answer. The NAM shares Treasury's concerns expressed at the hearing that, in substance, the state aid cases appear to reach results that are inconsistent with the internationally accepted standards in place at the time the income was earned.

Question. If the cases result in a single member state collecting tax on virtually all of the income, without regard to the level of economic activity within that state—wouldn't that actually contradict the underlying premise of the BEPS project—to align taxing rights with underlying value creating activity?

Answer.Yes, disregarding the level of economic activity within the EU member state under investigation would seem to contradict the underlying premise of BEPS to align taxing rights with underlying value creating activity.

Question. With respect to income from intangible property, isn't it true that a significant portion of this value-creating activity is likely to have taken place in the U.S., giving the U.S. primary taxing rights, on a deferred basis or otherwise?

Answer. We are not familiar enough with the cases to answer this question.

PREPARED STATEMENT OF MICHAEL DANILACK, PRINCIPAL, PRICEWATERHOUSECOOPERS LLP

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 crystallize.

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.

QUESTIONS SUBMITTED FOR THE RECORD TO MICHAEL DANILACK

QUESTIONS SUBMITTED BY HON. ORRIN G. HATCH

MASTER FILE REPORTING AND CONFIDENTIALITY

Question. There are concerns about taxpayer confidentiality in the Master File reports. Treasury officials have suggested that those concerns have been addressed because taxpayers have discretion over what they put in the Master File.

But there must be some limits to that discretion, right? To what extent will companies have discretion over what goes into the master file? Foreign countries may very well ask for items that taxpayers will wish to keep secret, right?

And what are other OECD countries thinking as to the amount of discretion to be allowed here? What recourse does a company have if the foreign tax authority disagrees with the company's judgment and demands sensitive information on audit or imposes a fine for non-compliance? Could a non-public company exclude from the master file consolidated financial statements or a global organizational chart if in its "prudent business judgment" that information goes beyond the "appropriate level of detail" and does not "affect the reliability of transfer pricing outcomes"? The Treasury Department has indicated that other countries can collect the Master File directly from multinational corporations, rather than going through the more typical information exchange process whereby foreign governments would ask the U.S. Government for such Master Files on a given taxpayer.

Answer. What is to be included in a master file report and what discretion a company will have in completing the report will be based entirely on the laws and administrative practices adopted by each country choosing to implement the requirement. In other words, the requirements and how they are enforced will vary from country to country, and possibly from situation to situation. Likely, some tax authorities will be sensitive to the concerns of business and circumspect about the information required, while others may make more expansive requests.

Question. What should the U.S. Government do if a foreign government fails to keep a U.S. multinational corporation's master file confidential? Does that heighten confidentiality concerns? Would there be greater protection of U.S. taxpayer confidentiality if the U.S. Government were the gatekeeper to this information?

Answer. In general, if a foreign tax authority discloses a U.S. company's tax information (whether master file information or other information) in violation of its own confidentiality laws, the foreign tax authority would not be accountable to the U.S. Government. If the disclosure is by a U.S. treaty partner, however, the IRS would likely take note of the violation, particularly if it reflects a systemic problem, because its agreement to exchange tax information with any foreign tax authority is premised on the country's laws and administrative practices being adequate to safeguard all tax information. Thus, *any* violation of a treaty partner's tax confidentiality laws (whether with respect to master file reports or otherwise) could cause the IRS to question the propriety of exchanging tax information with the tax authority of that country.

If the disclosed information had been collected by the IRS and then provided to the foreign tax authority under an exchange of information provision (that is, if the IRS were a "gatekeeper" of the information), the information would not be subject to any "greater protection" legally speaking. The provisions of tax treaties and tax information exchange agreements generally provide that information exchanged is to be protected by the receiving tax administration *in the same manner as information collected directly by that tax administration under its own laws.* Thus, treaty exchange provisions do not generally provide greater confidentiality protection to exchanged information. Some heightened "comfort" may be achieved, however, because a foreign tax authority may take more care with information it receives from the IRS, either out of a general sense of duty or in supposing the IRS will more likely call treaty exchange into question if it provides the information that is inappropriately disclosed. Further, the IRS may in fact be more watchful for, and sensitive about, inappropriate disclosures of information it provides a foreign tax authority than it may be about disclosures of confidential information its treaty partner acquires elsewhere. In theory, however, the IRS should be equally concerned about any violation of tax confidentiality by its treaty partners.

COUNTRY-BY-COUNTRY REPORTING

Question. Does the Treasury Department have the authority to issue regulations as called for by the BEPS reports as to country-by-country reporting? If so, how will the country-by-country reports assist the U.S. Government in the collection of U.S. income taxes?

Answer. Statutory authority granted to the IRS to collect information (whether under 6001, 6011, 6038, or 7602) is limited to collections of information relevant to the determination of a U.S. tax liability. Importantly, according to the preamble to the proposed Treasury regulations requiring country-by-country reporting, the IRS has concluded that the country-by-country reports it will collect from U.S.-based

multinational companies, as well as the country-by-country reports it will receive from other governments in the exchange process, "will assist in better enforcement of the Federal income tax laws by providing the IRS with greater transparency regarding the operations and tax positions taken by U.S. MNE groups."

QUESTIONS SUBMITTED BY HON. DEAN HELLER

Question. I strongly believe that tax reform, done the right way, can improve our fiscal picture. That said, without comprehensive tax reform, we are left with a crumbling tax code that negatively impacts our American and Nevadan businesses, while our other OECD partners are lowering their corporate tax rates and expanding their tax base. I am deeply concerned that U.S. multinational companies are being targeted and that the administration is not taking steps to defend our U.S. businesses.

As you know, the OECD BEPS plan generally can't force member governments to do anything they don't want to do. Does BEPS strengthen the EU Commission's hand by providing political cover?

I am deeply concerned with recent reports, as I am sure you are, that these EU state aid cases will lead to retroactive foreign tax increases on U.S. companies. Does it make sense that if the Commission finds that a country has violated its obligations to the EU that the company should be held liable retroactively?

Answer. I have no views either on whether BEPS provides political cover to the European Commission or on whether retroactive recoveries following EU state aid determinations make sense. I will point out, however, that if Congress is worried about retroactive taxation of U.S. companies' offshore profits, EU state aid recoveries should not be the only concern. The BEPS project outputs include vague new concepts that provide tax administrations with discretion to ignore entities and contracts in determining tax liabilities. Many U.S. companies are experiencing audits by foreign tax authorities in which these vague concepts are being applied for years past. The anti-BEPS rhetoric (that tax planning is abusive and that multinational companies have not paid a fair share) seemingly has encouraged tax authorities to apply these vague new concepts retroactively. Thus, it is increasingly likely that offshore profits will have already been taxed by foreign governments, perhaps more than once, when repatriated to the United States.

Question. As you may know, this committee is dedicated to overhauling the tax code. Earlier this year the committee held tax reform hearings analyzing simplicity, fairness, growth and international competitiveness. As this committee discusses overhauling the tax code, including international tax reform, what is the single biggest element that lawmakers can implement to promote pro-growth international competiveness?

Answer. International tax reform will require that several complex concepts be addressed carefully, but the "single biggest element" of such reform, which is essential to promoting growth and international competitiveness, is a substantially lower corporate tax rate.

Question. I am here to help. How can Congress protect U.S. businesses from being targeted by foreign governments?

Answer. Establishing U.S. tax relevance of information to be collected by the IRS is particularly important when the information is located offshore. The courts have established that, under principles of international law, the IRS has the authority to collect information located offshore, but only if it clearly identifies its tax purpose and the information is clearly relevant to that purpose. Presumably due to this sensitivity about offshore information, Congress granted special authority to the IRS, in section 6038 of the Internal Revenue Code, to collect particular offshore information needed to determine a U.S. person's liability under subpart F of the Code. Country-by-country information is not expressly covered by section 6038 itself. Treasury, however, was granted authority in section 6038(a)(1) to require other information that is "similar or related in nature" to the information listed in section 6038 or which the Secretary determines to be appropriate to carry out the provisions of the Internal Revenue Code.

QUESTIONS SUBMITTED BY HON. MICHAEL B. ENZI

Question. The EU state aid cases are targeting multinationals—predominantly U.S. multinationals. Based on its announcement of the first two decisions last month, the Commission believes the investigated countries as providing multinationals unfair competitive advantages over smaller domestic competitors through tax rulings that "do not reflect economic reality." We haven't seen the legal analysis of these cases yet, but if these are the standards that are being applied, do you agree that the decisions should not produce results that actually disadvantage integrated multinationals and that do reflect economic reality?

Isn't the arm's length principle the internationally accepted mechanism that strikes thatbalance?

Question. Regarding the EU state aid cases: What do these cases mean for our ability to rely on bilateral tax treaties negotiated with European countries if the European Commission can unilaterally change a treaty partner's tax positions through enforcement of EU competition policy?

Does the U.S. have any rights under the treaty to protect U.S. tax interests while ensuring U.S. multinationals are not subject to double taxation because of the EU state aid decisions?

Question. We've all heard how BEPS threatens the U.S. tax base because its general policy objective is to align taxing rights with value-creating activities. While BEPS represents prospective tax policy changes, and the U.S. at least had a seat at the table, the EU state aid cases represent EU assertion of retroactive taxing rights over the historical foreign earnings of U.S. multinationals, with the U.S. government unable to participate.

Do you view the EU state aid cases as an attempt by the EU to unilaterally and retrospectively attack the "stateless income" issue that the BEPS project was designed to address on a multilateral and prospective basis?

If the cases result in a single member state collecting tax on virtually all of the income, without regard to the level of economic activity within that state, wouldn't that actually contradict the underlying premise of the BEPS project—to align taxing rights with underlying value-creating activity?

With respect to income from intangible property, isn't it true that a significant portion of this value-creating activity is likely to have taken place in the U.S., giving the U.S. primary taxing rights, on a deferred basis or otherwise?

Answer. I am neither expert in EU competition law nor knowledgeable about the particular state aid cases pending at this time. Therefore, I have no responses to offer to Senator Enzi's questions above.

PREPARED STATEMENT OF HON. ORRIN G. HATCH,
A U.S. SENATOR FROM UTAH

WASHINGTON—Senate Finance Committee Chairman Orrin Hatch (R–Utah) today delivered the following opening statement at a committee hearing examining the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) reports, and the European Union's (EU) State Aid investigations regarding member-countries' tax rulings:

I want to welcome everyone here this morning and thank you all for attending this important hearing on international taxation, focusing particularly on the Organisation for Economic Co-operation and Development, or OECD's, project on base erosion and profit shifting, or BEPS.

The overall discussion about international tax is very timely.

Just a couple of weeks ago, we were informed that a major American pharmaceutical company had decided to invert—merging with another drug company, with the headquarters of the newly-formed corporation to be located in a foreign country.

Of course, this is nothing new. We've been seeing these types of transactions take place for some time.

Inversions like these are some of the clearest examples of base erosion and are largely motivated by tax considerations, as American companies determine that they can reduce their overall operating costs if they become foreign corporations. Given

the burdensome and anti-competitive nature of the U.S. tax code, these companies are, unfortunately, not acting irrationally.

The administration's response to the wave of inversions has, in my opinion, been short-sighted, focusing only on the symptoms rather than the underlying illness. While the latest proposed guidance from Treasury might very well stem the tide of inversions, it will leave other, potentially more harmful avenues for tax avoidance—like foreign takeovers—wide open, and perhaps even make them more attractive.

Long story short, any steps we take to address inversions should focus on fixing the shortcomings of the underlying system and make the U.S. a better place for companies to do business.

The BEPS project is another effort aimed at addressing international tax problems and base erosion, but on a more global scale. The purpose of the project was to provide OECD member countries with recommendations for both domestic tax policy changes and amendments to existing tax treaties to address business practices that result in base erosion. After several years of discussion, the OECD released its final reports earlier this year and, last month, leaders from the G20 countries endorsed the recommendations.

Throughout this process, we have heard concerns from large sectors of the business community that the BEPS project could be used to further undermine our nation's competitiveness and to unfairly subject U.S. companies to greater tax liabilities abroad. Companies have also been concerned about various reporting requirements that could impose significant compliance costs on American businesses and force them to share highly sensitive proprietary information with foreign governments.

I expect that we'll hear about these concerns from the business community and others during today's hearing.

In addition, throughout the BEPS negotiations, I urged the Obama administration to both acknowledge the limits of their authority under the law and to cooperate with Congress on any and all efforts to implement the recommendations. While the U.S. was a party to the BEPS negotiations, Congress had neither a seat at the negotiating table nor a meaningful opportunity to weigh in with the administration on the substance of the proposals.

However, it is Congress—and Congress alone—that has the ultimate authority to make changes to the U.S. tax code. While the Treasury Department does have broad regulatory authority under the law, that power is not without limits. Even in those areas where authority clearly exists for the administration to promulgate regulations, it is virtually always better if Congress is viewed as a partner in this process rather than an adversary. And, in those instances where the regulatory authority is less clear, congressional involvement and approval is even more important to ensure that policy changes are viewed by the public as legitimate.

Of course, most of this should go without saying. It is, after all, a basic lesson in government, and I don't think anyone here is in need of a civics refresher from me.

However, I think it also goes without saying that the current administration hasn't always viewed Congress as a necessary or even important part of its efforts to develop and implement policy changes. So, I think it is, at the very least, helpful to offer a brief reminder to everyone that Congress has a role to play on these issues that cannot be overlooked.

That's another set of concerns that I expect we'll discuss during this hearing. We have a representative from Treasury here today—so, I'm looking forward to getting a better sense of what elements of the BEPS recommendations the administration believes it can implement unilaterally and where they believe congressional action will be necessary.

I also want to note that I have asked the Government Accountability Office to provide its own analysis on the BEPS recommendations, taking into account all of the complex elements—both domestic and global—that are implicated with these types of policy changes. I expect their work will take some time, but gathering this type of information is, in my view, an essential part of our overall evaluation of the BEPS project.

There are other topics that I expect will come up today, including a discussion of so-called "state aid" remedies and recent activities in the eurozone that, to me,

look like attempts to impose retroactive taxation on multinational enterprises, including a number of U.S.-based companies.

Speaking more broadly, I just want to say that, when it comes to international tax issues, I hope we all have the same goals in mind.

I would hope that we all want to improve conditions for American businesses.

I would hope that we all want to make our country more competitive on the world stage.

And, to that end, I would hope that we all want to improve the overall health of the U.S. economy. That's why all of us are here today, or at least it should be.

Any regulations promulgated by the administration to prevent businesses from moving offshore should have these goals in mind.

At the same time, while international efforts to align tax systems are worth exploring, we shouldn't be negotiating agreements that undermine our own interests for the sake of some supposedly higher or nobler cause. The interests of the United States—our own economy, our own workers, and our own job creators—should be our sole focus.

So, throughout today's discussion—whether we're talking about BEPS, inversions, or any other international tax issues—I am most interested in hearing views as to how various policies and proposals will or will not serve our Nation's interests and advance these important goals.

Long story short, we have quite a bit to talk about today. And, we have a distinguished panel of witnesses who should be able to shed some light on these complicated issues. I look forward to their testimony.

PREPARED STATEMENT OF ROBERT B. STACK, DEPUTY ASSISTANT SECRETARY FOR INTERNATIONAL TAX AFFAIRS, DEPARTMENT OF THE TREASURY

Chairman Hatch, Ranking Member Wyden, and distinguished members of the committee, I appreciate the opportunity to appear today to discuss some key international tax issues, including the recently completed G20/Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project. We appreciate the committee's interest in these important issues.

I would like to begin by describing the outcome of the G20/OECD BEPS project, and then describe the expected BEPS follow-on work. I will then link that discussion to a consideration of the need for general corporate and international tax reform, as well as the related need to address U.S.-base stripping and inversion transactions. I will close with a discussion of the European Commission's current state aid investigation of multinational firms, including U.S. multinationals.

G20/OECD BASE EROSION AND PROFIT SHIFTING (BEPS) PROJECT

In June 2012, at the G20 Summit in Los Cabos, Mexico, the leaders of the world's largest economies identified the ability of multinational companies to reduce their tax bills by shifting income into low- and no-tax jurisdictions as a significant global concern. They instructed their governments to develop an action plan to address these issues, which was endorsed by G20 leaders in September 2013 in St. Petersburg. The OECD has hosted this process, but all G20 governments, some of which are not members of the OECD, had a role. The G20/OECD BEPS Action Plan outlined 15 specific areas for further examination. The results were delivered to Finance Ministers this October in Lima, Peru, and to President Obama and other world leaders at last month's G20 summit in Antalya, Turkey.

The United States has a great deal at stake in the BEPS project and a strong interest in its success. Our active participation is crucial to protecting our own tax base from erosion by multinational companies, much of which occurs as a result of exploiting tax regime differences. A key goal of BEPS is to identify those differences and write rules that close loopholes. In addition, as the home of some of the world's most successful and vibrant multinational firms, we have a stake in ensuring that companies and countries face tax rules that are clear and administrable and that companies can avoid unrelieved double taxation, as well as expensive tax disputes. Both the United States and our companies have a strong interest in access to robust dispute resolution mechanisms around the world. In contrast, failure in the BEPS project could well result in countries taking unilateral, inconsistent actions, thereby

increasing double taxation, the cost to the U.S. Treasury of granting foreign tax credits, and the number and scale of tax disputes. Indeed, notwithstanding the BEPS project, some countries have taken unilateral action, and it is our hope that they will reconsider those actions in the post-BEPS environment.

The principal target of the BEPS project was so-called "stateless income," basically very low- or non-taxed income within a multinational group. The existence of large amounts of stateless income in a time of global austerity has called into question the efficacy of longstanding international tax rules. This issue is prominent in a global economic environment in which superior returns can accrue to intangibles that are easily located anywhere in the world and that often result from intensive research and development activities that a single multinational may conduct in many countries, or that result from marketing intangibles that can be exploited in one country but owned and financed from another country. Some countries with large markets believe that some of these premium profits should be taxed in the market country, whereas current international norms attribute those profits to the places where the functions, assets, and risks of the multinational firm are located—which are often not the market countries. Finally, I would be remiss to not note that the ability of U.S. multinationals to defer tax on large amounts of income in low- and no-tax jurisdictions has fed the perception of tax avoidance by these multinationals. This perception exists even though the U.S. would tax that income upon repatriation to the U.S. parent firm—whether voluntarily by the taxpayer, or through a deemed repatriation that might occur as a part of tax reform.

The G20/OECD project produced a broad array of reports outlining measures addressing stateless income ranging from revision of existing standards to new minimum standards, as well as describing common approaches, all of which are expected to facilitate the convergence of national practices. All OECD and G20 countries have committed to minimum standards in the areas of preventing treaty shopping, requiring country-by-country reporting, fighting harmful tax practices, and improving dispute resolution. In transfer pricing, existing standards have been updated. With respect to recommendations on hybrid mismatch arrangements and best practices on interest deductibility, countries have agreed on a general tax policy direction. In these areas, we expect that practices will converge over time through the implementation of the agreed common approaches. In the United States, most of the rules restricting the use of hybrid entities and hybrid securities and the rules limiting excessive interest deductibility would require congressional action, and the administration proposed new policies along these lines in the FY 2016 Budget. Guidance based on best practices will also support countries in the areas of disclosure initiatives and controlled foreign company (CFC) legislation. Finally, participants agreed to draft a multilateral instrument that countries may use to implement the BEPS work on tax treaty issues.

I would like to highlight some of the more important outputs from the BEPS project. Interest expense deductions are a major contributor to the BEPS problem. The ability to achieve excessive interest deductions, including those that finance the production of exempt or deferred income, is best addressed in a coordinated manner. The BEPS project has agreed on a best practice approach, which recommends that countries provide two alternative caps on interest deductions from which companies can choose. The first cap is a fixed ratio, which is similar to the rules under current U.S. law and looks at the ratio of interest expense to earnings before interest, taxes, depreciation and amortization, also known as EBITDA. The BEPS 2015 Final Report recommends that countries adopt a fixed ratio for allowable interest deductions within a range of 10 percent to 30 percent of EBITDA (current U.S. law allows up to 50 percent). The report also recommends that countries adopt as an alternative cap a group ratio based on earnings. Under this cap, each entity in a multinational group could deduct interest up to its allocable portion of the group's third party interest expense, which would be determined based on the entity's proportionate share of the group's worldwide earnings. This rule is based on the premise that multinational groups should be able to deduct interest up to their group-wide third party interest expense. The combination of this rule with a low fixed ratio also would ensure that groups would not be able to use related party loans to deduct interest expenses well in excess of the group's third party interest expense. As discussed below, the President's FY 2015 and FY 2016 Budget have included a proposal that is in line with this recommendation.

The OECD has agreed on hybrid entity and hybrid security best practices that target a "deduction/no inclusion" situation (*i.e.,* a tax deduction in one country without an income inclusion in the other country) and a double deduction situation (*i.e.,* tax deductions taken in more than one jurisdiction for the same item). In the case

of the "deduction/no inclusion" scenarios, these recommendations would require Congressional action, and are broadly consistent with rules proposed in the President's FY 2015 and FY 2016 Budget The recommendations addressing double deductions are modeled after existing U.S. rules. Importantly, the OECD approach to this action item is to neutralize the mismatch in tax outcomes, but not otherwise interfere with the use of such arrangements so as to not adversely affect cross-border trade and investment.

An agreement on a minimum standard to secure progress on dispute resolution was reached to help ensure that cross-border tax disputes between countries over the application of tax treaties are resolved in a more effective and timely manner. The Forum on Tax Administration (FTA), including all OECD and G20 countries along with other interested countries and jurisdictions, will continue its efforts to improve mutual agreement procedures (MAP) through its recently established MAP Forum. This will require an assessment methodology to ensure the new standard for timely resolution of disputes is met. In parallel, a large group of countries is committed to move quickly towards mandatory binding arbitration. It is expected that rapid implementation of this commitment will be achieved through the inclusion of arbitration as an optional provision in the multilateral instrument that would implement the BEPS treaty-related measures.

Standardized country-by-country reporting and other documentation requirements will give tax administrations a global picture of where profits, tax, and economic activities of multinational enterprises are reported, and the ability to use this information to assess various tax compliance risks, so they can focus audit resources where they will be most effective. Multinational Enterprises (MNEs) will report their revenues, pre-tax profits, income tax paid and accrued, number of employees, stated capital, retained earnings, and tangible assets in each jurisdiction where they operate. The implementation package provides guidance to ensure that information is provided to the tax administration in a timely manner, that confidentiality is preserved, and that the information is used appropriately. The filing requirement will be on multinationals with annual consolidated group revenue equal to or exceeding EUR 750 million, meaning this regime applies only to the largest and most sophisticated entities.

The existing standards in the area of transfer pricing have been clarified and strengthened as part of the BEPS project. Because the transfer pricing work is based on the arm's length principle, it is consistent with U.S. transfer pricing regulations under section 482. A key element of the work relates to the arm's length return to so-called "cash boxes," which would be entitled to no more than a risk-free return if they are mere funders of activities performed by other group members. The work on cash boxes is one aspect of new approaches to risk, which generally provide that contractual allocations of risk are respected only when the party contractually allocated risk has the capacity to control the risk and the financial capacity to bear it. The transfer pricing work also addresses specific issues relating to controlled transactions involving intangibles, including providing a special rule for hard-to-value intangibles akin to the U.S. "commensurate with income" standard.

Where do we go from here? Certain technical work remains for the OECD in 2016 and beyond. More importantly, however, we believe the best way to foster the G20 goal of supporting global growth is to actively promote the connection between foreign direct investment, growth, and efficient and effective tax administrations. Too often countries fail to recognize that strong civil institutions promote growth and investment. The OECD is expected to present to the G20 a framework for moving forward at the Finance Minister's meeting to be held in China in February 2016. We are working hard to ensure that issues around effective and fair tax administration are made part of the post-BEPS agenda.

INTERNATIONAL TAX REFORM

The G20/OECD BEPS project shined a spotlight on so-called stateless income, a phenomenon that is a byproduct of outdated tax rules. I would like to outline the steps the United States could take today to reform our own tax system to improve competitiveness, secure our tax base, and reduce incentives for profit shifting by U.S. firms.

As the President has proposed, we should reform our business tax system by reducing the corporate income tax rate and broadening the base. It is frequently noted that the United States has a high statutory corporate rate, but much lower effective tax rates. High statutory rates encourage multinational firms to find ways to shift

profits, especially on intangible income, to other jurisdictions. So lowering our statutory rate while broadening the base could help reduce erosion of the U.S. base.

But it would only be a start, because even with lower rates U.S. multinationals would continue to aggressively seek ways to lower their tax bills by shifting income out of the United States since there will always be jurisdictions with lower tax rates. We can, however, take other steps.

First, the President's framework for business tax reform proposes a minimum tax on foreign earnings that represent excess returns, which typically arise from intangible assets. This would reduce the benefit of income shifting and impose a brake on the international "race to the bottom" in corporate tax rates. Other recent tax reform plans have included similar proposals, which would improve on the current complex international tax rules by requiring that companies pay a minimum rate of tax (either to the United States or to a foreign jurisdiction) on all foreign excess returns.

Second, as part of tax reform, we should also take a close look at interest deductibility, noting that our thin capitalization rules are inadequate and that our system actually gives an advantage to foreign-owned multinationals. These foreign-owned multinationals can lend funds to their U.S. subsidiary to benefit from interest deductions against a 35 percent tax rate, while the related interest income is subject to significantly lower tax rates, or no tax at all, in the lending jurisdiction. It is especially disconcerting to observe that among the foreign multinationals that most aggressively take advantage of this strategy are so-called "inverted" companies—that is, foreign-parented companies that were previously U.S.-parented. The administration's FY 2016 Budget proposes to level the playing field by limiting the ability of U.S. subsidiaries of a foreign multinational to claim interest deductions in the United States that greatly exceed their proportionate share of the group's global interest expense. Specifically, this proposal would limit a U.S. subsidiary's interest expense deductions to the greater of 10 percent of the subsidiary's EBITDA or the subsidiary's proportionate share of worldwide third-party interest expense, determined based on the subsidiaries' share of the multinational's worldwide earnings.

A related administration FY 2016 Budget proposal would limit a U.S. multinational's ability to claim a U.S. deduction for interest expense that is related to foreign subsidiary income. U.S. multinationals typically borrow in the United States to benefit from interest deductions against a 35 percent tax rate, but they then use the borrowed cash throughout the multinational group, financing operations that may not be subject to current U.S. tax. Indeed, we have recently seen examples of U.S. multinationals borrowing in the United States—rather than bringing back cash from offshore operations—to pay dividends to their shareholders. The proposal would align the treatment of interest expense deductions with the treatment of the income supported by the proceeds of the borrowing.

In addressing stripping of the U.S. base, it is also important to consider so-called "hybrid arrangements," which allow U.S. subsidiaries of foreign multinationals to claim U.S. deductions with respect to payments to related foreign entities that do not result in a corresponding income item in the foreign jurisdiction. These arrangements produce stateless income and should be remedied. To neutralize these arrangements, the administration's FY 2016 Budget proposes to deny deductions for interest and royalty payments made to related parties under certain circumstances involving hybrid arrangements. For example, the proposal would deny a U.S. deduction where a taxpayer makes an interest or royalty payment to a related person and there is no corresponding inclusion in the payee's jurisdiction.

Additionally, shifting intangibles outside the United States is a key avenue through which U.S. base erosion occurs. The principal means of shifting intangible income is to undervalue intangible property transferred offshore or to take advantage of the uncertainty in the scope of our definition of intangibles. Once this intellectual property is located offshore, the income that it produces can accrue in low- or no-tax jurisdictions. The administration's FY 2016 Budget contains a number of proposals that would discourage the corporate tax base erosion that occurs via intangibles transfers. In addition to our proposal to impose a minimum tax on excess returns, the FY 2016 Budget would explicitly provide that the definition of intangible property includes items such as goodwill and going concern value and would also clarify the valuation rules to address taxpayer arguments that certain value may be transferred offshore without any U.S. tax charge. Another proposal would update subpart F to currently tax certain highly mobile income from digital goods and services.

CORPORATE INVERSIONS

By lowering rates and reducing the ability of multinationals to severely reduce their U.S. taxable income through outsized interest deductions, the United States could go a long way towards reducing the incentives that U.S. multinationals have to invert. Doing nothing and letting our corporate tax base erode through inversions will worsen our fiscal challenges over the coming years. Once companies undertake an inversion transaction, there is a permanent loss to the U.S. income tax base because it is unlikely that these companies will return their tax residence to the United States.

An anti-inversion provision has been part of the Internal Revenue Code since 2004, but experience has shown that this provision insufficiently deters inversions. According to a 2014 Congressional Research Service report, 47 U.S. corporations reincorporated overseas through corporate inversions in the 10-year period ending July 2014. This marked an increase from only 29 inversions in the prior 20 years. More inversions have occurred since the CRS report and proposed inversions are being reported in the media on a fairly regular basis.

Only legislation can decisively stop inversions. The administration has been working with Congress for several years in an effort to reform our business tax system, make it simpler and more pro-growth, and remove the incentives that encourage companies to engage in inversions. To reinforce the existing anti-inversion statute, the administration has proposed in recent Budgets to broaden the scope of the statute to prevent more inversion transactions. As amended by the proposal, the statute would provide that, unless the inverted company has substantial business activities in the country where it purports to have moved its tax residence, the inverted company would continue to be treated as a domestic corporation for U.S. Federal income tax purposes if either (i) shareholder continuity in the inverted company after the transaction is more than 50 percent, or (ii) the transaction involved the combination of a larger U.S. entity with a smaller foreign entity and the group maintains its corporate headquarters in the United States. This strengthened anti-inversion statute is necessary to prevent a permanent reduction in Federal corporate income tax revenues.

In the interim, it is Treasury's obligation to protect the tax base, and we have repeatedly stated that we will use all of our existing administrative tools to address this problem. In Notice 2014–52, which was issued in September 2014, Treasury and the IRS took several steps to address inversions. First, the notice announced rules that would prevent inverted companies from accessing a foreign subsidiary's earnings while deferring U.S. tax through the use of so-called hopscotch loans (which are loans from a foreign subsidiary of the former U.S. parent either to the new foreign parent or one of its foreign affiliates). Second, the notice closed a loophole pursuant to which an inverted company could restructure the group's ownership in the foreign subsidiaries of the former U.S. parent and thereby access earnings in those entities without incurring the U.S. tax that would otherwise have been due. Third, the notice made it more difficult for U.S. companies to invert by strengthening the requirement that the former owners of a U.S. company own less than 80 percent of the new combined entity.

A few weeks ago, Treasury and the IRS issued Notice 2015–79 to further limit the ability of U.S. companies to invert and to reduce the tax benefits of inversions. This most recent notice makes it more difficult for U.S. companies to undertake a corporate inversion by (1) limiting the ability of U.S. companies to combine with foreign entities using a new foreign parent located in a "third country;" (2) limiting the ability of U.S. companies to inflate the new foreign parent corporation's size and therefore avoid the rule requiring minimum ownership of the combined firm by the shareholders of the foreign target entity; and (3) requiring the new foreign parent to be a tax resident of the country where the foreign parent is created or organized in order to take advantage of the substantial activity exception that permits an inversion into a country in which the inverted group has at least 25 percent of its worldwide business activities. Additionally, the notice reduces the tax benefits of inversions by limiting the ability of an inverted company to transfer its foreign operations to the new foreign parent after an inversion transaction.

Treasury will continue to examine additional ways to reduce the tax benefits of inversions, including through limiting the ability of inverted companies to strip earnings with intercompany debt. However, only legislation can effectively address these issues. To this point, we look forward to working with Congress in a bipartisan manner to protect the U.S. tax base, to address the issue of corporate inversions, and to reform our business tax system.

STATE AID INVESTIGATION

In June 2014, the European Commission opened three in-depth investigations to examine whether decisions by tax authorities in Ireland, the Netherlands, and Luxembourg with regard to the corporate income tax paid by Apple, Starbucks, and Fiat Finance and Trade, respectively, complied with the EU rules on state aid. In October 2014, the EU announced that it had also opened an in-depth investigation into whether the decision by Luxembourg's tax authorities with regard to the corporate income tax to be paid by Amazon complied with EU rules on state aid. On October 21, 2015, the EU Commission announced its conclusions that Luxembourg has granted selective tax advantages to Fiat's financing company and the Netherlands has granted selective tax advantages to Starbucks's coffee roasting company. Finally, press reports have explained that tax rulings given to several other U.S. companies are also being examined by the EU Commission. In the area of state aid, as I understand it, the remedy is for the Commission to require the member state to collect the amount of income tax that, in the Commission's view, should have been imposed in the first place. State aid rulings can go back and reexamine up to 10 years of prior conduct.

Treasury has followed the state aid cases closely for a number of reasons. First, we are concerned that the EU Commission appears to be disproportionately targeting U.S. companies. Second, these actions potentially undermine our rights under our tax treaties. The United States has a network of income tax treaties with the member states and has no income tax treaty with the EU because income tax is a matter of member state competence under EU law. While these cases are being billed as cases of illegal state subsidies under EU law (state aid), we are concerned that the EU Commission is in effect telling member states how they should have applied their own tax laws over a 10-year period. Plainly, the assertion of such broad power with respect to an income tax matter calls into question the finality of U.S. taxpayers' dealings with member states, as well as the U.S. Government's treaties with member states in the area of income taxation. Third, the EU Commission is taking a novel approach to the state aid issue; yet, they have chosen to apply this new approach retroactively rather than only prospectively. While in the Starbucks case, the sums were relatively modest (20 to 30 million Euros), they may be substantially larger—perhaps in the billions—in other cases. The retroactive application of a novel interpretation of EU law calls into question the basic fairness of the proceedings. Fourth, while the IRS and Treasury have not yet analyzed the equally novel foreign tax credit issues raised by these cases, it is possible that the settlement payments ultimately could be determined to give rise to creditable foreign taxes. If so, U.S. taxpayers would wind up footing the bill for these state aid settlements when the affected U.S. taxpayers either repatriate amounts voluntarily or Congress requires a deemed repatriation as part of tax reform (and less U.S. taxes are paid on the repatriated amounts as a result of the higher creditable foreign income taxes).

Finally, and this relates to the EU's apparent substantive position in these cases, we are greatly concerned that the EU Commission is reaching out to tax income that no member state had the right to tax under internationally accepted standards. Rather, from all appearances they are seeking to tax the income of U.S. multinational enterprises that, under current U.S. tax rules, is deferred until such time as the amounts are repatriated to the United States. The mere fact that the U.S. system has left these amounts untaxed until repatriated does not provide under international tax standards a right for another jurisdiction to tax those amounts. We will continue to monitor these cases closely.

CONCLUSION

Chairman Hatch, Ranking Member Wyden, and distinguished members of the committee, let me conclude by thanking you for the opportunity to appear before the committee to discuss the administration's work on various international tax matters. We appreciate the committee's continuing interest in the BEPS Project, international tax reform, inversions, State Aid, and other matters. On behalf of the administration, that concludes my testimony, and I would be happy to answer any questions.

Questions Submitted for the Record to Robert B. Stack

Questions Submitted by Hon. Orrin G. Hatch

master file reporting and confidentiality

Question. There are concerns about taxpayer confidentiality in the Master File reports. Treasury officials have suggested that those concerns have been addressed because taxpayers have discretion over what they put in the Master File.

But there must be some limits to that discretion, right? To what extent will companies have discretion over what goes into the master file? Foreign countries may very well ask for items that taxpayers will wish to keep secret, right?

And what are other OECD countries thinking as to the amount of discretion to be allowed here? What recourse does a company have if the foreign tax authority disagrees with the company's judgment and demands sensitive information on audit or imposes a fine for non-compliance?

Could a non-public company exclude from the master file consolidated financial statements or a global organizational chart if in its "prudent business judgment" that information goes beyond the "appropriate level of detail" and does not "affect the reliability of transfer pricing outcomes"?

The Treasury Department has indicated that other countries can collect the Master File directly from multinational corporations, rather than going through the more typical information exchange process whereby foreign governments would ask the U.S. government for such Master Files on a given taxpayer.

Answer. The purpose of the so-called "master file" is to provide context to the more detailed information on the taxpayer, including financial information, provided in the country-by-country (CbC) report and the local file. Apart from specific documents requested as part of the master file, such as consolidated financial statements and a global organizational chart, taxpayers have complete discretion to provide this important contextual information in the way that they think best. We think that taxpayers are in the best position to balance the desire to protect sensitive information with the need to provide relevant information to tax authorities, and this concept lies at the heart of the work. The BEPS report on transfer pricing documentation specifically explains that "taxpayers should use prudent business judgment in determining the appropriate level of detail for the information supplied, keeping in mind the objective of the master file to provide tax administrations a high-level overview of the MNE's (multinational enterprise's) global operations and policies." The reference to "prudent business judgment" is intended to highlight to taxpayers and to revenue authorities that this is inherently a cost/benefit exercise: maintaining the balance between taxpayer compliance burden and confidentiality concerns and the provision of truly useful information. During the course of the work, Treasury representatives focused on maintaining such a balance.

It should be noted that foreign countries have always had and continue to have under their own domestic laws the ability to ask for information from entities doing business in their country in order to enforce their tax laws. Those countries also have had and will continue to have the ability to impose fines on taxpayers who do not supply requested information (presumably after the exhaustion of local administrative and judicial processes). The master file component of the new guidelines on transfer pricing documentation does not alter those domestic laws, nor could it be expected to do so. The transfer pricing documentation work, taken as a whole, had the goal of bringing increased harmonization to transfer pricing documentation requirements in order to improve the information collected and to minimize the burden on business that would result if each country set its own documentation requirements.

Question. What should the U.S. Government do if a foreign government fails to keep a U.S. multinational corporation's master file confidential?

Please explain the reason for that. Does that heighten confidentiality concerns? Would there be greater protection of U.S. taxpayer confidentiality if the U.S. Government were the gatekeeper to this information?

Does the U.S. Government anticipate requiring foreign-based multinational corporations to file a master-file report with the IRS?

Answer. The United States cannot prevent foreign governments from requesting the master file information directly from subsidiaries of U.S. multinational groups,

a capability these governments have always had. The work at the OECD was aimed at helping minimize burden on taxpayers by achieving international agreement on a single uniform document that would be acceptable to all participating G20/OECD jurisdictions. If the U.S. had insisted that this information be presented by U.S.-based firms first to the IRS and then shared via treaties and tax information exchange agreements, it is not clear that we would have achieved the goal of standardization and burden reduction desired by U.S. taxpayers.

If a foreign government fails to protect the confidentiality of a U.S. multinational group's master file, the U.S. Government may raise that issue directly with the foreign government and take the issue into account in its assessment of the suitability of the foreign country's data-protection safeguards for country-by-country reporting and other exchange-of-information programs.

At this time, the Treasury Department does not have plans to modify existing U.S. transfer pricing documentation regulations applicable to foreign-based multinational corporations, which request much of the same information as the master file requests, but will consider doing so in the course of our continuing evaluation of our regulations and reporting requirements.

COUNTRY-BY-COUNTRY REPORTING

Question. Does the Treasury Department have the authority to issue regulations as called for by the BEPS reports as to country-by-country reporting? If so, how will the country-by-country reports assist the U.S. Government in the collection of U.S. income taxes?

Answer. The Treasury Department has authority under sections 6001, 6011, 6012, 6031, 6038, and 7805 of the Tax Code to issue final regulations consistent with the proposed regulations published on December 23, 2015. The information that would be provided under the proposed regulations will assist in better enforcement of the Federal income tax laws by providing the IRS with greater insight into the operations and tax positions taken by U.S. multinational groups. In particular, it is expected that the information will improve transparency and help the IRS perform high-level transfer pricing risk identification and assessment.

Question. Could you please tell us more about how the IRS will use the information from the country-by-country reports? Specifically, does Treasury plan on following the BEPS Action 13 report in terms of who must file (*i.e.,* those multinationals with group revenue in excess of 750 million euros) and the information that is to be included in the report (*i.e.,* income, taxes paid, etc.)? If not, what additions or changes should taxpayers expect in terms of the reporting requirements?

Is Treasury considering making the reporting requirement effective for taxable years beginning in 2016? If so, when would the reporting be provided to the IRS and Treasury? By the extended due for the tax return for the applicable tax year?

When would the first CbC reports be shared with foreign governments?

Do Treasury and the IRS currently plan on requesting CbC reports *from* foreign governments? What is the criteria that Treasury and the IRS plan on utilizing in making the determination of what CbC reports they want to obtain? Do Treasury and the IRS currently have a plan of action for analyzing and utilizing the data they may obtain from CbC reports?

It appears that Treasury agreed to provide foreign governments with a significant amount of information on U.S. multinationals via the CbC report, as well as agreeing to allow foreign governments to directly obtain master file and local file information from local subsidiaries of U.S. multinationals. What is Treasury getting in return, particularly if it may not obtain master file or local file information from local subsidiaries of foreign multinationals and if CbC reports provided by foreign governments are not effectively utilized?

Answer. The Treasury Department issued proposed regulations to implement country-by-country (CbC) reporting on December 23, 2015. Those regulations do, in general, follow the BEPS Action 13 report in terms of filing threshold and information included in the report. Specifically, a U.S. MNE group does not have to file a CbC report if the group has revenues of less than $850 million. The information to be reported includes: (i) revenues generated from transactions with other constituent entities of the U.S. MNE group; (ii) revenues not generated from transactions with other constituent entities of the U.S. MNE group; (iii) profit or loss before income tax; (iv) income tax paid on a cash basis to all tax jurisdictions, including any taxes withheld on payment received; (v) accrued tax expense recorded on

taxable profits or losses, reflecting only the operations in the relevant annual accounting period and excluding deferred taxes or provisions for uncertain tax positions; (vi) stated capital; (vii) accumulated earnings; (viii) number of employees on a full-time equivalent basis; and (ix) net book value of tangible assets other than cash or cash equivalents.

The regulations incorporating the CbC reporting requirement are proposed to be applicable to taxable years of ultimate parent entities of U.S. MNE groups that begin on or after the date of publication of the final regulations. As a practical matter, this will mean that for most U.S. taxpayers the CbC reporting requirement will be effective for taxable years beginning in 2017. The regulations require the CbC report to be filed with the U.S. MNE group's tax return, on or before the extended due date of that return.

CbC reports generally will be provided to foreign countries with which the United States has a treaty or tax information exchange agreement within 15 months of the end of the fiscal year to which the CbC report relates. For example, a CbC report for the year ending on December 31, 2017, will be filed with the U.S. corporate parent's tax return on or before September 15, 2018 (the due date for returns with extensions to file), and will be provided to foreign countries before March 31, 2019. Likewise, foreign countries generally will provide foreign CbC reports to the IRS within 15 months of the end of the fiscal year to which the CbC report relates. Importantly, CbC reports will only be provided to foreign countries in which one or more members of the U.S. MNE group carry on a business that is subject to tax and only if the foreign country has agreed to provide the United States with CbC reports filed in that foreign country by foreign MNE groups that have operations in the United States. Treasury plans to enter into Competent Authority Arrangements that will require foreign countries with which the United States has an exchange of information agreement to automatically provide the IRS with CbC reports that are filed by all foreign MNE groups that carry on a business in the United States.

The IRS plans to use the data provided by CbC reports in high-level transfer pricing risk assessment. The CbC reports will provide the IRS with information related to the MNE group's income and taxes paid, together with indicators of the location of economic activity within the MNE group on a country-by-country basis. This information, along with other transfer pricing documentation provided by the MNE group, will aid in the identification of transfer pricing practices that may warrant further inquiry, resulting in more efficient use of IRS examination resources.

By agreeing to provide CbC reports to foreign countries pursuant to exchange of information agreements, Treasury secured several benefits for U.S. MNE groups and tax administration in the United States. It is important to note that foreign countries already have the right to ask U.S. MNE groups to provide, at a minimum, the CbC information, master file information, and local file information. In agreeing to the Action 13 standards, particularly with respect to CbC reporting, these countries have effectively agreed not to exercise their right to require additional information, such as transactional data on intercompany royalties and intercompany service fees, as part of the standard reporting package. The model CbC reporting template reflects an agreed international standard for reporting that will promote consistency of reporting obligations across tax jurisdictions and reduce the risk that countries will depart from the agreed standard by imposing inconsistent and overlapping reporting obligations. This will reduce compliance costs of U.S. MNE groups. In addition, the IRS will receive CbC reports that will be useful in evaluating the compliance risk associated with transfer pricing practices of both U.S. MNE groups and foreign MNE groups conducting business in the United States, thereby enhancing the efficient use of IRS examination resources. In sum, Treasury limited the reporting burdens of U.S. MNE groups and provided the IRS with a useful tool for the efficient risk assessment of transfer pricing practices of U.S. and foreign MNE groups.

SENATE ADVICE AND CONSENT TO MULTILATERAL INSTRUMENT

Question. BEPS Action 15 envisions a multilateral process to come up with a multilateral instrument to allow for numerous tax treaties to be amended in one fell swoop, rather than having the world's network of tax treaties be renegotiated in thousands of bilateral tax treaty negotiations. I understand the U.S. Treasury is participating in this process.

Please tell us what you envision the U.S. Treasury's negotiating posture to be as to this multilateral instrument? Please confirm that any multilateral instrument

that the U.S. signs on to would need the Senate's Advice and Consent in order to become ratified and effective.

Answer. The multilateral instrument discussions will generally be limited to negotiations on the different treaty provisions recommended as a part of the BEPS project. Given that most U.S. tax treaties already contain most of the treaty provisions that are part of the BEPS minimum standard, theTreasury Department will have to determine if signing the multilateral instrument, or agreeing to particular provisions in it, will on balance be beneficial to the United States.

The multilateral instrument is a treaty instrument and as such, if the United States becomes a signatory, the instrument would require the advice and consent of the Senate.

QUESTIONS SUBMITTED BY HON. DEAN HELLER

Question. I strongly believe that tax reform, done the right way, can improve our fiscal picture. That said, without comprehensive tax reform, we are left with a crumbling tax code that negatively impacts our American and Nevadan businesses, while our other OECD partners are lowering their corporate tax rates and expanding their tax base. I am deeply concerned that U.S. multinational companies are being targeted and that the administration is not taking steps to defend our U.S. businesses. Will you fight to protect U.S. businesses from targeting? "Yes" or "No."

Answer. Yes.

Question. Does the U.S. have any legal authority to fight these rulings on behalf of U.S. multinationals?

Answer. The U.S. Government may have a sufficient stake in the outcome of these cases such that it can intervene in any or all of these cases when and if they are appealed, either to the European General Court, or subsequently to the European Court of Justice.

Question. As you know, the OECD BEPS plan generally can't force member governments to do anything they don't want to do. Does BEPS strengthen the EU Commission's hand by providing political cover?

Answer. The G20/OECD BEPS project has heightened awareness of techniques used by multinationals to minimize their tax bills. It is my view that this general awareness has influenced efforts in Europe and elsewhere to constrain the use of these practices.

Question. Can you explain the process for how the EU Commission determines if a case is deemed state aid?

Answer. The Commission's antitrust (competition) authorities are investigating tax arrangements between EU member states and multinational firms. These investigations are meant to examine whether the tax authorities of specific countries have entered into special arrangements with individualfirms to provide tax benefits that are unavailable to competitor firms and thus constitute impermissible state aid under EU competition rules.

It is my understanding that the EU's state aid rules are aimed at member state policies that favor one business or sector over another, and typically come into play when states give subsidies to businesses or sectors to the detriment of other businesses or sectors. Demonstrating "selectivity" is the key to a showing of improper state aid. In tax cases, the Commission typically establishes, first, the general rules and practices that apply to similarly situated taxpayers in a country and, second, that the practice or law in question deviates from that framework in a material way (commonly referred to as "selectivity" or "selective benefit"). This might occur, for example, if one company obtained a ruling that a similarly situated company was unable to obtain, or, more broadly, where a specific industry obtained rulings that other industries could not obtain.

Question. I am deeply concerned with recent reports, as I am sure you are, that these EU state aid cases will lead to retroactive foreign tax increases on U.S. companies. Does it make sense that if the Commission finds that a country has violated its obligations to the EU that the company should be held liable retroactively?

Answer. As I understand it there are well-grounded ways in which state aid law could be, and has been, applied to tax rules. However, to our knowledge, the Commission has never before examined determinations by member state tax authorities

regarding the application of their tax laws (as opposed to examining the laws/rules themselves) in particular cases without finding that a specific benefit was given to specific taxpayers that was not available to similarly situated taxpayers. In the current cases, our understanding is that there is no allegation that the countries involved gave special deals to these companies that were not available to similarly situated companies that engaged in cross border transactions. Rather, the theory of selectivity appears to be that the rulings would be available only to companies with affiliate dealings (for which transfer pricing is set by tax rules), but would not be available to firms without affiliates (for which the market sets prices). It is this latter theory of selectivity that is novel. Given that the theory is novel and could not have been anticipated by the firms and Member states involved in the ruling process, it seems unfair to apply it on a retroactive basis.

Question. These back-door tax increases on American companies could also result in American taxpayers footing the bill through foreign tax credits. Does the Treasury have any plans to address this?

Answer. We have not yet analyzed whether the resulting payments to be made by companies as a result of the state aid investigations are creditable foreign taxes and whether they would generate foreign tax credits that could be used by the affected firms.

Question. As you may know, this committee is dedicated to overhauling the tax code. Earlier this year the committee held tax reform hearings analyzing simplicity, fairness, growth and international competitiveness. As this committee discusses overhauling the tax code, including international tax reform, what is the single biggest element that lawmakers can implement to promote pro-growth international competiveness?

Answer. Reducing the Federal corporate income tax rate by broadening the tax base, as outlined in the President's Framework for Business Tax Reform (an updated version of which the administration released in April) and implementing the international tax reform proposals outlined in the administration's FY 2017 budget, would promote growth and the competitiveness of U.S. businesses, including U.S.-based multinational corporations as well as domestic and small businesses.

Question. I am here to help. How can Congress protect U.S. businesses from being targeted by foreign governments?

Answer. Enacting comprehensive business tax reform that includes measures such as a minimum tax on low-taxed excess returns earned abroad would help by eliminating the income that other countries regard as "stateless income" and try to tax. The President's Framework for Business Tax Reform and the FY 2017 Budget submission provide more detail on desirable tax policies in this area.

Question. I am deeply concerned with the EU Commission's determination of whether a measure constitutes state aid. Specifically, that state aid is determined based on its effects, not its objectives. Would that mean that all tax rulings that include an element of negotiation be deemed state aid in the future?

Answer. The Commission's position as to when interactions between a company and a member state concerning tax issues might or might not constitute state aid is unclear, so it is difficult to draw a conclusion as to their view of the scope of their authority.

Question. In what ways did the Treasury consult Congress as the BEPS plan was taking shape?

Answer. I briefed interested staff members at various times, answered questions, and welcomed comments.

Question. If nothing is legally binding in the BEPS process, why has the Treasury decided to implement country-by-country reporting?

Answer. The Treasury Department has determined that the information that would be required under the proposed regulations published on December 23, 2015, will assist in better enforcement of the Federal income tax laws by providing the IRS with greater insight into the operations and tax positions taken by U.S. multinational groups. Country-by-country reporting also assists U.S. businesses by harmonizing transfer pricing documentation across jurisdictions around the world, thereby reducing compliance costs.

QUESTION SUBMITTED BY HON. PAT ROBERTS

Question. Mr. Stack, Interest-Charge Domestic International Sales Corporations ("IC–DISCs") are important vehicles that enable small businesses to reach foreign markets. I understand that farmers and farmer cooperatives are eligible to use IC–DISCs to facilitate the export sale of agricultural product grown by farmers and cooperative members. However, guidance is needed to clarify how the accounting rules applicable to farmer cooperatives under subchapter T of the Internal Revenue Code interact with the IC–DISC rules. Without such clarity, cooperatives may not go forward with IC–DISCs, hindering the ability for farmers to efficiently reach export markets. I understand that the IRS may not have the resources to issue private letter rulings to all cooperatives seeking to form IC–DISCs. I believe that Treasury could and should issue formal guidance clarifying these issues. Properly drafted guidance would remove uncertainty in this area, provide uniform treatment among similarly situated taxpayers, and ensure that farmers can avail themselves of the benefits Congress intended in enacting the IC–DISC rules.

Thank you for your attention to this matter. I respectfully request that Treasury and the IRS add a guidance project on the next quarterly revision of your Priority Guidance Plan to address these issues, and would appreciate a response to this request beforehand.

Answer. Thank you for highlighting this issue encountered by farmers and farmer cooperatives. We have in fact met with representatives of these taxpayers to discuss the questions that you describe regarding how the accounting rules applicable to farmer cooperatives under subchapter T of the Internal Revenue Code interact with the IC–DISC rules, and we can appreciate the need for guidance in this area. As you noted, the IRS has limited resources. In this regard, Treasury and IRS have to make difficult decisions regarding which formal guidance is needed most within the next plan year. We will take your views into account when making these determinations.

QUESTIONS SUBMITTED BY HON. MICHAEL B. ENZI

Question. The EU state aid cases are targeting multinationals—predominantly U.S. multinationals. Based on its announcement of the first two decisions last month, the Commission believes the investigated countries as providing multinationals unfair competitive advantages over smaller domestic competitors through tax rulings that "do not reflect economic reality." We haven't seen the legal analysis of these cases yet, but if these are the standards that are being applied, do you agree that the decisions should not produce results that actually disadvantage integrated multinationals and that do reflect economic reality?

Isn't the arm's length principle the internationally accepted mechanism that strikes that balance?

Answer. Yes. The arm's length principle is the internationally accepted mechanism for cross-border transactions that strikes the balance. The concern is whether the EU Commission will reach the same interpretation of the arm's length standard that the member state did when it initially granted the multinational the ruling in question, and whether taxpayers were on notice that the Commission might be reviewing member country transfer pricing rulings well after they were issued. If taxpayers were not aware that the Commission would be reviewing transfer pricing rulings for their adherence to the arm's length standard then it seems unfair to impose substantial retroactive payments on them.

Question. Regarding the EU state aid cases, what do these cases mean for our ability to rely on bilateral tax treaties negotiated with European countries if the European Commission can unilaterally change a treaty partner's tax positions through enforcement of EU competition policy?

Answer. We are concerned that the European Commission's broad new assertion of authority in tax matters if applied to cases directly between a U.S. entity and an EU entity would undermine our ability to rely on our treaties with member states, in particular our ability to utilize the mutual agreement procedures.

Question. Does the U.S. have any rights under the treaty to protect U.S. tax interests while ensuring U.S. multinationals are not subject to double taxation because of the EU state aid decisions?

Answer. None of the current cases we are aware of have yet to implicate a treaty issue between the U.S. and a member state.

Question. We've all heard how BEPS threatens the U.S. tax base because its general policy objective is to align taxing rights with value creating activities. While BEPS represents prospective tax policy changes, and the U.S. at least had a seat at the table, the EU state aid cases represent EU assertion of retroactive taxing rights over the historical foreign earnings of U.S. multinationals, with the U.S. Government unable to participate.

Do you view the EU state aid cases as an attempt by the EU to unilaterally and retrospectively attack the "stateless income" issue that the BEPS project was designed to address on a multilateral and prospective basis?

Answer. Yes, and done on a retroactive basis.

Question. If the cases result in a single member state collecting tax on virtually all of the income, without regard to the level of economic activity within that state, wouldn't that actually contradict the underlying premise of the BEPS project—to align taxing rights with underlying value-creating activity?

With respect to income from intangible property, isn't it true that a significant portion of this value-creating activity is likely to have taken place in the U.S., giving the U.S. primary taxing rights, on a deferred basis or otherwise?

Answer. To us, "aligning taxing rights with underlying value-creating activity" is another term for "appropriately remunerating functions, assets, and risks under the arm's length principle." Under our domestic law *and* the OECD transfer pricing guidelines (which all EU countries embrace), all contributions of value must be appropriately remunerated. Accordingly, if a single member state collects tax on virtually all of the firm's income regardless of the amount of economic activity that occurs in the state that may imply that important contributions to value are not being considered, which would reflect a contradiction of the underlying premise of the BEPS project.

While it is difficult to comment in the absence of specific facts, we agree that quite often a critically important value-creating activity with respect to intangible assets or intellectual property is R&D activities, and that these activities often take place in the U.S.

QUESTIONS SUBMITTED BY HON. RON WYDEN

Question. Regarding the EU state aid cases, I am concerned about the implications for our tax treaty policy when it comes to members of the EU.

What do these cases mean for our ability to rely on bilateral tax treaties negotiated with European countries if the European Commission can unilaterally change a treaty partner's tax positions through enforcement of EU competition policy?

Answer. We are concerned that the European Commission's broad new assertion of authority in tax matters if applied to cases directly between a U.S. entity and an EU entity would undermine our ability to rely on our treaties with member states, in particular our ability to utilize the mutual agreement procedures.

Question. Does the U.S. have any rights under the treaty to protect U.S. tax interests while ensuring U.S. multinationals are not subject to double taxation because of the EU state aid decisions?

Answer. None of the current cases we are aware of have yet to implicate a treaty issue between the U.S. and a member state.

Question. How can Congress protect U.S. taxpayers and help ensure that Europe does not retroactively impose a back-door tax on these earnings?

Answer. If Congress were to deny a foreign tax credit for amounts recovered under the State Aid rules, U.S. taxpayers as a whole would not be at risk of footing the bill for amounts imposed by the EU Commission in these cases. However, the U.S. MNE would be required to make the payment, disadvantaging this U.S.-based firm.

QUESTIONS SUBMITTED BY HON. THOMAS R. CARPER

Question. Following up on a question during the hearing, I'd like to ask about the timeline for ratification of the BEPS Action on permanent establishment (PE). It's admirable how quickly the BEPS process has moved forward; it's rare for a multilateral negotiation to successfully develop and come to (general) agreement around a comprehensive set of recommendations—or at the very least, options—within just a couple years.

However, I have concerns that the speed of the BEPS process may not leave sufficient time for even the most diligent and prescient taxpayers to adjust and build the accounting systems needed to comply with new PE proposal.

Mr. Stack, can you give us a reasonable estimate as to when other countries will ratify the BEPS multilateral instrument regarding permanent establishment? What do you think is a reasonable effective date?

Answer. The work on the multilateral instrument is supposed to be complete at the end of 2016, and assuming that the timeline is met, we may expect that some countries would be in a position to sign and ratify the instrument in 2017. It is common practice among countries to make the text of a tax treaty available when the agreement is signed. This public release of a signed tax treaty before it enters into force can serve as a helpful advance notice to taxpayers of the terms of the treaty before it enters into force. Further, it is common for treaty provisions to take effect for the taxable periods beginning on or after the first day of the year following the date on which the convention enters into force.

Question. Will taxpayers given a reasonable amount of time to create the necessary accounting systems (and possibly inventory systems) to comply?

Answer. At this time the Treasury Department has not decided whether to include most of the new permanent establishment provisions into U.S. tax treaties, or to agree to the multilateral convention provisions relating to permanent establishment. Unfortunately, we cannot speak to how or if other countries that seek to adopt the new permanent establishment rules will permit transition periods to allow taxpayer to create any necessary accounting or inventory systems.

Question. The BEPS changes regarding permanent establishments will trigger a permanent establishment based on a person "habitually playing the principal role leading to conclusion of contracts that are routinely concluded without material modification by the enterprise." The commentary further indicates that this principal role will "typically be associated with the actions of the person who convinced the party to enter into a contract."

Mr. Stack, does this trigger a permanent establishment even if the sales person has no authority to modify a contract and does not even participate in conclusion of a contract that is done online?

Answer. Permanent establishment determinations are fact intensive. We would need to determine what type of activities are performed by the sales person in your example and whether such sales solicitation activities play the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. If, for example, the sales activities are merely providing marketing and promotional services, such activities would not directly result in the conclusion of contracts on behalf of the enterprise. See also bottom of paragraph 32.5 of the Commentary to Article 5(5) of the OECD Model Tax Convention.

Question. I have concerns about how clear a standard we are talking about when discussing who may or may not have "convinced the party to enter into a contract." What about a case in which a seller of a good or service is already well known prior to any customer contact? Or alternatively, what about a situation in which the principal contributing factor was a positive recommendation by an unrelated third party? Can you outline for us your concerns you have that this standard might leave taxpayers unclear on whether they have any genuine taxable presence or permanent establishment? If so, what actions should be taken, going forward, to provide more clarity and certainty?

Answer. Throughout the development of the new tax treaty provisions, in particular the development of the so-called "principal purpose test" to combat treaty shopping and the new permanent establishment provisions, the Treasury Department has stressed our concern that any new treaty provisions be as clear as possible, because ambiguous or unclear rules are likely to lead to disputes between taxpayers and the revenue authorities. The lack of certainty in the application of the

principal purpose test is a primary reason why the Treasury Department (in concurrence with the views of the Senate) rejects the inclusion of such a rule in U.S. tax treaties. The Treasury Department is interested in developing ways to mitigate the compliance burdens that the new permanent establishment rules could create, and to facilitate the resolution of any disputes of interpretation, perhaps by coupling such rules with mandatory binding arbitration.

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Position Paper on the Organisation for Economic Co-Operation and Development's Project on Base Erosion and Profit Shifting

Submitted to The United States Senate Committee on Finance

In relation to Full Committee Hearing: International Tax: OECD BEPS and EU State Aid

Date 3 December 2015

BIAC has been supportive of the OECD's Base Erosion and Profit Shifting ("BEPS") project since its inception and has provided constructive and detailed input from the international business community in response to all discussion drafts. Although we value the openness of the consultation processes and acknowledge the efforts of OECD and G20 member governments and the OECD Secretariat, we are anxious that some serious business concerns have not been sufficiently considered or addressed.

At the March 2015 meeting of the BIAC Tax Committee, a substantial number of member organizations expressed concerns over the direction of certain aspects of the BEPS project, and the potential significant negative economic consequences of several Action Items, and it was agreed to set those out in a short document. This document has been updated following the release of the OECD's final reports in October 2015. We would reiterate, despite the concerns noted below, that we want the BEPS project to succeed. We will continue to approach this project—both before and after the adoption of the recommendations by the G20—in a constructive, flexible and incremental way as we believe this is the best way of achieving that success. We call on the OECD to continue to include us in the completion of outstanding work, and the development and implementation of the G20 proposed framework for implementation.

General Comments

Many of the concerns identified in this Position Paper are common across the range of Action Items. We feel they are worth repeating up front as their importance continues to grow as the follow-up and implementation work commences.

Economic Impact: There is great concern that the economic consequences of the recommendations have not yet been fully considered. Countries should be undertaking realistic assessments of the tax revenues they may be due under the consensus reached, rather than assuming that implementation will bring additional tax revenues. The possibility should be understood that overly strict regulation could force economic activity out of countries. Countries should not rush to implement proposals with such aims in mind when the actual impact on their tax revenues has not been determined—this could undermine the BEPS process and bring about unintended economic implications. Although uncertainty, double taxation, disputes and compliance burdens are a focus of business, we are also concerned about the broader economic impact, which may include, for example, the impact on the efficiency of markets, or the sustainability of certain legitimate non-tax driven commercial transactions and structures (for example, cross-border infrastructure projects or regionalisation of certain functions to improve quality and efficiency). We believe that the justified targeting of BEPS activities must be integrated with larger eco-

nomic concerns related to creating jobs and growth through cross-border trade and investment.

Complexity and Compliance: In a number of areas, the BEPS Action Plan proposes substantially new and complex rules to tackle avoidance. Given the pressures of the ambitious timeframe, there have been very few opportunities to explore how these complex proposals can be adopted and implemented on an international basis. Both tax authorities and businesses will need detailed implementing guidance to ensure that the intention of each recommendation is clear. This will be critically important in ensuring that the recommendations are uniformly adopted, whilst avoiding overlaps. The challenges that will be brought about through the interaction of different timelines and domestic implementations should not be underestimated. They could lead to double taxation and a significant compliance burden on both businesses and tax authorities and create uncertainty that will delay necessary investments. We look forward to the OECD's development of an inclusive framework to support and monitor the implementation (as proposed by the G20 Finance Ministers) to assist in maintaining international co-operation and as much consistency in timing and application as is possible. We would encourage the OECD to seek agreement from involved countries on effective dates after which new rules and guidelines will apply; even with the OECD's work on Action 14, it will be very difficult to eliminate double taxation and would be inequitable if some tax authorities seek to revisit past years with new concepts and methodologies.

Scoping: As part of the implementation framework, we believe it would be helpful to target the scope of each recommendation more narrowly to increase the chance of developing the necessary inter-governmental co-operation. At present, many proposals appear to go beyond the scope required to effectively target BEPS related activities. We strongly believe that "success" in the BEPS project would be achieved with a set of detailed, well-defined proposals that can be (and are) implemented consistently. Countries should be encouraged to avoid overly-broad implementation that could lead to a less uniform international tax regime.

Timing: As well as the timing concerns raised above in relation to the potential economic impact and the potentially disjointed international adoption of the recommendations, we also have a more general timing concern that impatient countries and tax authorities may seek to commence full implementation of recommendations where it has been agreed that further work is required. For example, critically important work remains in relation to profit attribution to permanent establishments and specific rules in relation to financial services and insurance businesses.

Reaching Consensus

BIAC has strongly supported the OECD as the best organisation to deliver a successful consensus outcome under the BEPS mandate and recognises the phenomenal work that the OECD has done in brokering compromises and consensus wherever it has been possible. However, despite the OECD's claims, we are concerned that in many instances it has proved difficult (and occasionally impossible) for member governments to reach consensus. This has resulted in a lack of clarity and a degree of ambiguity. For example, whilst the OECD has not recommended solutions regarding the "digital economy," the door has been left open for countries to implement solutions unilaterally which, if implemented, could lead to double taxation.

Understanding the Economic Impact

It remains a matter of some regret that, owing to the political nature of the timetable, the BEPS project could not begin with a detailed economic analysis of the abuses identified in the Action Plan, including the scale and importance of "double non-taxation" and "tax competition." We are concerned that the public announcements and discourse have been optimistic in terms of the amounts of additional tax that will be collected as a result of the BEPS recommendations, due in part to the conclusions reached in Action 11, and strengthened by the impression that the expectation of additional tax receipts was in some way a pre-requisite of reaching a broad consensus. Whilst we understand the public and political pressure surrounding the project elevated a need for consensus in agreeing that businesses should be taxed on all profits, most countries who have offered a public opinion on the matter seem to have assumed that the implementation of the proposals will increase their tax revenues substantially.

In reality, depending on which of the proposals are introduced by themselves and/or other countries, there could be many countries that do not receive additional tax revenues. There may be cases where overly strict regulation pushes economic activity out of some countries. If not dealt with by rigorous impact assessments both at

international and domestic levels, we are concerned that this expectations gap could lead to countries budgeting for higher tax revenues than they will receive. The resulting pressure could end in countries opting not to implement all of the proposals uniformly, an outcome that would result in double taxation and more pressure on individual tax authorities to aggressively audit taxpayers in an attempt to collect *more* tax rather than the *right amount* of tax based on the consensus agreed. A failure of the BEPS project in such a manner is not in the interests of business, governments or the public and will significantly increase the costs of tax administration and tax compliance.

Complexity and Compliance Burden

The BEPS recommendations are likely to create significant implementation difficulties and greater compliance burdens, not only for Multinational Enterprises (MNEs), but also governments—this is in part due to the substantial number of recommendations, but also their complexity and the different timelines that will need to be followed to implement them (for example, the adoption of revised OECD Guidelines into domestic law, or different processes for implementing domestic recommendations). Public and considered consultation and strong commitment by countries to work together (supported by the OECD's implementation framework to be developed in 2016) are essential to avoid fragmentation.

We would encourage the OECD to seek agreement from involved countries on effective dates after which new rules and guidelines will apply; even if the OECD's work on Action 14 is successful in improving dispute resolution, it will be very difficult to eliminate double taxation and would be inequitable if some tax authorities seek to revisit past years with new concepts and methodologies.

We support the OECD's statement that VAT registrations should not create PEs, and we would encourage tax administrations to heed this and not assume that PEs exist where a company is registered for VAT (or vice versa), which would result in significant compliance burden. Other Action Items (for example, Actions 2, 3, 4, 7 and 12) are also likely to require significant additional resource to ensure compliance with new, complex and sometimes contradictory rules.

Discouragement of Related Party Trade

Many of the BEPS Action Items apply only in an intra-group context and could significantly increase the cost of performing various functions or undertaking certain transactions inside a group of related companies. For example, the recommendations to lower the PE threshold and the complex new transfer pricing analyses that only apply to transactions between affiliates could greatly increase the compliance cost and tax liabilities associated with various intra-group activities. In some cases, taxpayers may, effectively, be forced to conduct business with third parties to mitigate excessive tax cost or uncertainty. This would reduce commercial and economic efficiencies and hamper international trade (as well as, quite possibly, lowering the wages and benefits in outsourced functions—especially in developing countries). We believe that these effects should be considered in greater detail and encourage additional guidance to be developed to provide greater certainty.

Appropriate Resources for Tax Administrations

Tax administrations already receive significant amounts of information that they often struggle to process. We are concerned that without additional resources, tax administrations will face difficulties in effectively using additional information and in dealing with the expected increase in requests for exchange of tax information between countries. It may actually become more difficult to identify risks, or to target abuse, to the advantage only of the most aggressive taxpayers.

We believe a greater focus on tax administration would be beneficial—for example, through fully integrating the work of the Forum on Tax Administration—and the use of targeted risk-based measures. This could include materiality thresholds and other risk-identification tools to target higher risk taxpayers/issues that represent the most substantial sums of lost tax revenues. Such approaches reduce the burden on the vast majority of compliant taxpayers, freeing up resources for more productive, value-creating activities. Cooperative compliance also has an important role to play in this area.

Multilateral Implementation

The ultimate success of the BEPS project will be the multilateral implementation of specific, measurable, achievable and realistic recommendations on a timely basis. Whilst much work on implementation mechanisms is still to come throughout 2016;

we encourage early discussions on approaches to enhance credibility and likely success of the project. We make the following recommendations in this regard:

- The G20 proposed engagement framework should be prepared and managed by the OECD Secretariat;
- As a first step, all countries should agree to key principles to be followed in any domestic legislation used to enact BEPS proposals. Such principles could include that:
  - the policy objective should be clearly stated;
  - the policy objective should be consistent with the BEPS recommendation, and in particular, should be limited to addressing specific abuses;
  - draft legislation should be prospective in application and be published with a minimum period for detailed stakeholder consultation; and
  - an impact assessment should be prepared to evaluate any compliance burdens created.
- We encourage the OECD to coordinate the implementation so that national measures have a reasonable degree of consistency.

BEPS Action Item-Specific Comments

Address the Tax Challenges of the Digital Economy (Action 1)

We *greatly* welcomed the original 2014 report (*Addressing the Tax Challenges of the Digital Economy*), but we consider that the final 2015 report does not go far enough by recommending only that such countries are mindful of their treaty obligations until further review in 2020. There is concern amongst BIAC members that some countries are considering withholding taxes on digital transactions, and whilst the final report recognises that this is not recommended, it neither discourages such action nor identifies the treaty obligations and implications that such taxes could breach. Such unilateral action will certainly result in double or even multiple-taxation unless there is a very clear and strong consensus as to how the profits of digital business transactions should be taxed. BIAC looks forward to participating in ongoing monitoring and evaluation characteristics of digital trade that may cause BEPS concerns.

Neutralizing the Effects of Hybrid Mismatch Arrangements (Action 2)

While we do not defend hybrid mismatches as a general policy matter, we do want to make three important points on the final report:

- It is not clear which countries intend to implement any or all of the recommendations, when they plan to do so, or how the interaction with the local legislative processes will result in differences between countries in terms of application or timing. Implementation through a combination of complex changes to domestic laws, bilateral treaty provisions and potentially a multilateral instrument increases the uncertainty on timing further. We welcome the development of an inclusive monitoring framework in early 2016 to assist international cooperation but retain concerns in particular regarding the risk of double taxation, increased compliance burden, and uncertainty that will arise from countries implementing at different times.
- Even if implemented in a coordinated manner, the complexity of the proposed rules will create substantial compliance difficulties, and will complicate the allocation of taxing rights between jurisdictions, increasing the risk of double taxation (*e.g.,* the rules on "imported mismatches"). The accompanying expanded examples may provide clarity on some issues, but at the price of still further complexity.
- The financial services industry continues to be concerned that insufficient attention has been given to how the proposals will impact instruments deemed important by banking regulatory authorities for systemic liquidity. By relying on countries to opt not to tax such transactions at their discretion increases uncertainty and the risk of double taxation.

Strengthen CFC Rules (Action 3)

The broad nature of the OECD's final CFC proposals illustrate the difficulty in reaching a consensus position on even the basic purpose of rules, with clear disagreements between governments over whether such rules should tackle profit shifting from the parent entity or foreign-to-foreign abuse. Without clear agreement over the underlying principles, the chances of delivering clear, proportionate and practical solutions were almost impossible. This was an opportunity missed to refine a useful tool, based on well-understood concepts of "active" and "passive" income in ways that could reduce dependence on subjective, fact-intensive enquiries while at the same time limiting the compliance burden and risk of double taxation. We urge

the OECD to consider CFC rules further when addressing any future BEPS concerns that the monitoring and analysis highlight.

Limiting Base Erosion Via Interest Deductions and Other Financial Payments (Action 4)

The final report on Action Item 4 will have serious implications for groups' economic activity and their ability to obtain tax deductions for funding costs. The proposals have been made without a clear articulation of how they specifically target BEPS activities. The OECD's proposals are likely to restrict interest deductions for a significant number of non-aggressive taxpayers, particularly those investing in infrastructure or long term projects where it remains unclear whether they would qualify for the proposed exemptions. The lack of support for the arm's length principle in Action Item 4 also undermines legitimate commercial reasons for having intercompany debt. A group's cash position and decisions on how to deploy cash should not be limited by rules that are not based on the arm's length principle.

However, given the options previously put forward in discussion drafts, we do welcome the broadening of the corridor approach to a range between 10 percent and 30 percent of EBITDA and the relative simplicity it brings. However, this approach could have serious consequences if detailed work is not undertaken to determine appropriate ratios, taking into account the funding requirements of different industries. Where ratios are set too low, this could substantially raise the cost of capital for low-risk taxpayers undertaking commercial transactions. We are disappointed that the proposals do not recommend more strongly the elements of the proposals that would seek to limit double taxation, such as the ability to carry forward unutilised interest capacity (especially for start-ups and companies in loss-making positions) or give credit for all withholding taxes suffered.

Additionally, we note that interest is the "raw material" for financial services businesses. Although a "net interest" approach is endorsed, it is important that the outstanding questions facing the financial services industry be resolved, particularly so that proposals do not contradict the regulatory agenda.

Whilst we welcome the attention that the OECD plans to give to the group wide ratio rules, financial services and insurance industries 2016, we have serious concerns that so much work remains outstanding in this area at a time when countries are otherwise being encouraged to start implementing the rules.

Prevent Treaty Abuse (Action 6)

We are concerned that significant uncertainty remains as to whether treaty relief is available in ordinary commercial circumstances. This uncertainty risks undermining the usefulness of treaty networks in facilitating trade and promoting economic growth. Whilst we recognise that tax administrations require assurance that treaty benefits are only being granted in appropriate circumstances, anti-abuse rules should be applied in a proportionate and targeted manner. The existing provisions and Guidance could provide more clarity (*e.g.,* low taxed branches with substance, calculation of head office tax rate). Broad disapplication of treaty benefits could create substantial withholding tax burdens and negatively impact cross-border trade.

The final proposed minimum treaty standards are at the very least expected to create a significant compliance burden for taxpayers (especially where both a simplified LOB and a PPT rule are adopted in certain treaties), and will potentially bring into scope legitimate structures that ought to be entitled to treaty benefits. We remain concerned that:

- Structures not involving treaty shopping may be unintentionally caught by broad rules.
- There will be increased cross-border investor uncertainty, especially for pension fund investors and sovereign wealth funds, where the potential for tax treaty abuse is low.
- Uncertainty for Collective Investment Vehicles (CIVs) will be unavoidable, and the time taken to receive repayments of tax deducted at source will impact the Net Asset Values of funds.
- Source country tax authorities may experience additional demands to process an increased volume of reclaims, placing further pressure on already resource constrained administrations.

Whilst we recognise that the OECD has further work to do regarding the commentary on LOB rules and the impact on non-CIVs and pension funds and welcome the OECD's commitment to consult on such matters, we remain concerned that in

order for this to be taken into account as a meaningful component of the multilateral instrument negotiations, this work must be completed swiftly.

Preventing the Artificial Avoidance of PE Status (Action 7)

Whilst many of our members welcome the move away from the ambiguous language of the discussion draft that sought to establish a PE where persons "negotiated the material elements of contracts," we are concerned that the final deliverables introduce new concepts that were not open to consultation and so retain ambiguity. Whilst we welcome the move to recommendations that a dependent agent PE is only established where a person "plays the principal role" in negotiating contracts, we urge the OECD to undertake additional consultation and provide tax authorities with additional guidance to clarify the meaning further. Similarly, the meanings of "complementary functions that are part of a cohesive business operation" in relation to fragmentation and "at the disposal of" regarding fixed places of business should be more tightly defined to ensure consistency in implementation.

It is disappointing that recommendations regarding PE thresholds have been released before the guidance that will follow on profit attribution. We are concerned that tax authorities will seek to establish the existence of PEs based on new concepts before providing business with any certainty regarding the attribution of profits to these newly defined PEs. For instance, the example of a PE being triggered by an agent who convinces customers to accept standard contracts without any authority to make deviations is very different to the previous definitions. Additionally, we would welcome the confirmation that PEs can be loss making.

It is more disappointing still that the changes required to the OECD Model Treaty, OECD Guidance and domestic/multilateral implementation thereof will undoubtedly be disjointed, and we fear that some tax authorities may seek to apply the new concepts to open periods, which will cause considerable uncertainty and double taxation to arise. We urge the OECD to consider the impact of this as part of the implementation framework being developed and wait until there is a consistent understanding of the concepts before updating the Model Treaty and Guidance.

Transfer Pricing (Actions 8–10)

We have consistently acknowledged the need to update international tax rules on Transfer Pricing (TP), especially in relation to intangibles. However, aspects of BEPS project illustrate fundamental differences in opinions between countries over the Arm's Length Principle (ALP) in TP and its continued viability. We are hesitant in agreeing with the OECD that the final report's recommendations have been finalised without a departure from the ALP.

We welcome the confirmation that where clear contractual arrangements exist that are supported by economic reality, then recharacterisation is not generally required. However, we are concerned about the complexity of the process, the level of detail required, and the consequences it will entail in the practical application. For example, the modifications do not clearly address the relevance of or extent to which (control and) performance of DEMPE functions and risk should contribute to calculating price under the ALP. These are not generally factors that are taken into account by unrelated parties. We welcome the reiteration that the most appropriate TP methodology should be used, and the OECD's commitment to developing guidance on profit split methodologies. However, we note that with this work expected to remain incomplete until 2017, a significant period of uncertainty remains, which will cause considerable uncertainty and double taxation to arise. We urge the OECD to consider the impact of this as part of the implementation framework being developed and prioritise these areas accordingly.

We welcome the confirmation that tax authorities should only be permitted to consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements where taxpayers cannot demonstrate that the uncertainty was appropriately measured in the pricing methodology adopted. However, the distinction between foreseen and unforeseen is subjective and very difficult to make. Additionally, there are many areas of the report that appear ambiguous which will allow countries to take divergent positions. We believe that there remains a significant risk of divergence in interpretation and extent of these approaches, and ultimately of tax authorities using hindsight to recharacterise non-abusive transactions.

Whilst we would welcome the simplicity that the elective regime for Cost Contribution Arrangements (CCAs) could provide, without a commitment from a significant number of countries to implement such a regime it remains the case that businesses will still face a significant compliance burden in satisfying the countries that do not

implement it. If a significant number of countries could be encouraged to implement the elective regime at least in part (*e.g.,* service CCAs) this would address these concerns in some cases.

Financial services institutions face regulatory pressures that differentiate them from groups operating in other sectors. The OECD's 2010 report on the attribution of profits to PEs remains relevant for the taxation of this sector. BIAC cautions against special measures or general principles that move away from this well-established approach.

BEPS Data (Action 11)

Whilst the business community generally agrees that insufficient data is available and that such data would be useful (and are thus supportive of the initiative), there has not been significant engagement with business in this area. We would welcome the opportunity to assist the OECD in its further work on identifying and analysing data on BEPS.

Re-examine Transfer Pricing Documentation (Action 13)

BIAC fully supports the recognition under Action 13 of the importance of protecting the confidentiality of commercially sensitive information. This protection should apply across all three pillars of TP documentation. We consider it would be a useful addition (perhaps under the framework to be developed in 2016) if peer review mechanisms could be developed to monitor jurisdictions' adherence to appropriate confidentiality standards, and to ensure that the OECD's proposals are uniformly adopted.

The Action 13 recommendations will create substantial burdens for business, and effective compliance will require much preparation. For example, there remains ambiguity around areas such as the practicalities of reporting Master Files on a business line basis whilst maintaining a global overview, and many countries are already seeking to implement the country-by-country reporting elements recommendations before the guidance and XML schema are even released. Without further guidance, much of the necessary preparation is impossible. Such implementing guidance should, where possible, leverage data reported under similar regimes (for example the EU's CRD IV for banking organisations) to streamline the compliance burden for as many taxpayers as possible. Only uniform TP documentation rules across countries will limit the resulting increase in compliance costs for companies, and we urge the OECD to encourage consistency in this area.

Make Dispute Resolution Mechanisms More Effective (Action 14)

We congratulate the OECD on the significant steps forward that have been taken in its work on Mutual Agreement Procedure (MAP). The recommended minimum standards on MAP and peer reviews is a welcomed development in the final report. We welcome the OECD FTA's MAP Forum as the best place for peer reviews to be undertaken, and encourage the OECD and governments to commit appropriate resource to ensure that the minimum standards can be upheld. The full picture of the success of the minimum standards on MAP (and the success of the BEPS Project as a whole) cannot be judged with reference only to tax authorities' data; we would welcome the opportunity to also be consulted as part of the OECD's monitoring framework.

We also congratulate the OECD on securing the commitment of 20 countries to binding arbitration and we urge the OECD to allocate necessary resource to ensuring this area is successful. We hope that this will demonstrate to non-participating countries the benefits of such a process to its participants and hope that this will become an international standard that other countries are compelled to join.

Multilateral Instrument (Action 15)

We congratulate the OECD on securing the commitment of c.90 countries to participate in the development of this ambitious project in 2016. We recognise the benefits that could arise from a significant number of countries signing up to the instrument in order to swiftly and uniformly implement the OECD's proposals.

Whilst the detailed timeline and consultation requirements have not been made public; we hope that the OECD will seek to consult widely and take up BIAC's offer of support in its work on development of the Multilateral Instrument.

CENTER FOR FREEDOM AND PROSPERITY

Statement of

Andrew F. Quinlan
President

Senate Committee on Finance
Hearing on International Tax: OECD BEPS and EU State Aid

December 1, 2015

Chairman Hatch, Ranking Member Wyden, and Members of the Committee on Finance, thank you for the opportunity to submit written testimony on the OECD's project on Base Erosion and Profit Shifting (BEPS).

My name is Andrew Quinlan. I am the president of the Center for Freedom and Prosperity (CF&P). The primary mission of the Center for Freedom and Prosperity is to defend tax competition as an important principle that helps ensure a prosperous global economy.

The BEPS project poses a direct threat to tax competition and American business.

First and foremost, it is necessary to understand that the OECD does not have American interests at heart, nor even the welfare of the global economy. Rather, it is an unaccountable bureaucracy that serves the narrow interests of finance ministers and tax collectors from its rich-nation members.

The OECD has a long documented history of advocating policies against the interests of American taxpayers and businesses, and of abusing its reputation to strong-arm jurisdictions into adopting self-destructive tax policies.

The United States must not buckle under pressure to do so in the case of BEPS.

The project on Base Erosion and Profit Shifting has been pushed under a dishonest premise. Despite a relatively small and temporary dip in recent years thanks to the recession, corporate tax revenues as a share of global GDP have trended steadily and decisively upward over the last few decades. The contrary but popular idea of a corporate tax dodging problem is a myth designed to draw attention away from irresponsible budgets and profligate government spending.

In order to avoid scrutiny of the project, BEPS preceded rapidly from conception to completion. The OECD is now hoping that the world similarly implement its dictates without the careful consideration the subject demands.

It is paramount that Congress prevent the U.S. Treasury from unilaterally fulfilling the OECD's wish to rewrite global tax rules without democratic oversight. In particular, rules designed to enable global fishing expeditions on American businesses through demands for inordinate and unnecessary amounts of private and proprietary data should be rejected.

Far from acquiescing to the OECD's scheme, the U.S. should take a leading role in defending the principles of free and open markets, and call on other nations to similarly reject their demands.

For further substantiation of the OECD's motives and more in-depth explanation of the true costs of allowing BEPS to proceed, please consider the additional materials appended to this statement.

Coalition for Tax Competition

July 14, 2015

Dear Senators and Representatives:

The Organisation for Economic Co-operation and Development (OECD) is rapidly working to rewrite global tax rules in the name of combating base erosion and profit shifting (BEPS). We the undersigned organizations are deeply concerned that this process lacks oversight and will result in onerous new reporting requirements and higher taxes on American businesses, and are urging Congress to speak up for U.S. interests by adding its voice to the process.

The OECD has a history of supporting higher tax burdens and larger government, and the BEPS project represents just the latest salvo in a long-running campaign by global bureaucrats to undermine tax competition and its restraining force on political greed.

Because the OECD is populated by tax collectors and finance ministers, new rules being drafted through the BEPS initiative are necessarily going to be skewed in their favor. Businesses are given only a token voice, while other interests are not considered at all. Consumers, employees, and everyone that benefits from global economic growth are not able to make their preferences known.

The inevitable prioritizing of tax collection over every other political or economic interest ensures that the result of the BEPS project will be economic pain. And based on the OECD's own acknowledgement that corporate tax revenues have not declined in recent years, that pain will provide little to no real gain to national treasuries.

BEPS recommendations already released further show a troubling trend toward excessive and unnecessary demands on taxpayers to supply data not typically relevant to the collection of taxes. This includes proprietary information that is not the business of any government, and for which adequate privacy safeguards are not and likely cannot be provided.

The Treasury Department should not be the only voice representing U.S. interests during this critical process. We urge members of Congress to get involved before it is too late, and to protect American interests by ensuring that the voices of tax collectors are not allowed to speak for everyone.

Sincerely,

Andrew F. Quinlan, President
Center for Freedom and Prosperity

Grover Norquist, President
Americans for Tax Reform

Pete Sepp, President
National Taxpayers Union

Michael A. Needham, CEO
Heritage Action for America

Tom Schatz, President
Council for Citizens Against Government Waste

Seton Motley, President
Less Government

Wayne Brough, Chief Economist and Vice President of Research
Freedom Works

J. Bradley Jansen, Director
Center for Financial Privacy and Human Rights

Phil Kerpen, President
American Commitment

David Williams, President
Taxpayers Protection Alliance

Bob Bauman, Chairman
Sovereign Society Freedom Alliance

Karen Kerrigan, President
Small Business and Entrepreneurship Council

Sabrina Schaeffer, Executive Director
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BEPS Has Tax Competition in the Crosshairs

Brian Garst, Center for Freedom and Prosperity

Originally published October 2015 by *Offshore Investment*

The OECD's work on Base Erosion and Profit shifting is completing after what can only be described as an extremely rushed process by global policy standards. In an effort to understand the broader implications of the project and what it means for the future of international taxation, I authored a study published June 2015 by the

Center for Freedom and Prosperity titled, "Making Sense of BEPS: The Latest OECD Assault on Tax Competition."[1] The following is an abridged version of the paper.

Introduction

Under direction of the G20, the Organisation for Economic Co-operation and Development (OECD) began 2 years ago a major initiative on "base erosion and profit shifting" (BEPS). The project has garnered little interest from U.S. policymakers to date, yet its ever expanding scope and profound implications for the global economy should demand their attention.

In February 2013 the OECD released a report titled, "Addressing Base Erosion and Profit Shifting" (BEPS Report), declaring that, "Base erosion constitutes a serious risk to tax revenues, tax sovereignty, and tax fairness for OECD member countries and non-members alike." The OECD followed up with a plan in July 2013, "Action Plan on Base Erosion and Profit Shifting" (Action Plan), that identified 15 specific areas to address.

Through the BEPS project, the OECD is continuing its war against tax competition. Its proposals would enable endless global fishing expeditions and provide cover for governments to choke the economy with new taxes.

The Threat to the Economy

The OECD and other supporters of the BEPS initiative argue that there are economic benefits to preventing legal tax avoidance techniques. Namely, they contend that activity undertaken in response to tax policy represents a market distortion. In the narrow sense this is accurate, but as a justification for the OECD's current activities, it falls short.

Typically ignored in the BEPS discussion are the broader implications of proposed reforms on the political economy. If all differences in tax policy were successfully minimized, to some extent it would indeed reduce profit-shifting aimed at suppressing tax burdens. So too would reducing taxes to zero, but policymakers have a variety of objectives to weigh and ought not elevate ending profit-shifting above all other national interests.

BEPS would lead to an overall higher tax environment as politicians freed from the pressures of global tax competition inevitably raise rates to levels last seen in the early 1980s, when reforms by Reagan and Thatcher sparked a global reduction in corporate tax rates that has continued to this day. Through tax competition, the average corporate tax rate of OECD nations declined from almost 50 percent in 1981 to 25 percent in 2015.

Taxes themselves distort the market by shifting resources away from market driven activities and toward politically driven activities, and higher rates, all else being equal, increase the effect of the distortion. Poorly designed tax systems—the global norm—introduce yet more distortions through the common practice of double taxing capital, which is of particular importance when discussing BEPS given that corporate taxes are often identified as the most destructive form of capital taxation, as even OECD affiliated economists have acknowledged.

Governments necessarily need taxes to fund essential functions, but ideally should seek to minimize the economic footprint of taxation as much as possible. Political incentives, however, often work in opposition of this goal. Politicians face pressure to demonstrate to constituents that they are performing and to please the interests that support their campaigns, and that in turn encourages taxes to rise above and beyond the level of optimum growth, or where new spending no longer provides net economic benefits.

Tax competition thus provides one of the main sources of push-back against the drive to spend and tax.

Tax collectors and finance ministers have inordinate say in the activities of the OECD, so it's expected that the BEPS initiative would represent their views above all else. The Action Plan thus considers the benefits of tax competition to be the real problem, explaining that "there is a reduction of the overall tax paid by all parties involved as a whole." The prospect of there being less money to be spent by politicians is perceived as a problem to be solved, rather than as a positive for the global economy.

[1] The full version is available at *www.freedomandprosperity.org/2015/publications/making-sense-of-beps.*

The Threat to Privacy

Several BEPS action items raise serious privacy concerns. Proposed recommendations for transfer-pricing documentation and country-by-country reporting, for instance, feature broad reporting requirements that go far beyond what is required for purposes of immediate tax assessment.

Guidance for Action 13 recommends a three-tiered approach to transfer-pricing documents consisting of a master file, a local file, and a country-by-country (CbC) reports. Information contained in the local and master files are particularly vulnerable, since it would take a breach in only a single jurisdiction for it to be exposed. The OECD makes assurances for the confidentiality of these reports, but they are empty promises. Such government assurances of privacy protection are contradicted by experience and the long history of leaks of taxpayer information. In the United States alone tax data has frequently been exposed thanks to inadequate safeguards, or even released by officials to attack political opponents.

Even without malicious intent, governments are ill equipped to protect sensitive information from outside access. According to the U.S. Treasury Inspector General for Tax Administration, 1.6 million American taxpayers were victimized by identity theft in the first half of 2014, up from just 271,000 in 2010. Chinese hackers were blamed for a breach that exposed the data of 4 million current and former federal employees, and the massive new collection effort and reporting system being established to enforce the Foreign Account Tax Compliance Act has also been faulted for its insufficient privacy safeguards.

As poor as the United States has proven at protecting privacy, there are likely to be nations even more vulnerable. Through the master file and other reporting mechanisms, BEPS will demand of corporations propriety information and other sensitive data that they have every right to keep private and out of the hands of competitors. When it takes a breach of only a single national government to expose this information, there will no longer be such expectation of privacy.

Is BEPS a Serious Problem?

The OECD's website describes BEPS as "tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid." The BEPS Report further claims that, "it may be difficult for any single country, acting alone, to fully address the issue." Or as the website more succinctly describes, BEPS "is a global problem which requires global solutions."

No significant evidence for these assertions is provided, however. The OECD's BEPS Report itself undercuts the argument that there is a pressing need for a global response when it acknowledges that "revenues from corporate income taxes as a share of GDP have increased over time."

Academic research on the impact of BEPS is far less certain than the rhetoric of the G20 and the OECD. The strongest analysis yet to date comes from Dhammika Dharmapala, whose survey of the literature reports that recent studies tend to find lower levels of shifting than earlier works. It also challenged arguments that "point to the fraction of the income of MNCs that is reported in tax havens or to various similar measures as self-evidently demonstrating *ipso facto* the existence and large magnitude of BEPS." Simply identifying money in other jurisdictions, even those with low tax rates, is not evidence of a BEPS problem. It should be expected to see more money being earned where tax policy is less hostile.

Part of the reason there exists little evidence of a significant global BEPS problem is that domestic policy solutions are already available to address legitimate areas of concern when they arise. More importantly, the best solution available for preventing base erosion is the adoption of a competitive tax code. Pro-growth tax policy that eschews double and worldwide taxation not only won't cause capital flight, but will attract investment instead.

Broader Aims of the OECD

To fully understand the significance of the BEPS effort, it's necessary to place the current agenda within the broader context of the OECD's work in recent decades. In 1998 the OECD declared war on tax competition with a report entitled, "Harmful Tax Competition: An Emerging Global Issue." Its authors worried that, among other things, tax competition "may hamper the application of progressive tax rates and the achievement of redistributive goals."

The organization was eventually forced by political opposition to back away from explicit condemnations of all tax competition, but has not abandoned its views. Rather, it has adopted new tactics toward the same end. To make this point clear, the Action Plan favorably references *Harmful Tax Competition* as justification for its recommendations. It also repeats a popular but baseless theory among left-wing academics and politicians about tax competition—that it promotes a "race to the bottom."

The "race to the bottom" theory has claimed for decades that tax competition would force zero rates on mobile capital. It hasn't happened. One review of common such claims finds: "there can be little doubt that history has proven wrong the prediction of a complete erosion of capital tax revenue. Comparative data on corporate and capital tax rates demonstrate that governments in all economies continue to tax mobile sources of capital, effective capital tax rates have not changed much compared with the mid-1980s, when tax competition was triggered by the 1986 U.S. tax act, and tax systems are as varied as countries and political systems themselves, with no visible sign of converging."

Nevertheless, the BEPS report notes: "In 1998, the OECD issued a report on harmful tax practices in part based on the recognition that a 'race to the bottom' would ultimately drive applicable tax rates on certain mobile sources of income to zero for all countries, whether or not this was the tax policy a country wished to pursue." Reality, essentially, is an unwarranted intrusion on the desire of policymakers to act without consequence. The BEPS report goes on: "It was felt that collectively agreeing on a set of common rules may in fact help countries to make their sovereign tax policy choices." Unless, that is, their sovereign choice involves something other than raising taxes.

Nations that opt for little to no taxes on capital are a problem for this quixotic theory of sovereignty—where the rest of the world must be brought to heel in order to ensure that politicians ought not have to consider the economic consequences of their policies—hence why the primary indicator for determining whether a nation is to be identified as "potentially harmful" is that it has "no or low effective tax rates."

Other factors are said to be considered, but without clear indication of how they are to be weighted any calculation will be arbitrary and open to excessive emphasis on the "gateway criterion" that is a low tax rate. When a low-tax scourge is identified, the OECD benevolently provides that, "the relevant country will be given the opportunity to abolish the regime or remove the features that create the harmful effect." To make perfectly clear that this is the sort of offer a nation cannot refuse, they warn: "Where this is not done, other countries may then decide to implement defensive measures to counter the effects of the harmful regime, while at the same time continuing to encourage the country applying the regime to modify or remove it."

The OECD's previous aggressions against low-tax jurisdictions in pursuit of its quest to abolish tax competition make clear just what "defensive measures" it has in mind, and how its members will go about trying to "encourage" compliance. In the years that followed release of *Harmful Tax Competition,* the OECD used threats of blacklists, peer pressure, and intimidation to cajole low-tax jurisdictions into adopting various policies presented under the auspices of increasing tax transparency and combating evasion. In practice the changes were intended to undermine the attractiveness of low-tax jurisdictions and protect high-tax nations from base erosion due to capital flight.

Of particular relevance for understanding the BEPS initiative is the pattern demonstrated by the OECD during the course of this campaign. After each recommendation was widely adopted—typically under duress in the case of low-tax jurisdictions—the OECD immediately pushed a new requirement that was more radical and invasive than the last.

The fact that the OECD is always ready with a new policy after one is implemented suggests either that the organization's goal is not merely what is stated, or that it is horribly ineffective. In either case it should serve as a blow to its credibility and a reason to question its work on BEPS.

Conclusion

Were the OECD merely a research institution, its work could be dismissed simply as a bad idea that no nation need adopt. Unfortunately, Europe's dominant welfare states use the OECD's work as a benchmark when coercing other nations through use of political and economic leverage. For the low-tax jurisdictions, and now multinational businesses, caught in the OECD's crosshairs, the ride truly never ends. The

BEPS project is a continuation of the OECD's well-documented effort to eliminate tax competition, and will likely follow the same pattern of consistently moving goal-posts.

The BEPS project began at the behest of a tiny few, without open and public debate regarding the assumptions motivating the effort, its goals, or the most appropriate methods to achieve them. There is a lack of accountability, reflected in the activities of the BEPS initiative, that can only be rectified through real public debate and more direct political oversight.

MOTION PICTURE ASSOCIATION OF AMERICA

December 15, 2015

The Honorable Orrin Hatch	The Honorable Ron Wyden
Chairman	Ranking Member
Senate Finance Committee	Senate Finance Committee

Re: December 1st Hearing: "International Tax: OECD BEPS and EU State Aid"

Dear Chairman Hatch and Ranking Member Wyden:

The MPAA and its member companies are grateful to you and your staffs for your efforts to reform the U.S. tax system. We very much appreciate the Committee's recent hearing entitled "International Tax: OECD BEPS and EU State Aid" and the examination of the potential effects of BEPS Actions on U.S. companies. We also are grateful for the efforts of the various working groups, which helped to advance the tax reform process.

In particular, we are hopeful that the bipartisan findings of the International Tax Bipartisan Tax Working Group will provide an impetus and structure for international tax reform. We believe one of the most important elements of tax reform will be to modernize our international tax system in order to put American companies on a level playing field when competing in the global market place. The current U.S. worldwide system is an outlier among major developed countries with its high statutory rates and the imposition of a residual U.S. tax on foreign earnings. This has a number of adverse economic consequences, causing our companies to be less competitive overseas, encouraging foreign ownership of IP, and locking out cash that could be used for domestic investment. We also agree with the co-chairs' conclusion "that we must take legislative action soon to combat the efforts of other countries to attract highly mobile U.S. corporate income through the implementation of our own innovation box regime that encourages the development and ownership of IP in the United States, along with associated domestic manufacturing." [1]

In that regard, we would like to submit the following comments for the record focused on BEPS Action 5 and the need for the U.S. to adopt an innovation box to respond to actions being taken overseas. This is essential to encourage domestic innovation and development, to preserve and create well-paying U.S. jobs, and to generate economic growth in an increasingly competitive global marketplace.

Introduction

The MPAA's six members—Walt Disney Studios Motion Pictures, Paramount Pictures Corporation, Sony Pictures Entertainment, Inc., Twentieth Century Fox Film Corporation, Universal City Studios LLC, and Warner Bros. Entertainment Inc.—produce, distribute and export theatrical motion pictures, television programming, and home video entertainment. The studios typically license their IP directly, or indirectly through subsidiaries, to unrelated parties for distribution in U.S. and foreign markets. In exchange, they receive royalties that historically have been subject to tax in the United States.

The motion picture and television industry is an important productive component of the U.S. economy. The industry employed directly or indirectly nearly 2 million people in the United States in 2013 and generated $113 billion in wages. Core production, marketing, manufacturing, and distribution jobs paid an average of $84,000, which is nearly 70 percent higher than the national average. The industry is comprised of a nationwide network of tens of thousands small businesses across

[1] Senate Committee on Finance, Report of the International Tax Bipartisan Tax Working Group (July 2015), p. 76.

all 50 states, with 85 percent of these businesses employing fewer than 10 people. The industry also supports good jobs and wages in thousands of companies with which it does business, such as caterers, hotels, equipment rental facilities, lumber and hardware suppliers, transportation vendors, and many others. Finally, the industry creates one of our country's most successful products, garnering a positive balance of trade with virtually every country to which we export and generating an overall $13.4 billion trade surplus in 2013.

Background—BEPS Action 5

Several countries have introduced favorable tax regimes for income that is derived from ownership of intellectual property. These "IP Box" regimes were enacted with the aim of attracting foreign investment and ownership of IP in the applicable country. Prior to BEPS and Action 5, such regimes generally have not required work related to the IP be carried out within the country in order to be eligible for IP box benefits. Thus, the tax benefit is currently not dependent on economic activity and innovation taking place in the jurisdiction.

Several OECD countries had raised concerns that these types of regimes are "harmful" and artificially shift IP ownership and taxable profits away from the country or countries where the value of the IP is created. In part to address whether these regimes are harmful, the OECD released its final report on Action 5 "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance" in early October. Under the final report, to avoid being labeled as harmful, a preferential regime generally must require substantial economic activity occur within the country for a taxpayer to be eligible for benefits. Specifically, Action 5 proposes that there must be a nexus between the income receiving the benefits and the expenses contributing to that income. Put another way, IP income will only qualify under this "nexus approach" for the preferential rates under an innovation box regime to the extent that the IP development expenses are incurred in the relevant country. Consequently, companies wishing to take advantage of the preferential regimes will need to shift at least a portion of their IP development jobs overseas.

International Tax Reform: The Need for a U.S. Innovation Box

In addition to adopting lower statutory rates and a dividend exemption system, the U.S. needs to take specific steps to respond to BEPS and other developments overseas that, if left unanswered, will result in significant U.S. job and revenue loss. We agree with the co-chairs of the International Tax Bipartisan Tax Working Group that "the anticipated impact of the new nexus requirements on innovation box regimes will have a significant detrimental impact on the creation and maintenance of intellectual property in the United States, as well as on the associated domestic manufacturing sector, jobs, and revenue base."[2]

As noted above, other countries are aggressively seeking to attract IP creation and commercialization through the introduction of broad IP regimes and other incentives.[3] The nexus requirement under BEPS Action 5 will likely require companies to shift IP development and jobs overseas in order to take advantage of innovation box incentives. Because companies like ours are facing increased pressure from stakeholders to take advantage of these incentives, many will decide to locate IP ownership and a higher proportion of IP development functions overseas to establish the requisite "nexus" to claim such benefits or to justify a higher allocation of income attributable to that IP. This will cause U.S. tax revenues to shrink as the U.S. tax base attributable to IP decreases and credits for foreign taxes paid on IP developed and owned overseas increase.

To prevent greater migration of IP ownership and quality jobs to other developed countries, and loss of the associated tax revenue, we believe the U.S. needs to respond quickly by adopting an IP box that encourages the development, ownership and commercialization of film and other IP in the United States. This is essential to counteract BEPS and other actions overseas, and help ensure that IP development and the associated well-paying jobs remain in the United States.

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[2] See id, p. 73.

[3] Specifically, with respect to films, many of our major trading partners (*e.g.,* Australia, Canada, France and the United Kingdom) offer significant wage credits and other above-the-line incentives to attract film productions and jobs abroad, in addition to their lower statutory rates. In fact, recognizing the benefits of film production to its economy, the United Kingdom this year sweetened its film and television production incentives by increasing its refundable tax credit from 20 percent to 25 percent for all qualifying UK film expenditure.

To date, there are two principal alternative approaches to designing an innovation box regime. First Congressmen Boustany and Neal released an innovation box proposal in late July that proposes a 10.15-percent effective rate of corporate tax on certain "innovation box profits" derived from qualifying IP, including films.[4] We believe the inclusion of films in the types of "qualified property" eligible for the innovation box deduction properly reflects the fact that production of films, like other forms of IP, is highly mobile and susceptible to other developed countries' incentives. The determination of innovation box profits would be dependent on a nexus ratio based on the taxpayer's research and development expenditures in the United States.

To ensure the purposes of adopting an IP box are fully met with respect to films, we believe that certain modifications should be made to the Boustany-Neal bill that properly account for differences between the development of films and other forms of IP. Most notably, the ratio in the discussion draft is based on incurring R&D expenses, rather than IP production expenditures generally. The production of films, in contrast to most other forms of IP, requires only limited R&D expenses. The numerator and denominator of the nexus ratio should be modified appropriately to reflect all IP development costs (incurred domestically compared to worldwide), not just R&D expenses. Also, the inclusion in the numerator and denominator of costs of an expanded affiliated group will often lead to anomalous results. For example, a corporation with significant business activities unrelated to development of IP, such as cruise ships, will be disadvantaged for no apparent reason relative to competitors without such activities. Conversely, a corporation that has an affiliate with significant unrelated IP development activities could be advantaged relative to its competitors.

Also, similar to section 199, income derived from film-related copyrights and trademarks should be eligible for the deduction under the discussion draft, because such income is a significant portion of the film's revenue stream and is essential to the decision whether to produce a film or not.

In addition, on-line viewing is a rapidly evolving portion of the film and television market that should be encouraged. Congress recognized this when it specifically provided that the methods and means of distributing a film should not affect eligibility under section 199. Failure to extend eligibility for innovation box benefits to income derived from digital broadcasts could mean that, as the demand for digital programming grows, the intended tax incentive for domestic film production could shrink substantially over time.

Finally, we believe it is important that the benefits of an innovation box be available to partnerships, as well as corporations. A substantial number of film projects every year are produced through partnerships, co-productions and joint ventures. Film production by partnerships is also susceptible to foreign incentives and the effects of nexus requirements under BEPS. Thus, to counteract those incentives and preserve the U.S. revenue base and jobs, partnerships should also be eligible for innovation box benefits.

The other alternative approach to implementing an innovation box in the U.S. would be to adopt an approach similar to the one taken by former Ways and Means Committee Chairman Camp in his tax reform bill (H.R. 1) to address base erosion.[5] By establishing a competitive tax rate on IP income and a balance between the treatment of exported IP and IP owned overseas, the "carrot and stick" approach of H.R. 1 will promote the creation, ownership and commercialization of IP in the United States.

The incentive effect of the "carrot" in H.R. 1 could be enhanced in several sensible ways. For example, the carrot will be heavily dependent on how intangible property development expenses are allocated for purposes of determining foreign intangible income. Specific rules are provided in the regulations under section 861 to allocate and apportion R&D expenses (Treas. Reg. sec. 1.861–17). These rules were adopted in part to encourage domestic research and development. Applying similar allocation and apportionment rules to film industry content and other intangible property for purposes of determining net foreign intangible income would provide similar incentives and help to ensure the carrot properly encourages domestic production of intangible property.

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[4] The effective tax rate would be achieved through a 71-percent corporate tax deduction on "innovation box profits."

[5] See H.R. 1 , "The Tax Reform Act of 2014," sec. 4211.

It would also enhance the "carrot" to specify that indirect expenses are not taken into account in computing net foreign intangible income. This would exclude expenses not directly allocable to IP development, including SG&A, stewardship and interest costs. A similar approach is used in Chairman Camp's discussion draft to define foreign source taxable income for purposes of the foreign tax credit limitation. This would provide a consistent approach for both purposes.

Finally, similar to the computation of the "stick" (which is done on a CFC-by-CFC basis), net losses from one transaction should not offset net intangible income from other transactions in determining the carrot under the bill.

Conclusion

We are very appreciative of the work by the Finance Committee to improve our tax system in order to promote domestic job growth and enhance the global competitiveness of U.S. businesses.

As we have written to the Committee before, our industry is highly sensitive and responsive to global competition. Recent technological developments have created an environment where jobs related to the production of underlying works, and the creation and commercialization of valuable intellectual property, are more highly mobile than ever before. At the same time, other countries are becoming more aggressive in using lower statutory tax rates, targeted tax incentives, broad innovation box regimes, and other subsidies to attract IP production and ownership overseas. The nexus requirements under the BEPS project will create pressures for companies like ours to move film and other IP development (and the associated jobs) overseas to take advantage of these incentives. We believe the U.S. must act quickly to respond to these challenges to avoid migration of IP development to foreign countries.

We are grateful for your efforts to address these challenges so U.S. companies remain highly competitive, and IP development (and the resultant revenue base) remains at home. We believe that a significant reduction in the U.S. corporate tax rate and adoption of a dividend exemption system with an appropriate IP box will successfully achieve these goals.

Please contact Patrick Kilcur (202) 378–9175 if you have any questions or need anything else from us. We look forward to working with the Committee members and the staff on these important issues.

Sincerely,

Joanna McIntosh
Executive Vice President, Global Policy and External Affairs

cc:
Members of the Senate Finance Committee

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Senate Finance Committee

Hearing on OECD BEPS Reports

December 1, 2015

The Tax Innovation Equality (TIE) Coalition is pleased to provide this statement for the record of the Finance Committee's hearing on the OECD BEPS Reports.[1] As the testimony at the hearing made clear, many of the concerns of the U.S. government and U.S. businesses with the BEPS Reports would be alleviated by reforming the U.S. tax code. Therefore, as the Committee considers what actions to take in view of the OECD BEPS Reports, we urge you to move forward with tax reform that will modernize the U.S. tax system and help American businesses compete in a global market. The TIE Coalition believes that the U.S. must: (i) implement a competitive territorial tax system; (ii) lower the U.S. corporate tax rate to a globally com-

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[1] The TIE Coalition is comprised of leading American companies and trade associations that drive economic growth here at home and globally through innovative technology and biopharmaceutical products. For more information, please visit *www.tiecoalition.com.*

petitive level; and (iii) not pick winners and losers in the tax code by discriminating against any particular industry or type of income—including income from intangible property (IP).

Recognizing the importance of IP to the U.S. economy, many of the members and witnesses at the hearing expressed concern about the adoption of so-called "innovation boxes" by OECD countries, raising questions about whether these measures will result in the movement of IP jobs from the U.S. to other countries and asking whether the U.S. should adopt similar measures. The TIE Coalition does not have a position on the adoption of a U.S. "innovation box" but we are very concerned that in prior international tax reform proposals income from intangible property (IP) would be singled out for harsher tax treatment than income from other assets. By discriminating against IP income as compared to income from other types of assets, these prior proposals would create an unfair advantage for companies who don't derive their income from IP and significantly disadvantage the most innovative U.S. companies, especially compared to their foreign competition.

For example, the "Tax Reform Act of 2014" (H.R. 1), as introduced by former House Ways and Means Chairman Camp, would seriously disadvantage innovative American companies. Under that proposal, Chairman Camp chose to use what is now widely known as "Option C." [2]

The problem with "Option C," is if it became the law of the land, its adverse tax treatment of IP income would significantly hinder U.S. companies who compete globally, and it would result in more inversions of U.S. companies. The TIE Coalition is opposed to "Option C" because it would have a devastating impact on both innovative technology and biopharmaceutical companies.

In an effort to really understand the full scope of "Option C," the TIE Coalition earlier this year commissioned a study by Matthew Slaughter, the Dean of the Tuck School of Business at Dartmouth University. We have attached a copy of the January 2015 study, entitled, "Why Tax Reform Should Support Intangible Property in the U.S. Economy," and urge the Finance Committee to consider its findings when examining options for international tax reform. A copy of the study can also be found at: *http://www.tiecoalition.com/why-tax-reform-should-support-intangible-property-in-the-u-s-economy.*

As Dean Slaughter emphasizes, "Policymakers should understand the long-standing and increasingly important contributions that IP makes to American jobs and American standards of living—and should understand the value of a tax system that encourages the development of IP by American companies." The study finds that "Option C" in the Camp legislation would fundamentally change the measurement and tax treatment of IP income earned by American companies abroad. The study finds that "Option C" of the proposal would disadvantage IP income earned abroad by U.S. companies in three ways. First, it would tax IP income at a higher rate than under current law. Second, it would tax IP income more than other types of business income. Third, it would impose a higher tax burden on the IP income of U.S. companies compared to their foreign competitors. The likely outcome of using "Option C" as proposed in the Camp legislation would be to increase corporate inversions and incentives for foreign acquisitions of U.S. based IP intensive companies.

The Slaughter study finds that the "United States, not abroad, is where U.S. multinationals perform the large majority of their operations. Indeed, this U.S. concentration is especially pronounced for R&D, which reflects America's underlying strengths of skilled workers and legal protections such as IP rights that together are the foundation of America's IP strengths, as discussed earlier." The Slaughter study concludes that the overseas operations of these companies complement their U.S. activities and support, not reduce, the inventive efforts and related jobs of their U.S. parents. So it is increasingly important to America's IP success that these companies continue to operate profitably overseas and any tax reform proposals do not impose discriminatory taxes on income from intangible assets located there.

IP jobs are very important to the U.S. economy and make up a large portion of the workforce. That is why it is important to have a tax code that supports the IP economy here in the U.S. To that point, the U.S. Chamber's Global Intellectual Property Center commissioned a study on the benefits of IP jobs to economic growth in the U.S. The study found that in 2008–09 that there were 16 percent or 19.1 million direct IP jobs and 30 percent or 36.6 million indirect IP jobs in the U.S. IP or IP

[2] Please note that the TIE Coalition is opposed to both versions of "Option C" (version one of "Option C" in the Camp Draft and version two of "Option C" in H.R. 1 as introduced).

related jobs account for 46 percent of the U.S. economy or 55.7 million jobs. With our modernizing economy it is likely that this number has grown.[3]

To be constructive and help the Committee find solutions that will allow American companies to succeed in a very competitive global market, the TIE Coalition has developed anti-base erosion solutions that do not target IP income. We would like to work with the Committee to develop alternative options that would apply to situations in which companies are simply trying to shift income to low tax jurisdictions with no substance or real business presence, but would not discriminate against income from intangible assets. Such options would apply to income from all goods and services, not just income from intangible assets.

In conclusion, the TIE Coalition supports tax reform that modernizes the U.S. tax system, allowing American businesses to compete in global markets in a manner that does not discriminate against any particular industry or type of income, including income from intangible property. As the witnesses at this hearing indicated, many other countries are lowering their corporate tax rates and adopting tax rules to attract IP companies to their shores. So, it would be especially harmful to the U.S. economy to adopt a tax policy that will hurt, not help, American companies who compete globally. Now is not the time to drive high paying American jobs overseas.[4]

Why Tax Reform Should Support Intangible Property in the U.S. Economy

Matthew J. Slaughter

January 2015

About the Author

Matthew J. Slaughter is Associate Dean for Faculty and Signal Companies' Professor of Management at the Tuck School of Business at Dartmouth. He is also a Research Associate at the National Bureau of Economic Research, an adjunct Senior Fellow at the Council on Foreign Relations, and an academic advisor to the McKinsey Global Institute. From 2005 to 2007, he served as a Member of the President's Council of Economic Advisers.

This report was sponsored by the Tax Innovation Equality Coalition. The views expressed in this report are those of the author.

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Executive Summary

America today continues to confront a competitiveness challenge of too little economic growth and too few good jobs. In the future America has the potential to create millions of good, knowledge-intensive jobs connected to the world via international trade and investment. Doing so will require sound U.S. policies that are based on a comprehensive understanding of how innovative American companies succeed in today's dynamic global economy.

In particular, policymakers should understand the long-standing and increasingly important contributions that intangible property (IP) makes to American jobs and American standards of living—and should understand the value of a tax system that encourages the development of IP by American companies. Unfortunately, the tax-reform proposals in former House Committee on Ways and Means Chairman Camp's Discussion Draft, the Tax Reform Act of 2014, would undermine these contributions. This white paper develops three central messages.

[3] See, *http://image.uschamber.com/lib/fee913797d6303/m/1/IP+Creates+Jobs+-+Executive+Summary+Web+-+2013.pdf.*

[4] The U.S. Chamber study found that "IP-intensive companies added more than $2.8 trillion direct output, accounting for more than 23 percent of total output in the private sector in 2008–09" and that the "Output per worker in IP-intensive companies averages $136,556 per worker, nearly 72.5 percent higher than the $79,163 national average. Id.

1. The Discussion Draft proposes sweeping changes to the U.S. tax treatment of IP. It would fundamentally alter the measurement and tax treatment of IP income earned by the foreign affiliates of U.S.-based multinational companies—and in so doing would discriminate against these affiliates' IP income relative to their non-IP income. Moreover, it would imperfectly measure this IP income—in many cases far too broadly. The bottom line is that the Discussion Draft would raise the current U.S. tax liability on IP income earned by the foreign affiliates of U.S.-based multinational companies—and thus would discourage these companies' investment in IP.
2. In three important ways, the Discussion Draft would disadvantage IP income earned abroad by U.S.-based multinationals. First, the U.S. tax burden on IP income would be higher than the tax burden on IP income under current law. Second, the U.S. tax burden on IP income would be higher than the tax treatment of many other forms of business income under the Discussion Draft. Third, the U.S. tax burden on IP income of U.S.-headquartered multinational companies would be higher relative to the tax burden on IP income of their foreign competitors as compared to current law. This would aggravate the nettlesome issue of corporate inversions and would create additional incentives for foreign acquisitions of U.S.-based IP-intensive companies.
3. Globally engaged U.S.-headquartered multinational companies, which create the large majority of America's IP, rely on their worldwide operations to maximize the creativity and benefits of their U.S. inventions. These globally engaged U.S. companies have long performed the large majority of America's IP discovery and development. Increasingly central to America's IP success is the ability of U.S. companies to operate profitably around the world. The latest research continues to show that the foreign-affiliate operations of U.S.-based multinationals complement their U.S. activities. Foreign affiliates support, not reduce, the inventive efforts and related jobs of their U.S. parents.

America's economic recovery remains too tentative and productivity growth has slowed dramatically in recent years. America stands to gain much from broad and fundamental policy reform that creates an internationally competitive tax system. But that reform should not discriminate against IP and its increasingly important contributions to the American economy.

Section One:
Overview of the Discussion Draft's Proposals
for Reform of U.S. Tax Treatment of IP Income

The Discussion Draft would enact sweeping changes to U.S. tax treatment of IP. It would fundamentally alter the measurement and tax treatment of IP income earned by the foreign affiliates of U.S.-based multinational companies—and is so doing would discriminate against these affiliates' IP income relative to their non-IP income. Moreover, it would imperfectly measure this IP income—in many cases far too broadly. The bottom line is that the Draft would raise the current U.S. tax liability on IP income earned by the foreign affiliates of U.S.-based multinational Companies—and thus would discourage these companies' investment in IP.

The Treatment of Intangible Income Under the Discussion Draft: Description of FBCII

In February 2014, Chairman of the House Committee on Ways and Means, Dave Camp (R–MI), introduced a Discussion Draft on comprehensive tax reform, the Tax Reform Act of 2014. This Discussion Draft proposed sweeping changes to America's taxation of both individuals and corporations overall—including current taxation of intangible income of U.S.-headquartered multinational companies.[1]

Under current law, when a foreign subsidiary of a U.S.-headquartered multinational earns income in a foreign jurisdiction, that income—regardless of whether related to tangible property or to intangible property (IP)—generally can be deferred and does not bear U.S. tax until the income is distributed to the U.S. parent. Thus, like other income, a foreign subsidiary's intangible income generally is not taxable in the

[1] At the end of the 113th Congress, the Discussion Draft of Chairman Camp was formally introduced as H.R. 1, The Tax Reform Act of 2014. At the time of writing in early 2015, the 114th Congress showed no indications of reviving this bill.

United States so long as it is not repatriated back to the U.S. parent. Stated differently, a foreign subsidiary's intangible income is not currently subject to immediate taxation under Subpart F.[2]

When fully phased in over 5 years in 2019, the Discussion Draft would implement a statutory corporate tax rate of 25 percent, 10 percentage points below today's rate of 35 percent. In addition, it would effectively replace today's worldwide taxation of U.S.-based multinationals with a hybrid territorial system. The non-IP related foreign earnings of U.S.-based multinationals would enjoy a dividends-received deduction of 95 percent. This would result in an effective U.S. tax rate of just 1.25 percent on the non-IP related foreign-affiliate earnings repatriated back to U.S. parents through dividends.[3] Thus, the Discussion Draft would establish a baseline of largely exempting from U.S. taxation the non-IP related income of the foreign subsidiaries of U.S. multinationals.

The IP-related income of these foreign subsidiaries would be treated quite differently, however. Section 4211 of the Discussion Draft would create a new category of immediately taxable income, "foreign base company intangible income" (FBCII), and thus would replace today's deferral-based worldwide system with a pure worldwide system for IP-related income. Here is the definition: [4]

> FBCII would equal the excess of the foreign subsidiary's gross income over 10 percent of the foreign subsidiary's adjusted basis in depreciable tangible property (excluding income and property that are related to commodities).

In addition, the calculation of FBCII would also subtract from gross income an "applicable percentage" of the foreign affiliate's other "foreign base company income," or FBCI. Depreciable tangible property consists of physical assets used by the affiliate in the course of its production, such as office buildings and equipment. The adjusted basis on this tangible property would be determined each tax year in accordance with rules specified elsewhere in the tax code. The 10 percent applied to the adjusted basis in depreciable tangible property receives little explanation in the Discussion Draft or its technical explanation, beyond being described as "in effect exempting normal returns on investments in tangible property."

Consistent with current U.S. tax treatment of Subpart F income, this newly created FBCII would cause an immediate tax liability for a U.S. multinational. The effective tax rate applied to FBCII would vary depending on whether the goods and services linked to that FBCII were for use inside or outside of the United States.

For goods and services for use in the United States—*e.g.,* for FBCII realized by a foreign affiliate exporting products back to customers in the United States—the effective tax rate on FBCII would ultimately be the Discussion Draft's statutory rate of 25 percent. This 25 percent tax rate on U.S.-connected foreign-affiliate IP earnings would be *20 times* the effective tax rate of 1.25 percent that the Discussion Draft would levy on non-IP related earnings of foreign affiliates.

For "foreign derived" FBCII related to goods and services intended for use outside the United States, the Discussion Draft would allow a deduction that, if enacted, would result in a lower effective tax rate. "The U.S. parent could claim a deduction equal to a percentage of the foreign subsidiary's FBCII that relates to property that is sold for use, consumption, or disposition outside the United States or to services that are provided outside the United States." [5] During the phase-in years, the amount of this deduction from FBCII would phase down in conjunction with the

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[2] The Internal Revenue Service defines intangible property to include the following six broad sets of ideas and related economic manifestation thereof: "computer software; patents, inventions, formulae, processes, designs, patterns, trade secrets, or know-how; copyrights and literary, musical, or artistic compositions; trademarks, trade names, or brand names; franchises, licenses, or contracts; methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data." See this definition and related discussion at *http://www.irs.gov/irm/part4/irm_04-048-005.html.* This paper follows this definition of intangible property.

[3] The tax rate of 25 percent applied to the non-deductible 5 percent of foreign-affiliate non-IP related earnings results in an effective tax rate on those earnings of just 1.25 percent (5 percent multiplied by 25 percent).

[4] *Tax Reform Act of 2014 Discussion Draft,* Committee on Ways and Means Majority Tax Staff, pp. 149–150. House Ways and Means Committee Majority Counsel and Special Advisor for Tax Reform Ray Beeman later clarified that FBCII would likely include royalties, after initial uncertainty arose on this. "I don't believe we meant to exclude royalties because that is where we started in the process. . . . That's definitely something we will want to go back and evaluate."

[5] *Tax Reform Act of 2014 Discussion Draft,* Committee on Ways and Means Majority Tax Staff, p. 150.

phase-in of the new lower statutory corporate tax rate, ultimately reaching 40 percent starting in 2019. This 40 percent deduction, if enacted, would imply a 15 percent effective tax rate on FBCII linked to foreign sales. A 15 percent tax rate on foreign-derived foreign-affiliate IP earnings would be *12 times* the effective tax rate of 1.25 percent that the Discussion Draft would levy on non-IP related earnings of foreign affiliates.[6]

This deduction would also be available to any U.S. corporation that earns foreign intangible income directly—*e.g.,* through exports from the United States to a foreign customer—rather than through a foreign affiliate. Thus, a U.S. company—a purely domestic company or a U.S. parent of a U.S. multinational—would also face an effective tax rate of 15 percent (assuming the 40 percent deduction applies), rather than the baseline statutory rate of 25 percent, on intangible income linked to sales or services abroad.

This particular deduction, if enacted, results in an effective rate of 15 percent on intangible income from serving foreign markets regardless of the location of intangible property or whether it is earned by the foreign affiliate or by the U.S. parent. Chairman Camp therefore claimed that the Discussion Draft "removes incentives companies currently have to move their innovation offshore, by providing a neutral 15-percent tax rate on profits from innovations regardless of whether the manufacturing takes place in the United States or overseas."[7]

To avoid foreign affiliates facing double taxation of FBCII, their effective U.S. tax would be reduced for any affiliate whose FBCII first faced a tax liability to the host-country tax authorities: all foreign taxes on FBCII would be eligible for credit against the U.S. tax. FBCII would be taxable immediately in the U.S. only when that foreign effective tax rate was lower than the effective U.S. tax rate.

Relative to current law, which leaves untaxed by the U.S. any un-repatriated foreign-affiliate intangible income, the Discussion Draft would raise substantial amounts of U.S. tax revenues. This is mainly because it would treat all such FBCII as immediately taxable (subject to any foreign tax credits). The Joint Committee on Taxation estimated that this new FBCII, along with some related changes, would raise net U.S. tax revenues by $115.6 billion over the years of 2014 through 2023.[8]

The Discussion Draft Would Disadvantage the IP Income of Foreign Affiliates of Multinationals

Under Discussion Draft the IP income of foreign affiliates of U.S. multinationals (as calculated under the FBCII formula) would become immediately taxable income. This would mean foreign affiliates would face a higher rate of U.S. taxation on their IP income than they do today under current law. These affiliates may face some foreign tax liability on this IP income (a foreign tax liability that would tend to offset any U.S. tax liability). But today there is no U.S. tax liability until and unless that IP income is repatriated. Under the Discussion Draft, that IP income would face an immediate additional U.S. tax liability of up to 25 percent.

As described above, the effective tax rate on this FBCII is intended to be the statutory 25 percent for income linked to serving U.S. customers and 15 percent for income linked to serving foreign customers—the lower effective rate attainable only if the intended 40 percent deemed deduction of the calculated FBCII ends up enacted into law. *So, under the Discussion Draft, a foreign affiliate of a U.S.-headquartered multinational would face a U.S. tax rate on IP income somewhere between 12 and 20 times the effective tax rate of 1.25 percent that the Draft would levy on non-IP related earnings of that foreign affiliate.*

A fundamental problem with the overall structure of Discussion Draft is it would disadvantage IP income earned abroad by U.S.-based multinationals. The U.S. tax burden on IP income under the Draft would be higher compared with the tax burden on IP income under current law. And the U.S. tax burden on IP income under the Draft would be higher compared with the U.S. tax burden on many other forms of

[6] Suppose a foreign affiliate earns FBCII of 100 through sales to host-country customers. Then against its FBCII it can claim a deduction of 40 (*i.e.,* of 40 percent of 100) and thus face a deduction-included FBCII of just 60. A statutory 25-percent tax on this 60 yields 15; thus would the effective tax rate on FBCII linked to foreign sales be just 15 percent.

[7] *The Tax Reform Act of 2014: Fixing Our Broken Tax Code So That It Works for American Families and Job Creators,* House Ways and Means Committee, p. 20. These revenue estimates should most accurately be thought of as 9-year estimates (rather than the more-common 10-year estimates) because its effective date is generally the tax years beginning after 12/31/14.

[8] *Technical Explanation of the Tax Reform Act of 2014: Title III—Business Tax Reform,* Joint Committee on Taxation, JCX–14–14, February 26, 2014.

business income under the Draft. As Section Two of this paper will discuss, there is no economic rationale for discriminating against IP income. Indeed, as Section Three of this paper will discuss, IP has long driven the large majority of the productivity growth and job creation at the foundation of generations of American economic success—investment in which is complemented by the foreign affiliates of U.S. multinationals.

The Discussion Draft's policy preference for foreign affiliates intensive in the ownership and use of tangible property is underscored by the FBCII formula itself. The larger the adjusted basis in depreciable tangible property that a foreign affiliate owns, the smaller the affiliate's FBCII would be and thus its current U.S. tax liability (thanks to being able to subtract off 10 percent of the adjusted basis). As Section 2 discusses, this preference would tend to dampen investment in tangible property in the United States by U.S.-based multinational companies.

Beyond this fundamental economic problem with the Discussion Draft's increased and uneven taxation of foreign-affiliate IP income, two other concerns with the design of FBCII merit mentioning: its formulary approach and its possible violation of World Trade Organization (WTO) obligations. Consider each of these in turn.

Using the formula of FBCII to measure IP-related income of foreign affiliates would constitute a radical departure from the current practice of defining and taxing income based on legal and market-based definitions that distinguish different sources and kinds of income based on the assets and/or the operations generating the income. This deviation has little precedent, either within the history of U.S. tax code or in terms of other countries' treatment of IP income.

This formulary approach to measuring IP income does promote administrative simplicity because it would not require companies to identify specific intangible assets or income flowing from those intangible assets. On this point, here are the words of House Ways and Means Committee Majority Counsel and Special Advisor for Tax Reform Ray Beeman.[9]

> We developed a formula that would apply to everybody. We could have gone in a direction where you created exact ways to measure embedded intangible income. . . . The formula should be a lot simpler to apply. . . . We are aware of and appreciate the fact that in service industries, there may be more of an effect. . . . Now I think we have something that is probably not always going to perfectly measure intangible income, but it's far easier to use. It's a formula that basically measures the return on invested capital . . . an example where you see precision in measuring income at war with simplicity.

Simple though the administration of FBCII might be, as will be discussed below, conceptually it is only vaguely linked to IP and thus cannot capture and adjust for the complex variety of business models both within and across industries. This vague link is especially worrisome given today's reality of U.S.-based companies increasingly producing their goods and services in elaborate global supply networks dictated by their evolving business needs. And, it is essential to stress again, these measurement problems of FBCII sit in the broader context of the more-fundamental problem with FBCII discussed above; namely, that it discriminates against the IP that has long driven the large majority of the productivity growth and job creation at the foundation of generations of American economic success.

On measurement, it is also important to note there is no obvious economic rationale for setting this percentage at 10 percent, rather than at some other share. This chosen percentage is intended to be a "normal" return to tangible investments. But there is nothing inexorable about this 10 percent. In particular, there is no established research literature supporting its chosen constancy. Rather, it is well documented that different countries often have persistently different real interest rates because of different underlying fundamentals. Simple though a fixed rate of return of 10 percent might be, no standard economic theory or evidence supports its blanket application in FBCII.

The other design feature of the Discussion Draft's treatment of IP income that raises concerns is the possibility that it may not comply with the rules of the World Trade Organization (WTO). Recall the tax rate of 15 percent that the Draft aims to impose on IP income linked to foreign customers regardless of whether that foreign customer is served by a U.S. multinational's U.S. parent or foreign affiliate

[9] Comments delivered on a March 7, 2014 webcast sponsored by KPMG, LLP.

(again, assuming that the 40 percent deduction is applied to foreign-linked IP income). This means a U.S. company earning IP income from exports would pay a 15-percent tax rate. But IP income stemming from the imports by a U.S. customer from a foreign affiliate of a U.S. multinational would be subject to a 25 percent tax rate. Many WTO rules prohibit countries from subsidizing exports relative to imports. Thus have a number of analysts voiced concern about taxing income from imports at a higher rate than income from exports.

For example, scholar Reuven S. Avi-Yonah has commented that Section 4211 "translates into a 15 percent tax rate applied to rents from exports but a 25 percent rate on rents from imports, which raises serious WTO compatibility issues." [10] Similarly, "former Ways and Means staffer John Buckley previously argued that [a similar provision, Option C in the 2011 Camp international tax reform draft, which largely resembles the Discussion Draft's treatment of FBCII,] violated WTO agreements as a prohibited export-contingent subsidy." [11]

For over a decade the WTO has been struggling to close a successful Doha Development Round and to make progress on other important initiatives such as updating the original Information Technology Agreement. In this fragile trade-policy environment, a new U.S. violation of WTO rules would not help. And history clearly demonstrates that U.S. tax-related WTO violations can carry serious consequences—for example, when U.S. law regarding Foreign Sales Corporations was forced to be altered because of such violations.

Regardless of whether the higher tax rate on affiliates' exports to America would be WTO compliant, it clearly would impair the global competitiveness of these affiliates relative to foreign-headquartered companies exporting to America because under the Discussion Draft, foreign companies would face no FBCII tax. This anticompetitive implication of the Draft Section Two explores. For now, it also underscores a substantial concern about the Draft's practical implementation, to which this paper now turns: the challenges of measuring FBCII in today's complex reality of global supply networks.

Measuring FBCII Would Not Be Simple in Today's Complex Reality of Global Supply Networks

In today's era of rapidly expanding global supply networks, measuring FBCII by a simple formula would be only vaguely linked to IP conceptually and would not be adjustable for a complex variety of business models within and across industries. For example, in these networks global companies often choose not to own the physical assets involved in the production of their goods and services. It is critical to stress that favoring owned tangible assets in today's era of globalized production is a major conceptual mismatch of FBCII.

A distinguishing feature of the world economy over the past generation has been the fragmentation of production. Companies increasingly produce within elaborate global supply networks in which parts of final products are made by companies of all sizes, in many stages, spanning many countries, and linked together by knowledge, trade, and investment. How companies produce their goods and services today differs dramatically from earlier generations, when companies made in-house most of the components and value of their products.

This proliferation of global supply networks is a striking and (barring catastrophe) irreversible feature of the world economy in which companies must operate to succeed. Three main forces account for their rise.

One has been widespread reductions in political barriers to trade, investment, and immigration. At the multilateral level, the Uruguay Round, in many ways the most comprehensive trade agreement ever, was implemented in the years after its 1994 closing. At the national level, a number of far-reaching unilateral, bilateral, and regional liberalizations have been implemented in the past generation, including the North American Free Trade Agreement in 1994 and China's accession to the World Trade Organization (WTO) in December 2001. At the industry level, the WTO Information Technology Agreement was signed in 1996, whereby 70 countries representing about 97 percent of world trade in IT products agreed to eliminate duties on hundreds of intermediates, capital goods and final products in the IT industry.

[10] "The Devil Is in the Details: Reflections on the Camp Draft," by Reuven S. Avi-Yonah, in *Tax Notes International,* March 24, 2014, p. 1056.

[11] "Royalties Included in Reduced Intangibles Rate in Camp Draft, Ways and Means Says," by Andrew Velarde, *Tax Notes,* March 11, 2014.

Government restrictions on inward and outward foreign direct investment (FDI) have also fallen.

A second important force driving global supply networks has been the choice of many mainly labor-abundant countries to allow their billions of citizens to integrate into the global economy by lowering trade and investment barriers—rather than choosing to prevent globally engaged companies from competing in their markets, as so many countries did over much of the 20th century. Prominent here are the BRIC countries of Brazil, Russia, India, and China.

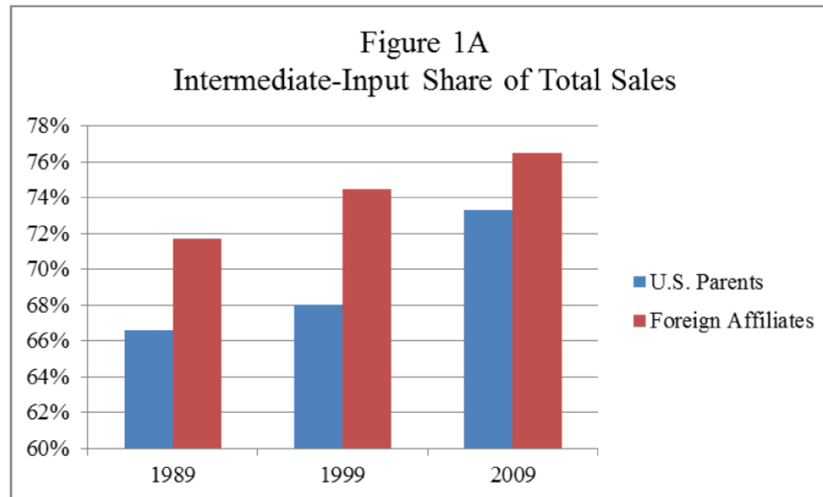
The third and perhaps most dramatic force driving global supply networks has been IT innovations that have driven to near zero the cost of global communication and information transmission. In the past generation, connectivity and communication facilitated by IT and the Internet have dramatically reduced the costs of trading many goods and, for services as discussed above, vastly expanding the scope of what activities are tradable.

This IT revolution has interacted with the first two forces. The conscious choice of so many countries to connect to the global economy, plus falling policy barriers to the international flow of ideas, people, capital and products, have opened to global companies dramatically more options for how to configure what they produce where. But in many ways it has been IT that has made these options both low-enough cost to do and also manageable despite this complexity.

The net result of these three forces has been a proliferation of global supply networks: elaborate and fluid structures in which companies locate different production tasks in different countries, some performed in-house and others with external partners. The productivity gains have been enormous: more innovation, lower costs, faster customer responsiveness and lower risks. The result for America (and others) is deeply globally engaged companies, each determining and building its strengths connected to the world to ensure continued success in keenly competitive world markets.

Publicly available data on U.S.-headquartered multinational companies shed clear light on how important global production networks are to them. Figure 1A provides one indicator of this. For each of three years 1989, 1999 and 2009, it reports the share of total sales of U.S. parents and foreign affiliates of U.S.-headquartered multinational companies.[12]

[12] Every year since 1977, the U.S. Bureau of Economic Analysis has multinational companies in America through legally mandated surveys (with penalties for noncompliance) that collect and publicly disseminate operational and financial data. By design, BEA statistics track all multinational companies in the United States: both the U.S. parents of U.S.-headquartered multinationals (as well as their foreign affiliates) and the U.S. affiliates of foreign-headquartered multinationals (but not their foreign parents). In accord with the practice of many countries, the BEA defines a U.S.-headquartered multinational company as any U.S. enterprise (the "parent") that holds at least a 10 percent direct ownership stake in at least one foreign business enterprise (the "affiliate"). The BEA analogously defines a U.S. affiliate of a foreign-headquartered multinational company as any U.S. enterprise in which at least a 10 percent direct ownership stake is held by at least one foreign business enterprise. In Figure 1A, shares data were obtained from the BEA data online at *www.bea.gov.*



The key message of Figure 1A is that the share of intermediate inputs (*i.e.,* of goods and services that companies purchase from other companies to help produce their own goods and services) in total sales has been high and rising for both the U.S. and foreign operations of U.S.-based multinationals: from 66.6 percent in 1989 to 68.0 percent in 1999 and 73.3 percent in 2009 for U.S. parents and from 71.7 percent in 1989 to 74.5 percent in 1999 and 76.5 percent in 2009 for foreign affiliates. These high and rising shares reflect the deepening engagement of these companies in global supply networks.

Looking at different industries offers additional insight into the dynamic evolution of how these companies produce. Companies changing their positions in global supply networks sometimes switch primary industry—and this trend has increased over time as companies switch focus from goods to services. In the words of the U.S. Department of Commerce:

> The tendency for U.S. sellers of goods to shift their activities from manufacturing toward wholesale trade predates 1999, but it has been growing in importance. For example, the number of parent companies whose primary industry classification changed from manufacturing to wholesale trade in 1999–2009 more than doubled from the preceding 10-year period. The acceleration in this trend may be partly related to the rise of global value chains in firms' business strategies.[13]

This blurring of traditional distinctions between goods and services, not just across but even within companies, is a hallmark of global supply networks. These networks allow the production of goods to be unbundled into a collection of inputs that are not just goods but services as well—and conversely the production of services such as wholesale trade, may require supply chains of goods. Successful globally engaged companies must continually shift the blend of goods and services they produce and sell. Indeed, many of America's leading manufacturing companies make and sell services as an essential part of their overall operations. One recent study found that companies whose main business was manufacturing are among America's largest exporters and importers of services spanning R&D, business processing, and management consulting.[14]

The clear implication of the rise of complex global supply networks is that FBCII would be only vaguely linked to IP conceptually and would not be adjustable for the complex variety of business models within and across industries. This combination

[13] Barefoot, Kevin B., and Raymond J. Mataloni, Jr. 2011. "Operations of U.S. Multinational Companies in the United States and Abroad: Preliminary Results from the 2009 Benchmark Survey." *Survey of Current Business,* November, pp. 29–55.

[14] Barefoot, Kevin B., and Jennifer Koncz-Bruner. 2012. "A Profile of U.S. Exporters and Importers of Services." *Survey of Current Business,* June, pp. 66–87.

of features means FBCII likely would carry two unattractive features: (1) it would capture an unreasonably large fraction of current affiliate income, sharply reducing the Discussion Draft's stated goal of largely exempting from U.S. taxation foreign-affiliate income; and (2) it would measure cross-industry variation that is only somewhat linked to common measures of industry IP intensity because of variation driven by different global-supply-network strategies of different companies.

Consider, for example, a labor-intensive foreign affiliate whose many employees work with capital goods that are leased from its main customer in making its products. Under the FBCII formula, because this affiliate owns little tangible capital it would have very little to subtract from its gross income—and thus would be measured as having high IP-related income regardless of the actual IP intensity (or lack thereof) of the underlying production activities.

More generally, companies that are more adept in situating themselves into the high-value-added positions of global supply networks will be companies that earn high profits whether or not those positions are in any way linked to IP assets. In some cases IP would be involved in a successful global production strategy, but surely not in all cases as there are a number of non-IP-related strategies that can yield profitability. High-quality customer service, for example—perhaps linked to products wisely tailored to local tastes—can generate high foreign-affiliate income regardless of any particular role for IP.

This problematic tendency of FBCII to measure income as IP-related when it actually is not has been identified by a number of analysts. Here, for example, is an excerpt from a Tax Notes International article that includes the thoughts of Peter Merrill of PWC.[15]

> Taxpayers in the services industry may not like the proposal much, particularly if they do not have significant amounts of depreciable property. Merrill pointed out that under the draft [Camp bill], a services firm could face a situation in which nearly all of its foreign income becomes FBCII. That result is contrary to the residual profit-split method used in transfer pricing, which gives a routine return for things like payroll and other factors of production before allocating residual profits. Merrill said the focus on depreciable property has implications for other types of industries, too. Banks, for example, have mostly non-depreciable assets would get no return on those assets under the formula, he said. Taxpayers who rent buildings and equipment abroad would have a huge incentive to buy them. . . . Another complication would arise when a company has acquired another company that has already depreciated its assets and would therefore have no tangible returns to reduce the amount . . . attributed to intangible income.

In general, foreign affiliates with low profits—for whatever long-terms structural or short-term cyclical reasons—will have little or no FBCII. In contrast, foreign affiliates with large profits and/or little tangible property will have FBCII calculated to be very close to their total profits. In a world of constantly evolving global supply networks, only some of this variation in calculated FBCII will be driven by variation in IP-intensity. This less-than-tight correlation between calculated FBCII and IP-intensity is far from ideal.

These measurement concerns can be demonstrated using publicly available Bureau of Economic Analysis (BEA) data on the operations of majority-owned foreign affiliates of U.S.-headquartered multinational companies (see note 12). Figure 1B below uses these BEA data for the most recent year available, 2012, to approximate the formulaic calculation of FBCII of these foreign affiliates, both for all industries together and for a number of particular industries.

To estimate FBCII, the formula's "gross income" is approximated using the BEA's measure of net income.[16] The formula's "depreciable tangible property" is approximated using the BEA's measure of net property, plant, and equipment (PPE) assets—*i.e.,* the book value of these PPE assets net of accumulated depreciation charges. The Discussion Draft may intend to include other types of tangible prop-

[15] "The Camp Proposal: Patent Boxes in the Age of BEPS," by Marie Sapirie, *Tax Notes International,* March 24, 2014, p. 1065.

[16] Note that these BEA calculations assume that implementation of FBCII would not measure gross income as something like total revenues—*i.e.,* would not encompass basic costs of goods sold such as materials purchased and payroll. If FBCII approximated gross income with something broader like total revenues, then the mismeasurement of FBCII discussed in the text would be all the more egregious because it would capture business expenses wholly unrelated to IP such as purchases of electricity, heating fuel, water, and sewer connectivity.

erty, but PPE are clearly an important part of this concept. Finally, the publicly available BEA data do not contain sufficient detail to adjust FBCII for the other "foreign base company income;" this may result in a slight over-estimate of FBCII. The six industries in Figure 1B highlighted with an asterisk are, as Section 3 will discuss, on many measures among America's most IP-intensive. One is software; the other five are part of manufacturing: pharmaceuticals, machinery, computers, electrical equipment, and transportation.

Figure 1B: Estimated FBCII for U.S.-Multinational Affiliates, 2012

Industry Group	Net Income ($M)	Net PPE Assets ($M)	Calculated FBCII	FBCII Share of NI
All Industries	1,062,817	1,283,875	934,430	87.9%
Manufacturing	176,714	399,922	136,722	77.4%
Pharmaceuticals *	42,376	28,089	39,567	93.4%
Machinery *	13,252	22,417	11,010	83.1%
Computers *	36,428	46,456	31,782	87.2%
Electrical Equipment *	5,366	8,043	4,562	85.0%
Transportation Equipment *	1,915	50,028	−3,088	−161.2%
Software*	14,633	3,128	14,320	97.9%
Retail Trade	8,991	63,392	2,652	29.5%
Wholesale Trade	69,593	45,727	65,020	93.4%
Finance and Insurance	93,665	37,127	89,952	96.0%

There are two important points from the analysis in Figure 1B. First, FBCII would seem to encompass the very large share of total foreign-affiliate net income of not just IP-intensive industries but of many other industries as well. For all industries this share is estimated to be 87.9 percent. For five of the six IP-intensive industries in Figure 1B this share exceeds 80 percent—and for two, pharmaceuticals and software, it exceeds 90 percent. The only other such estimate of FBCII to date, by Martin Sullivan, uses IRS data but reaches a very similar conclusion: his estimates from 2008 IRS data conclude that for all industries 79 percent of total earnings and profits of foreign subsidiaries would be considered FBCII.[17]

Whether such breadth of scope was intended when creating FBCII, in light of the above discussion of global supply networks this share seems implausibly high. To attribute to IP assets about or over 80 percent of all foreign-affiliate earnings misses the many other reasons for success such as high-quality products, responsive customer service, and efficient links to input suppliers. It seems to border on tautological to consider advantages of IP as encompassing all the many competitive advantages firms develop and deploy. Indeed, these FBCII calculations might more broadly call into question the notion that the Discussion Draft creates a near-territorial tax system for the United States. If upwards of 87.9 percent of all foreign-affiliate income is immediately taxable as Subpart F FBCII at rates of at least 15 percent, then only 12.1 percent of foreign-affiliate income would be left eligible for territorial treatment. It is doubtful such a regime would be more territorial than today's worldwide-plus-deferral regime.

The second important message of Figure 1B is the insensitivity of FBCII calculations to legitimate variation in business strategies and environments unrelated to IP—even among those industries that scholarship shows are IP-intensive.

To see this, compare transportation equipment to pharmaceuticals and software. Transportation equipment has nearly twice the PPE assets of pharmaceuticals and over 10 times that of software, which at least partly reflects the obvious difference

[17] "Camp's Approach Treats Most CFC Income as Intangible," by Martin A. Sullivan, in *Tax Notes International,* March 24, 2014.

in production technologies among the sectors. Building planes, trains, and automobiles requires massive amounts of sophisticated equipment and buildings. And the underlying demand dynamics often differ among these sectors. Much of the personal and business demand for transportation equipment is very sensitive to business-cycle conditions such as overall GDP growth, employment, and consumer confidence—conditions that in 2012 remained sluggish and fragile in regions such as the Europe. Demand for pharmaceuticals and software, in contrast, is often much less cyclically sensitive.

For these economic reasons, it is not surprising that 2012 net income in transportation equipment was so much lower than in pharmaceuticals and software. But the FBCII formula does not account for these economic differences in any way—and thus implies a vastly different tax liability for the two sectors. Pharmaceuticals and software face an FBCII estimated to be 93.4 percent and 97.9 percent of each's overall net income, respectively. But transportation equipment, because it earned so little net income and owned so many tangible assets, has *negative* FBCII.

Other IP-intensive businesses in Figure 1B resemble pharmaceuticals and software. Electrical equipment, for example, has been widely studied as having some of the world's most elaborate global supply networks in which participating companies tend to occupy relatively narrow spaces within the networks and contract heavily with partners for key intermediate inputs and even for renting shared production capacity. Thus it is not surprising how it, too, looks asset-light and has FBCII at a high 85 percent share of net income.

Surely some of the estimated FBCII for affiliates in pharmaceuticals, software, and electrical equipment is surely connected to their IP. But some of it is not, and the FBCII methodology would allow no way to distinguish these underlying causes. Regardless, of all this calculated FBCII would face an immediate U.S. tax liability of between 15 percent and 25 percent—*i.e.,* between 12 and 20 times the effective tax rate of 1.25 percent that the Discussion Draft would levy on non-IP related earnings of foreign affiliates.

It is important to stress that, with the continued expansion of global supply networks, foreign affiliates increasingly operate for global distribution, which includes exporting goods and services to the United States—either to U.S. parents or to purely domestic unrelated U.S. companies. This increasingly important dimension of global supply networks means that over time, a rising fraction of the FBCII calculated in Figure 1B would, under the Discussion Draft, face an immediate tax liability of 25 percent rather than just 15 percent (as discussed earlier in this section).

Figure 1C demonstrates this point. For the four most recent years of BEA data, the figure reports for majority-owned foreign affiliates their exports to the United States of goods (exports of services are tracked by BEA only infrequently); their total manufacturing sales, as a proxy for goods sales; and the share of these U.S. exports in affiliates' total manufacturing sales.

Figure 1C: Rising U.S.-Export Intensity of Foreign Affiliates

Year	Goods Exports to U.S. ($ Billion)	Manufacturing Sales ($ Billion)	Export Share
2009	258.1	2,029.4	12.7%
2010	292.6	2,228.6	13.1%
2011	345.3	2,570.2	13.4%
2012	346.4	2,525.2	13.7%

The key message of Figure 1C is the steadily rising share of foreign affiliates' goods production that is exported to the United States: from 12.7 percent in 2009 to 13.7 percent in 2012. This rising share accords with the substantial body of research that has documented the spread of global supply networks.[18] Indeed, much of what affili-

[18] For an overview and many references to research studies on global supply networks, see *American Companies and Global Supply Networks: Driving U.S. Economic Growth and Jobs by Connecting with the World,* white paper for Business Roundtable and United States Council for International Business, Matthew J. Slaughter, 2013.

ates are exporting to America are today intermediate inputs essential in the production of goods and services made in America. In recent years, over 60 percent of America's goods imports were intermediate inputs that were used in America with American workers, capital and know-how.[19] To succeed in global supply networks increasingly requires U.S. companies to import as well as export. "Made in America" increasingly hinges on creative new ways to make goods and services in conjunction with the world—including in conjunction with the foreign affiliates of U.S.-based multinationals. Yet under the Discussion Draft, the FBCII of these foreign affiliates connected to exports back to America and other ways of serving U.S. customers will face an immediate tax liability of 25 percent—versus just the effective tax rate of 1.25 percent that the Draft would levy on non-IP related earnings of foreign affiliates.

Whether taxed at a rate of 15 percent or 25 percent, Figures 1B and 1C together make clear that the tax base of foreign-affiliate FBCII income would be very large: hundreds of billions of dollars in 2012 alone. Again, the U.S. parents of these foreign affiliates would pay a U.S. tax only above and beyond whatever foreign taxes these affiliates would first pay. But the result would be a minimum effective tax on all foreign-affiliate income treated as FBCII, with any foreign tax rate below 15 percent (or 25 percent) on FBCII topped up to at least 15 percent (or 25 percent) for the U.S. owners.

For these reasons the Joint Tax Committee forecasts that the Draft "increases the U.S. taxation of income derived from intangibles owned or licensed by a CFC."[20] This tax increase would be large. JCT has estimated that this new Subpart F FBCII, along with some related changes to Subpart F income, would raise U.S. tax revenues by $115.6 billion over the years of 2014 through 2023.

The Discussion Draft's tax treatment of IP-intensive activities of multinational companies would be very discriminatory relative to all other activities. The IP-related income of foreign-affiliates would lose current-law deferral without any offsetting territoriality and thus would be subject to a minimum tax rate of between 15 percent and 25 percent—between 12 and 20 times the effective tax rate of 1.25 percent that the Discussion Draft would levy on non-IP related income of foreign subsidiaries.

Section Two:
Three Ways In Which the Discussion Draft Would Disadvantage the Foreign-Affiliate IP Income of American Companies

In three important ways, the Discussion Draft would disadvantage IP income earned abroad by U.S.-based multinationals. First, the U.S. tax burden on IP income under the Draft would be higher compared with the tax burden on IP income under current law. Second, the U.S. tax burden on IP income under the Draft would be higher compared with the U.S. tax burden on many other forms of business income under the Draft. Third, the U.S. tax burden on IP income of U.S.-headquartered multinational companies would be higher relative to the IP income of their foreign competitors under the Draft compared with under current law. This third aspect, in particular, would aggravate the already nettlesome issue of corporate inversions dominating much recent U.S. tax discussion and would further encourage the foreign acquisition of U.S.-headquartered IP-intensive firms.

Section 1 focused on the mechanics of Foreign Base Company Intangible Income (FBCII) under the Discussion Draft. The analysis highlighted important problems, taking as a given the current structure of operations of U.S.-headquartered multinational companies. Section 2 broadens the focus to analyze the strategic choices that multinational companies intensive in intangible property (IP) would face under

[19] The trade data cited in this sentence come from the U.S. Census Bureau and the BEA.
[20] *Technical Explanation of the Tax Reform Act of 2014: Title IV—Participation Exemption System for the Taxation of Foreign Income,* Joint Committee on Taxation, JCX–15–14, February 26, 2014, p. 40.

the Discussion Draft. For these IP-intensive multinational companies, three different strategic trade-offs are important to consider:

1. The U.S. tax burden on foreign-affiliate IP income under the Draft compared with the tax burden on foreign-affiliate IP income under current law.
2. The U.S. tax burden on foreign-affiliate IP income under the Draft compared with the U.S. tax burden on other forms of foreign-affiliate business income under the Draft.
3. The U.S. tax burden on foreign-affiliate IP income of U.S.-headquartered multinational companies relative to the IP income of their foreign competitors under the Draft compared with under current law.

The central message of this section is that the U.S. tax burden on foreign-affiliate IP income under the Discussion Draft is higher in all three comparisons: relative to current law, relative to other business activities under the Draft, and relative to foreign competitors under the Draft. From all three of these perspectives, U.S.-headquartered multinational companies will be disadvantaged by the treatment of foreign-affiliate IP income under the Discussion Draft.

Comparing Foreign-Affiliate IP Income Under the Discussion Draft Versus Under Current Law

Under current law, income related to IP that is earned by a foreign subsidiary of a U.S.-headquartered multinational can be deferred and is not a taxable event until distributed to the U.S. parent. Thus, a foreign subsidiary's intangible income is not taxable in the United States so long as it is not repatriated back to the U.S. parent. Stated differently, that foreign subsidiary's IP income is not considered part of immediately taxable income.

The Discussion Draft would exempt from U.S. taxation most of the non-IP income of the foreign subsidiaries of U.S. multinationals, by establishing a dividends-received deduction of 95 percent on the foreign earnings of U.S.-based multinationals. This would result in an effective U.S. tax rate of just 1.25 percent on the non-IP related foreign-affiliate earnings repatriated back to U.S. parents through dividends. The intangible income of these foreign subsidiaries would be treated quite differently, however. Section 4211 of the Discussion Draft would create a new category of immediately taxable income, FBCII, creating a worldwide tax base (without deferral) for IP-related income at an effective rate of either 15 percent or 25 percent—12 to 20 times more than the 1.25 percent effective tax rate on non-IP income of these subsidiaries.

In a Discussion Draft world, U.S.-based multinational companies would thus realize a smaller after-tax rate of return on IP investments relative to today's world because the incremental U.S. tax liability on that income would be realized much earlier in time. This higher taxation on IP income would, all else being equal, reduce the incentives of U.S.-based multinationals to invest in IP assets because of this lower after-tax rate of return. Indeed, JCT analysis of the economic impacts of the Discussion Draft finds that lower investment rates in IP—presumably through channels such as lower R&D spending—would, along with the loss of accelerated depreciation, contribute to a slightly smaller U.S. capital stock under the Draft than under current law. "Overall, the proposal is expected to increase the cost of capital for domestic firms, thus reducing the incentive for investment in domestic capital stock."[21]

The bottom line here is that the higher U.S. tax liability on foreign-affiliate IP income under the Discussion Draft would induce U.S.-headquartered multinational companies to undertake less IP investment than they would under current law—e.g., *less R&D spending and less other forms of knowledge discovery. As Section Three of this paper will discuss, IP has long driven the large majority of the productivity growth at the foundation of generations of American economic success—investment in which is complemented by the foreign affiliates of U.S. multinationals.*

Comparing Foreign-Affiliate IP Income Under the Discussion Draft Versus Other Business Activities Under the Discussion Draft

A second important perspective to consider is the U.S. tax burden on foreign-affiliate IP income compared with the U.S. tax burden on all other forms of business income, both under the Discussion Draft. Here, three important points merit stressing.

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[21] *Macroeconomic Analysis of the "Tax Reform Act of 2014,"* Joint Committee on Taxation, JCX–22–14, February 26, 2014, pp. 15–16.

First, economic theory clearly implies that pre-tax rates of return on IP investments should be higher than rates of return on investments in most tangible properties. This is because of the inherent riskiness of new-knowledge discovery: the uncertain prospects of cutting-edge innovations means the returns to successful discoveries should be and are high to compensate for their increased riskiness. Yet, because the intent of FBCII is to implement an immediate U.S. tax liability on foreign-affiliate IP income but not on income from other less-risky assets and activities, in practice the Discussion Draft would dull the economic incentive that induces companies to undertake risky investments in knowledge discovery.

Second, some companies in IP-intensive industries may be less intensive in physical capital—*e.g.,* property and equipment—than will other, more-traditional industries. Of course the optimal blend of knowledge and human capital in operations varies widely across companies—as was discussed in Section 1 in the context of measuring FBCII in an era of global supply networks—but some highly innovative firms do not use much tangible capital.

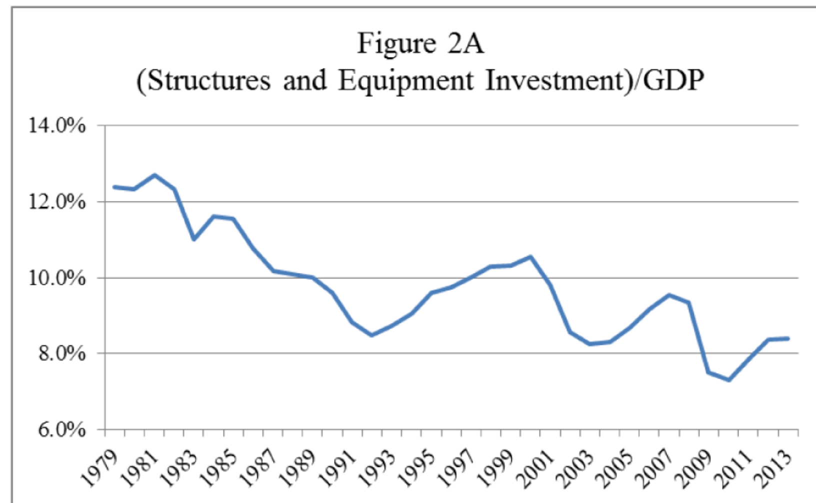
Third, evolving global supply networks mean that many globally engaged companies connect with foreign partners to help them produce and distribute their knowledge-intensive products in ways that do not require ownership abroad of a great deal of depreciable tangible assets. Section 1 discussed this important consideration in greater detail.

The net implication of these three business-strategy and economic considerations is that the calculation of FBCII will likely mean a greater share of foreign-affiliate income will be subject to immediate incremental U.S. tax for IP-intensive multinationals than will be the case for multinationals concentrated on other, more-traditional business activities. And, this calculated IP income of foreign affiliates will be taxed at much higher rates than the non-IP income of these foreign affiliates: at rates of 15 percent up to 25 percent, in contrast to just 1.25 percent. Incentives matter, and all of these considerations will tend to reduce the after-tax rate of return on U.S. multinationals' investments in IP assets—and thus will induce these multinationals to invest less in IP assets and more in non-IP assets.

For foreign affiliates, this skewing of business decisions away from IP might take a number of forms. The tax-induced value of owning tangible assets by foreign affiliates might compel multinationals to buy rather than lease tangible assets—*e.g.,* to purchase an office building where employees work rather than simply leasing space in that building—purely for tax reasons rather than for more-fundamental business-competitiveness reasons.

This skewing of business decisions away from IP might also compel U.S.-based multinationals to invest in tangible assets in their foreign affiliates rather than in their U.S. parent operations. Creating incentives to invest in physical capital abroad, not in America, would never make wise economic policy. But it would be especially unwelcome today given Figure 2A. For each year since 1980, Figure 2A reports America's total investment in non-residential structures and equipment as a share of U.S. GDP (gross domestic product, the value of all newly produced goods and services).[22]

[22] The underlying data in Figure 2A come from Table 1.1.5 of the National Income and Product Accounts of the Bureau of Economic Analysis, accessed on-line at *www.bea.gov.* The underlying dollar figures in Figure 2A are annual nominal totals. These two components of total U.S. capital investment together are the closest NIPA measure of the tangible assets specified in the Discussion Draft.



The key message of Figure 2A is that investment in the United States in business equipment and structures as a share of GDP has been falling for decades. Except for the increase in this share over much of the 1990s driven by the IT revolution and the resulting accelerated investment in IT capital goods, the share has fallen from a bit above 12 percent around 1980 to only about 8 percent in recent years. Indeed, slow growth in capital investment is one reason for the sluggish U.S. economic recovery from the Great Recession. Tax policies that incentivize U.S.-headquartered multinationals to invest in physical capital outside America without any underlying economic or strategic rationale to do so—multinationals that, as Section 3 will document, in 2012 accounted for 43.3 percent of all the U.S. investment in Figure 2A—would be especially unwelcome today, for reasons including the fact that such investment tends to spur job creation.

Tax distortions that disfavor one line of business relative to others are precisely what tax reform should avoid. The U.S. tax code should not induce U.S.-headquartered companies to migrate away from IP investments because, as Section 3 will discuss, IP has long been central to U.S. economic strength. Tax reform should not discriminate against any particular business activity—especially not IP creation and development. Yet the Discussion Draft would do just that: by raising the U.S. tax burden on foreign-affiliate IP income compared with the U.S. tax burden on many other forms of foreign-affiliate business income.

The Discussion Draft Would Undermine the International Competitiveness of IP-Intensive U.S. Multinationals

A third important perspective to consider is the U.S. tax burden on IP income of U.S.-headquartered multinational companies relative to the IP income of their foreign competitors. Suppose an IP-intensive U.S.-headquartered multinational competes in world markets against another IP-intensive multinational headquartered in a territorial country. Suppose further that in some third market these two companies earn the same pre-tax income and thus face the same (if any) third-market tax liability. Under current law, the U.S. company faces an incremental U.S. tax liability that its foreign competitor does not—but this U.S. tax liability can be deferred by not repatriating these foreign earnings. So, under current U.S. law of worldwide taxation plus the possibility of deferral, the U.S. company can structure its operations to compete evenly in terms of not facing any immediate U.S. tax liability.

Under the Discussion Draft, the situation would be markedly different. The U.S. multinational would face an immediate tax liability—at least 15 percent and as high as 25 percent—on the FBCII calculated for its foreign affiliate. As shown in Section 1, for most affiliates their taxable FBCII will likely constitute the large majority of their net income. Because FBCII would apply only to U.S.-based companies, the territorial-based foreign competitor would face no such new tax liability. Thus the Discussion Draft would disadvantage U.S. IP-intensive companies against the rest of the

world's IP-intensive companies. The short-term and long-term distortions of this tax disadvantage created by FBCII are many.

Start with the simple math of cash flows. All else being equal, U.S.-headquartered multinationals would have smaller after-tax cash flows from which to fund their R&D efforts to discover and develop new IP. This plus the reduced after-tax return on any IP investments would, as discussed earlier in this section, reduce the total amount of U.S. IP investment. Seen relative to other countries, this would also tend to mean more IP innovation being done abroad in foreign-headquartered global companies that would not face this FBCII tax burden—all at a time where, as Section 3 discusses, it is well documented that America's predominance in the world's IP production has long ago passed.

The differential after-tax cash flows would also mean that foreign-based companies would tend to outbid U.S.-based companies for other IP assets around the world, such as inventive new companies. This foreign-company bidding advantage may be especially salient in many IP-intensive industries in America in which start-ups play a central creative role. Under the Discussion Draft, these American start-up companies and/or their IP assets would be more likely to be purchased by foreign companies.

Over time, the FBCII disadvantage facing U.S.-based IP-intensive companies would make them more vulnerable to acquisition by their foreign-based competitors: at least to acquisition of their foreign affiliates, and in many cases to acquisition of their U.S. operations as well. Indeed, the already nettlesome issue of corporate inversions—in which the merger of a U.S. and foreign company results in a company domiciled outside America—would be aggravated for U.S.-headquartered IP-intensive firms. Under current law, today many of these U.S. companies already can realize tax savings on future foreign-affiliate earnings if incorporated outside of America. For many IP-intensive companies that would face certain U.S. taxation on their FBCII under the Discussion Draft, the tax advantages would be even stronger either of being acquired by a larger foreign company or of acquiring a smaller foreign company and inverting.

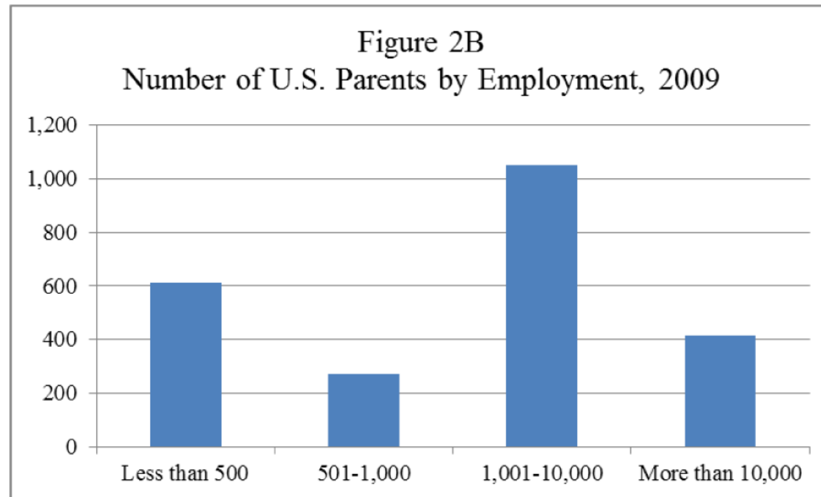
There is one other important dimension on which the Discussion Draft would disadvantage U.S.-based IP-intensive companies: it would undermine the likelihood of new IP-intensive companies being founded in America. The same logic by which the Discussion Draft would disadvantage existing U.S.-based IP-intensive multinationals against their foreign counterparts would be a force compelling new IP-intensive companies to be established abroad rather than in the U.S. This new tax burden on U.S. start-ups would come at a time when U.S. start-up rates have already been falling.

Research has long documented that young startup companies are a key source of U.S. innovation dynamism. Younger, smaller firms tend to produce more innovations per dollar of innovation effort than do many older, larger companies. This innovation edge stems from a number of impediments facing many older and larger companies: worries about innovation disrupting existing lines of business; more-rigid bureaucracies that inhibit new ideas; and weaker individual incentives connected to innovation success.[23] (Of course, U.S.-based multinational companies tend to contradict this overall pattern; as documented in Section 3, they are among America's most dynamic and innovative companies—thus their ability to succeed globally, an ability that would be impaired by tax reform as envisioned by the Discussion Draft.)

Tax policy that disadvantages the returns to IP income will be tax policy that inhibits the start-up of new IP-intensive companies in America. Lest one think from the above discussion that all globally competitive U.S. companies are monolithically large and old, that is not the case. By virtue of having operations outside America, in scope and in aspiration all U.S.-based multinationals are expansive. Yet, there are striking differences in their size in terms of common metrics such as employment and sales. Figure 2B documents this wide range: For the most recent year of data available, 2009, it splits the 2,347 U.S.-based multinational companies into four groups categorized by the number of U.S.-parent employees.[24]

[23] See surveys in, *e.g.,* Cohen, Wesley, and Steven Klepper, 1996, "A Reprise of Size and R&D." *Economic Journal,* 106(437). Another useful survey is Acemoglu, Daron, Ufuk Akcigit, Nicholas Bloom, and William Kerr, 2012, "Innovation, Reallocation, and Growth," manuscript.

[24] In Figure 2B, data were obtained from the BEA multinationals data online at *www.bea.gov.*



At one end of the spectrum, 415 companies each employ more than 10,000 people in America—indeed, an average of 43,630 workers each. At the other end of the spectrum, nearly 50 percent more multinationals, 613, each employ fewer than 500 people in America—and thus, as this report later discusses, fit the U.S. government definition of being a small or medium-sized enterprise (SME). Many of these SME multinationals are likely dynamic, fast-growth companies that were recently "born" into the group of U.S.-based multinationals by establishing their first foreign affiliate. Many of America's largest and most successful companies today once started small, with the quintessential person pursuing a dream from a garage or dorm room.

The fact that today 26.1 percent of U.S. multinationals are SMEs speaks to how diverse these important companies truly are. Many small multinationals dream of growing much bigger tomorrow. For those that are IP-intensive, tax disadvantaging IP income through the Discussion Draft would make achieving these dreams harder.

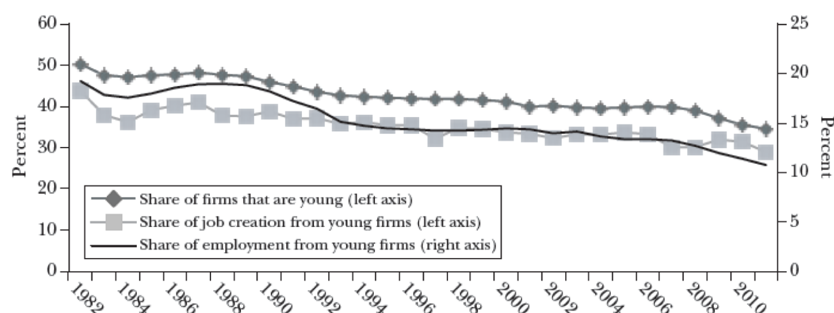
There is clear international evidence that tax burdens inhibit entrepreneurship. A recent study spanning 85 countries over decades estimated the drag of corporate taxes on entrepreneurship (measured either as new business establishments and also the rate of new-business registration). It found that a 10-percentage point increase in corporate tax rates reduces the rate of new-business startups by an average of 1.4 percentage points, which is 17.5 percent below the average startup rate of about 8 percent. This study also found that a similar increase in corporate taxes reduces a country's ratio of capital investment to GDP by a sizable 2–2.5 percentage points.

And it is important to recognize that America today is already facing an ongoing, worrisome decline in the rate of new-business start-ups. In the early-to-mid 1980s, each year about 12 percent to 13 percent of all U.S. firms were newly started that year. Starting in the late 1980s, however, this startup rate began to decline. This decline long pre-dates the World Financial Crisis, but its pace has quickened recently such that today only about 7 percent to 8 percent of all U.S. companies are startups.

A consequence of this drop in the rate of new-business startups is that the share of the overall U.S. economy—in terms of the number of companies or where people work—accounted for by young firms has been steadily declining. Figure 2C, reproduced from a recent publication on waning U.S. economic dynamism, shows this.[25]

[25] This figure is reproduced from "The Role of Entrepreneurship in U.S. Job Creation and Economic Dynamism," *Journal of Economic Perspectives,* Summer 2014, pp. 3–14, by Ryan Decker, John Haltiwanger, Ron Jarmin, and Javier Miranda.

Figure 2C: The Falling Share of Start-Ups in the U.S. Economy



Defining young firms as those aged five or less, in the early 1980s nearly 50 percent of all U.S. companies were young. Today that share is down to only about 39 percent—the lowest on record— with falls across all states. Similarly, the share of U.S. employment at these young firms has fallen from about 19 percent in the early 1980s to barely 10 percent today. And the share of job creation each year accounted for by these young firms has also been sliding: from over 40 percent in the early 1980s to only about 30 percent today.[26]

Taken together, ebbing startup trends indicate the United States is becoming less entrepreneurial. It has a much lower rate of new-business startups and thus a much smaller share of new firms in the overall private sector. The underlying causes at play are not fully known. That said, this development should worry policymakers. Given the historical importance of startups in many IP-intensive industries, tax disadvantaging IP income through tax reform as envisioned by the Discussion Draft would dampen innovation in IP-startups and reduce the number of such start-ups arising in the United States. And compounding this dampening, high-talent individuals might accordingly be more inclined to seek employment with foreign-based rather than U.S.-based companies.

The U.S. tax burden on foreign-affiliate IP income under the Discussion Draft would be higher in three important comparisons: relative to current law, relative to other business activities under the Draft, and relative to foreign competitors under the Draft. From all three of these perspectives, U.S.-headquartered multinational companies would be disadvantaged by the treatment of foreign-affiliate IP income under the Discussion Draft. This legislation would thus induce U.S.-headquartered multinationals to invest less in new ideas and innovation, to invest more in non-IP assets, to make those non-IP investments outside America rather than inside, and to be acquired by a larger foreign company or to acquire a smaller foreign company and invert. It would advantage foreign-headquartered multinationals not subject to its worldwide taxation in bidding for IP assets around the world, and it would discourage the start-up of new IP-intensive companies in America.

[26] Startup statistics in this and the previous paragraph come from the study in note 24 and also from Haltiwanger, John, Ron Jarmin, and Javier Miranda. 2012. *Where Have All the Young Firms Gone?* Kansas City: Kauffman Foundation.

Section Three:
How IP Innovation Strengthens the U.S. Economy

Globally engaged U.S. companies, which create the large majority of America's IP, increasingly rely on their worldwide operations to maximize the creativity and benefits of their U.S. inventions. Globally engaged U.S. companies have long performed the large majority of America's IP discovery and development. Increasingly central to America's IP success is the ability of U.S. companies to deploy their IP abroad-especially in light of the worrisome recent slowdown in U.S. productivity growth.

Intangible property (IP) has long played a central role in driving growth in U.S. output, jobs, and income—and this role will be even more important in the years ahead.

The Past: The Massive Contribution of Innovation and IP to America's Economy

Since the founding of the American republic, IP has played a central role in driving growth in U.S. output, jobs, and income. This central economic fact of knowledge discovery and development via innovation has been widely established by academic and policy research in recent decades, and it is widely recognized by leaders in business, in government, and beyond. For example, here is an opening of a recent White House report on innovation in America.

> The history of the American economy is one of enormous progress associated with remarkable innovation. . . . Innovation—the process by which individuals and organizations generate new ideas and put them into practice—is the foundation of American economic growth and national competitiveness. Economic growth in advanced countries like the United States is driven by the creation of new and better ways of producing goods and services, a process that triggers new and productive investments.[27]

Here is a similar statement on the centrality of IP to America's economic growth and overall success from a recent landmark study by the U.S. government of IP and the U.S. economy that focused on a subset of IP: patents, copyrights, and trademarks, or "intellectual property."

> Innovation, the process through which new ideas are generated and put into commercial practice, is a key force behind U.S. economic growth and national competitiveness. . . . Innovation protected by intellectual property rights is key to creating new jobs and new exports. Innovation has a positive pervasive effect on the entire economy, and its benefits flow both upstream and downstream to every sector of the U.S. economy. Intellectual property is not just the final product of workers and companies—every job in some way, produces, supplies, consumes, or relies on innovation, creativity, and commercial distinctiveness.[28]

IP created through innovation has been the foundation of America's economic strength. Over the arc of American economic history, many innovations have been incremental—slight refinements of products and processes that better served companies' customers. Other innovations have been truly disruptive and transformational, creating entire new industries and jobs—often while simultaneously displacing existing companies, jobs, and technologies.

The cumulative economic benefit of IP developed via innovation—indeed, the cumulative impact on the average standard of living of a country's citizens is best expressed in terms of productivity: the average value of output of goods and services a country produces per worker. The following quotation from Nobel laureate Paul Krugman concisely makes this point that is widely acknowledged by leading economists of all political persuasions.

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[27] See page 7 of The White House. 2011. *A Strategy for American Innovation: Securing Our Economic Growth and Prosperity.* February: National Economic Council, Council of Economic Advisers, and Office of Science and Technology Policy.

[28] See page 1 of United States Department of Commerce. 2012. *Intellectual Property and the U.S. Economy: Industries in Focus.* Washington, DC: Economics and Statistics Administration and the United States Patent and Trademark Office.

> Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker . . . the essential arithmetic says that long-term growth in living standards . . . depends almost entirely on productivity growth.[29]

The economics of this "essential arithmetic" for why productivity matters is very simple. The more and better quality goods and services people produce—that is, the more productive they are—the more income they receive and the more they can consume. Higher productivity means a higher standard of living.

How can a country raise its productivity? There are two basic means. One is to save and invest to accumulate the other inputs people work with to produce things. The most important other input needed is the tangible capital discussed earlier in this report, broadly defined as goods and services that help people make other goods and services—*e.g.,* buildings, machinery, and software.

The second way to raise productivity is to improve the technological know-how for transforming inputs into outputs thanks to innovation. New products and processes allow workers to make new and/or more goods and services. What makes innovation so potentially powerful for productivity is that many ideas don't depreciate with extensive use (unlike, *e.g.,* capital goods). Thus, the more ideas a country has today, the easier it is to produce additional ideas tomorrow.

So, what do the data say has driven America's rising productivity—and thus average standards of living—over the generations? A large body of academic and policy research has found that the overwhelming majority of America's growth in productivity and living standards over the 20th century was driven by new IP and the resulting technological advances of new products and processes, not by tangible capital.

Robert Solow, in seminal work that ended up being a major reason for being awarded the Nobel Prize in economics, calculated that the very large majority of U.S. growth during the first half of the 20th century was driven by innovation and technological progress. Of the rise in real GDP per person-hour in the United States from 1909 to 1949, he concluded that "It is possible to argue that about one-eighth of the total increase is traceable to increased capital per man hour, and the remaining seven-eighths to technical change."[30] Looking at the second half of the 20th century, an authoritative study found that for growth in U.S. per capita GDP from 1950 to 1993, 80 percent was accounted for by greater discovery and development of innovative ideas fostered by the combination of rising educational attainment and rising R&D effort.[31]

And looking at the most recent period of strong U.S. productivity growth that ran for a decade several years starting around 1995, the majority of that growth was driven by faster technological innovation in information-technology (IT)—one of the most IP-intensive industries. Post-1995, technical change has accounted for well over half of U.S. per capita GDP growth.[32]

Substantial research has found that IP and innovation matter because the social benefits of knowledge often exceed its private benefits—in the jargon of economics, discovery of ideas generates "positive externalities" through several channels (such as worker mobility, and the more-general property that ideas, different from nearly all goods and services, are easily shared). Studies have found that the social return to R&D tends to be at least double the private return.[33]

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[29] Pages 9 and 13 of Krugman, Paul R. 1990. *The Age of Diminished Expectations.* Cambridge: MIT Press.

[30] Page 316 of Solow, Robert M. 1957. "Technical Change and the Aggregate Production Function," *The Review of Economics and Statistics,* 39(3). See also his closely related work: "A Contribution to the Theory of Economic Growth," *Quarterly Journal of Economics,* 70(1), 1956.

[31] Jones, Charles I. 2002. "Sources of U.S. Economic Growth in a World of Ideas." *American Economic Review,* 92(1).

[32] For example: Feenstra, Robert C., Benjamin R. Mandel, Marshall B. Reinsdorf, and Matthew J. Slaughter, 2013, "Effects of Terms of Trade Gains and Tariff Changes on the Measurement of U.S. Productivity Growth," *American Economic Journal: Economic Policy,* 5(1).

[33] Jones and Williams (1998), p. 1121, estimate "the social return [to R&D] of 30 percent and a private rate of return of 7 to 14 percent: optimal R&D spending as a share of GDP is more than two to four times larger than actual spending." Bloom, et al (2012), p. 3, report, "We find that technology spillovers dominate, so that the gross social returns to R&D are at least twice as high as the private returns. . . . We estimate that the (gross) social return to R&D exceeds the private return, which in our baseline specification are calculated at 55 percent and 21 percent, respectively. At the aggregate level, this implies under-investment in R&D, with the so-

Continued

Public policies that help foster and protect IP and innovation have long been an essential ingredient to America's overall economic success. "Strong protection of intellectual property rights, business-friendly bankruptcy laws, a flexible labor force, and an entrepreneurial culture and legal system that favor risk taking and tolerate failure are among the framework conditions that have kept the U.S. at the forefront of innovation. Another crucial American advantage has been its openness to foreigners"—especially because of immigration's contribution to the talent, such as engineers and scientists, that discover, develop, and implement IP.[34]

Substantial academic and policy research has demonstrated how appropriate public policies have fostered America's innovation strength—especially when compared to other countries that are far less innovative. "Differences in levels of economic success across countries are driven primarily by the institutions and government policies (or *infrastructure*) that frame the economic environment in which people produce and transact. Societies with secure physical and intellectual property rights that encourage production [capital accumulation, skill acquisition, invention, and technology transfer] are successful."[35] And one important policy that shapes America's overall innovation environment is its tax treatment of IP.

The Present: The Strength of IP-Intensive Industries in America's Economy Today

IP's central role in driving growth in output, jobs, and income for the overall U.S. economy can perhaps best be seen at the level of individual companies and industries. Examples of innovative companies achieving great success thanks to their IP abound in the public lore: *e.g.,* companies born in the garages of Silicon Valley (sometimes literally, other times proverbially) that grow into global leaders in technology and many other IP-intensive industries. These examples are clearly borne out in more-systematic research. Companies that produce more IP tend to be more successful on several dimensions including profitability, revenues, and employment.[36] Looking more broadly, entire new industries such as biotechnology and software have been created by new IP—new industries that, as explained above, have boosted national output, created jobs, and raised standards of living.

The U.S. Department of Commerce recently undertook a landmark study aiming both to identify IP-intensive industries and to document their productivity-leading characteristics and the overall economy. Drawing on records and resources such as the USPTO, this study identified 75 industries (out of 313 total) that produce large amounts of IP measured by the three forms of IP-protection that entail government-granted or government-recognized legal rights: patents,[37] copyrights,[38] and trade-

cially optimal level being over twice as high as the level of observed R&D." Jones, Charles I., and John C. Williams, 1998, "Measuring the Social Returns to R&D," *Quarterly Journal of Economics,* 113(4). Bloom, Nicholas, Marck Schankerman, and John Van Reenen, 2012, "Identifying Technology Spillovers and Product-Market Rivalry," Manuscript.

[34] Both quotations in this paragraph come from p. 65 and p. 43, respectively, of National Research Council of the National Academies, 2012, *Rising to the Challenge: U.S. Innovation Policy for the Global Economy,* Washington, DC, The National Academies Press.

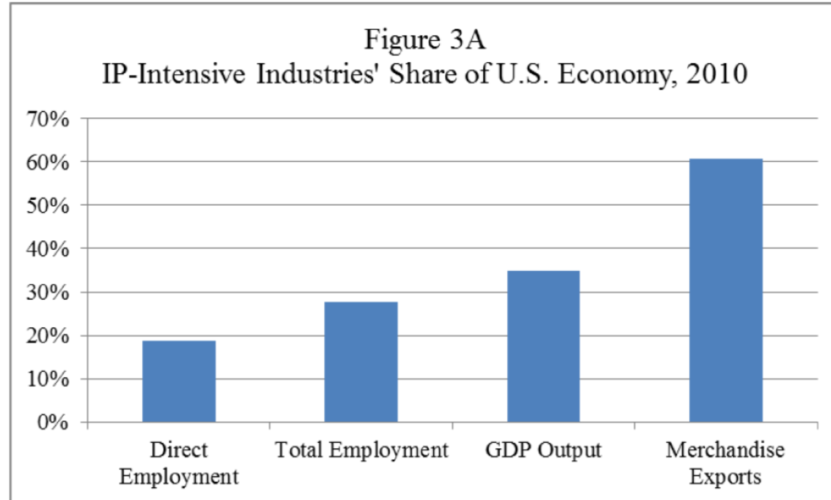
[35] Page 173 of: Hall, Robert E., and Charles I. Jones, 1997, "Levels of Economic Activity Across Countries," *American Economic Review,* 87(2).

[36] See, for example, Bloom and Van Reenen (2002) cited in note 33.

[37] This U.S. Department of Commerce study (cited in note 28) focused on utility patents, which it defines (p. 5) as "patents which assist owners in protecting the rights of inventions and innovative processes." Utility patents can be applied to processes, machines, articles of manufacture, and compositions of matter. The other two categories of U.S. patents are design patents, which cover the design of items (rather than the items themselves), and plant patents, which cover innovations of living plants. Patents enable the owner to pursue legal action to exclude, for a finite amount of time, others from making, using, or selling that invention in America. Patents are issued to individual inventors, who as they like can assign ownership rights to other individuals, corporations, universities, other organizations.

[38] As described by U.S. Department of Commerce (2012), p. 29, copyrights protect "original works of authorship. These works must be fixed in a tangible form of expression, meaning that concepts that never leave the confines of our minds cannot be copyrighted. Protection under copyright, which lasts for the life of the author plus an additional 70 years, is secured automatically when a work is created. Neither publication nor registration with the U.S. Copyright Office is required to secure copyright protection. But registering a copyright does establish a public record of the copyright, and it can be beneficial because of incentives provided to encourage registration." Works eligible for copyright protection include literary works, computer programs, musical works, dramatic works, pictorial and graphic works, motion pictures, and sound recordings. More than 33.7 million copyrights have been registered in America since Congress enacted the first copyright law in 1790. In 2009, more than 382,000 new basic copyrights were registered.

marks.[39] These industries were collectively defined to be "IP-intensive." Figure 3A reports their share of several key dimensions of U.S. economic activity in 2010.



The key message of Figure 3A is that America's IP-intensive industries perform large shares of America's economic activities that together support high and rising standards of living.

- *Employment:* IP-intensive industries directly employed 27.1 million jobs, 18.8 percent of total U.S. jobs (counting payroll jobs plus the self-employed and also unpaid family workers). IP-intensive industries supported an additional 12.9 million jobs indirectly through their supply-chain intermediate-input purchases of goods and services needed to make IP-intensive products. So, IP-intensive industries supported a total of 40.0 million U.S. jobs, 27.7 percent of the national total. If anything, this jobs tally is conservative because it does not examine indirect jobs downstream, *e.g.,* in distribution and trade of IP-intensive products.
- *Output:* IP-intensive industries produced 34.8 percent of all U.S. output (measured in terms of GDP)—nearly $5.1 trillion.
- *Exports:* IP-intensive industries exported $775 billion of merchandise to the rest of the world. This constituted 60.7 percent of total U.S. goods exports. From 2000 to 2010, IP-intensive exports expanded by 52.6 percent.

For workers in IP-intensive industries, the bottom line of all these productivity-enhancing activities has been high and rising earnings. In 2010, average weekly wages in IP-intensive industries were 42 percent above that of other industries ($1,156 versus $815). This IP compensation premium has been growing over time: from 22 percent in 1990 and 38 percent in 2000 to 42 percent in 2010.[40]

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[39] Trademarks protect the brands of goods and services. As defined by the U.S. Department of Commerce (2012), p. 11, a trademark is "a word, phrase, symbol, design, or combination thereof that identifies and distinguishes the source of the goods of one party from those of others. . . . Unlike a patent, which protects an invention, or a copyright, which protects a work of original authorship, a trademark does not protect a new product or service per se. A trademark instead confers protection upon the brand or identity of a good, thus preventing competitors from leveraging another firm's reputation and confusing consumers as to the source of the goods. Service marks are similar in nature to trademarks, but distinguish the source of a service rather than a good." With payment of a nominal fee, any company or individual, American or foreign, can apply to register a trademark with the United States Patent and Trademark Office. Once granted, trademark registrations can remain in force indefinitely as long as the trademark remains in active use and maintenance payments are made.

[40] What is tracked here is average weekly earnings of private wage and salary workers. Included in wages are pay for vacation and other paid leave, bonuses, stock options, tips, cash value of meals and lodging, contributions to deferred compensation plans such as 401(k) plans. All data in this paragraph, in the following paragraph, and in the related figure and related discussion come from U.S. Department of Commerce (2012).

Part of this compensation premium is explained by the higher average talent of workers in IP-intensive industries. 42.4 percent of workers aged 25 and older in IP-intensive industries had a bachelor's degree or higher—versus just 33.2 percent in the private sector. IP-intensive demand is commensurately lower for those with some college or an associate degree (27.4 percent vs. 27.7 percent), for high-school graduates (25.2 percent vs. 28.9 percent), and for high-school dropouts (5.0 percent vs. 9.2 percent).

The contributions to the U.S. economy of IP-intensive industries looks strong not only in and of itself, as indicated above, but also in relation to other countries as well. In recent years the United States remains the world's largest producer of many IP-intensive goods and services: in 2010, $3.6 trillion of knowledge-intensive services and $386 billion in high-technology manufactures, according to estimates by the U.S. National Science Foundation.[41]

The Future: Signs that America's IP Strength Is Waning

Despite America's historic strength in creating IP and transforming IP innovations into new products, companies, industries, and jobs, concern is rising among leaders in both the private and public sectors that America's IP strength is waning.

Perhaps the most alarming case for America's waning innovation strength has been made by the 2007 initial and 2010 follow-up *Gathering Storm* reports—alarming, not alarmist, because of the breadth of data brought to bear in this pair of studies for the National Academies of Sciences and Engineering by a distinguished committee comprised of leading academics, university presidents, CEOs of global firms, and Nobel laureates.

> It is widely agreed that addressing America's competitiveness challenge is an undertaking that will require many years if not decades . . . a primary driver of the future economy and concomitant job creation will be *innovation*. . . . So where does America stand relative to its position of 5 years ago when the *Gathering Storm* report was prepared? The unanimous view of the committee members participating in the preparation of this report is that our nation's outlook has worsened. . . . The only promising avenue, in the view of the *Gathering Storm* committee and many others, is through *innovation.* Fortunately, this nation has in the past demonstrated considerable prowess in this regard. Unfortunately, it has increasingly placed shackles on that prowess such that, if not relieved, the nation's ability to provide financially and personally rewarding jobs for its own citizens can be expected to decline at an accelerating pace. . . . The *Gathering Storm* Committee's overall conclusion is that . . . the outlook for America to compete for quality jobs has further deteriorated over the past 5 years. The *Gathering Storm* increasingly appears to be a Category 5.[42]

The sobering message of this gathering-storm metaphor has been widely repeated: "America cannot rest on its laurels. Unfortunately, there are disturbing signs that America's innovative performance slipped substantially during the past decade. Across a range of innovation metrics . . . our nation has fallen in global innovation-ranked competitiveness."[43] Several studies using many indicators and methodologies continue to reach the same startling conclusion: America's overall innovativeness, though still high, is falling—in many ways at a rapid rate.[44]

- The World Economic Forum's 2014–2015 rankings have U.S. "Total Competitiveness" at #3, down from #1 two cycles ago, and down to #5 in the "Innovation" category.
- For 2012, the World Intellectual Property Organization (in conjunction with the business school INSEAD) ranks the United States at #10 in its Global Innovation Index—down from #1 in 2009.

[41] Figures O–27 and O–28 of: National Science Board, 2012, *Science and Engineering Indicators 2012,* Arlington, VA: National Science Foundation (NSB 12–01).

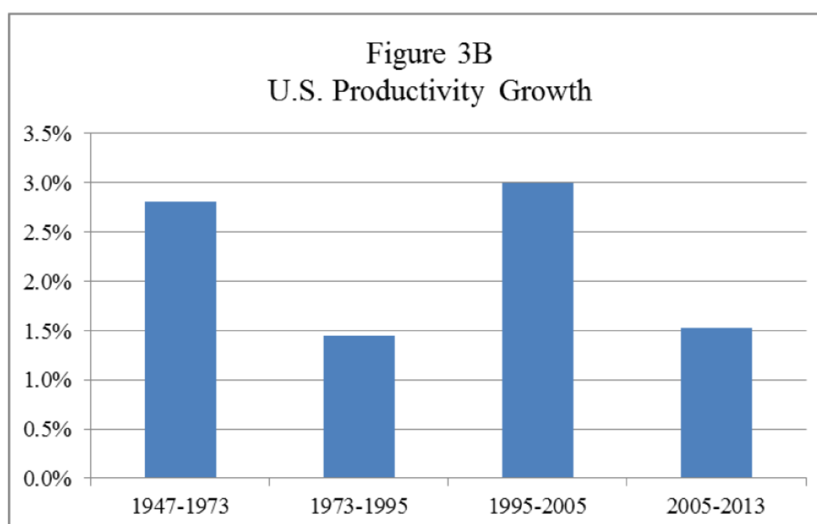
[42] Pages 1–5 of: National Academy of Sciences, National Academy of Engineering, and Institute of Medicine, 2010, *Rising Above the Gathering Storm, Revisited: Rapidly Approaching Category 5,* Washington, DC: The National Academies Press.

[43] The White House (2011), p. 8 as cited in note 27.

[44] For the three studies listed, see World Economic Forum (2014), World Intellectual Property Organization and INSEAD (2012), and Atkinson and Ezell (2012). World Economic Forum, Center for Global Competitiveness and Performance, 2014, *The Global Competitiveness Report: 2014–2015.* World Intellectual Property Organization and INSEAD, 2012, *The Global Innovation Index 2012: Stronger Innovation Linkages for Global Growth,* Fontainebleau: INSEAD Press. Atkinson, Robert D. and Stephen J. Ezell, 2012, *Innovation Economics: The Race for Global Advantage,* Yale University Press: New Haven and London.

- In 2009, the Information Technology and Innovation Foundation ranked 44 countries and regions on 16 core indicators of innovation capacity. The United States ranked #4. This was down from America's #1 ranking based on 1999 data. But when assessing the rates of change in innovation capacity during 2000–2009 (that is, the rate of improvement on these 16 indicators), the United States ranked #43—ahead of only Italy. On this rate-of-improvement metric, China ranked #1.

Consistent with these studies of weakening U.S. innovativeness are the data on America's slowing productivity growth. Figure 3B documents this productivity slowdown. For each of four post-World War II periods, Figure 1.1 reports two items: the average annual rates of growth in productivity (output per worker hour) in the U.S. non-farm business sector, and the average U.S. unemployment rate during that period.[45]



The first period in Figure 3B, 1947 to 1973, was marked by a strong average annual rate of productivity growth of 2.81 percent. During this period American companies across many industries were dynamic world leaders, thanks in part to their emerging connections to the world economy rebuilding in the wake of World War II devastation. The 1973–1995 period, however, saw average productivity growth plummet to just 1.45 percent per year. The initial causes of this slowdown included two major oil-price shocks and high and volatile inflation. Its persistence came to concern scholars, policymakers, and business leaders alike. With productivity growth averaging 1.45 percent per year average standards of living need 48 years to double—far slower than the 25 years needed when productivity growth was averaging 2.81 percent each year. Unemployment was painfully high in many years of this generation, averaging nearly 7 percent throughout.

Then came a productivity renaissance. For the decade starting with 1995, U.S. productivity growth unexpectedly accelerated—to an average annual rate of 3.00 percent. This surge was widely visible in accelerated growth in U.S. GDP, jobs, and worker earnings. At one point in 2000, U.S. unemployment dipped to just 3.9 percent, and for several years during this period real earnings rose briskly for all U.S. workers—even less-skilled workers including high-school dropouts. These large eco-

[45] These productivity-growth averages were calculated from annual data reported online by U.S. Bureau of Labor Statistics on 10/20/14 at *www.bls.gov* for data series #PRS85006092. The non-farm business sector is the most-commonly used measure of overall productivity growth for the U.S. economy, in part because of greater measurement challenges for both the public and agricultural sectors. Non-farm business accounted for about 74 percent of total U.S. gross domestic product in 2013. The unemployment rates are calculated for each period as the simple average of the constituent monthly unemployment rates, as reported online by U.S. Bureau of Labor Statistics on 10/20/14 at *www.bls.gov*.

nomic gains spread even to the U.S. government, for which unexpected surges in personal and business tax receipts led to federal-budget surpluses in the 4 years 1998 through 2001. A large body of scholarship has analyzed this U.S. productivity acceleration and has found that much of it was related to one particular IP-intensive industry: IT.

But since 2005, U.S. productivity growth has slowed dramatically. It has averaged just 1.53 percent in the past several years, a rate back to nearly the levels of the "lost generation" of 1973–1995. And even within this period productivity growth has been slowing even more: at annual rates of just 0.5 percent in 2011, 1.5 percent in 2012, and 0.5 percent in 2013. *Several leading scholars are now forecasting that U.S. innovativeness and productivity growth may be permanently lower.* Indeed, one such scholar has recently forecast that, in contrast to the average growth in U.S. GDP per capita of the past 150 years of about 1.9 percent, "future growth in consumption per capita for the bottom 99 percent of the income distribution could fall below 0.5 percent per year for an extended period of decades." [46]

This productivity slump is feared to continue not just by leading scholars but, increasingly, by many important policy-making agencies as well. In its most recent update to its 2014–2024 economic outlook in August 2014, the U.S. Congressional Budget Office foresees average annual growth in potential U.S. labor productivity of just 1.5 percent. Because of a similarly guarded outlook on U.S. productivity, the most recent September 2014 forecasts of the members of the Federal Open Market Committee foresee beyond 2018 annual U.S. GDP growth of somewhere between 1.8 percent and 2.5 percent.[47]

What explains America's darkening IP and productivity outlook? Part of the cause is America's waning investment in its innovation inputs—the people and resources dedicated to knowledge discovery and development. The pair of *Gathering Storm* reports cited above gather a wave of sobering evidence on America's declining IP investments—both relative to America of the past and relative to more and more other countries of today.

At one level, the growth in innovation investments around the world presents a tremendous opportunity for America—to, if supported by the right public policies, connect its innovation efforts with those of the world. Indeed, the surge in global innovation investments has transformed how new ideas are discovered and developed—now much more across borders rather than just within. "The innovation process can no longer be confined within geographic boundaries. Globalization has ushered in a swiftly evolving new paradigm of borderless collaboration among researchers, developers, institutions, and companies spanning the world." This new global norm for discovering and developing IP is clearly evident in at the micro-level of patents, article writing, and other individual building blocks of IP. One prominent study examined nearly 20 million academic papers and over 2 million patents over 50 years and across all major disciplines "to demonstrate that teams increasingly dominate solo authors in the production of knowledge." [48]

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[46] Page 1 of Robert J. Gordon, 2012, "Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds," National Bureau of Economic Research Working Paper No. 18315. See also, for example, the following three careful recent studies and references therein. John Fernald, 2014, "Productivity and Potential Output Before, During, and After the Great Recession," National Bureau of Economic Research Working Paper No. 20248. Robert J. Gordon, 2014, "A New Method of Estimating Potential Real GDP Growth," National Bureau of Economic Research Working Paper No. 20423. Robert E. Hall, 2014, "Quantifying the Lasting Harm to the U.S. Economy from the Financial Crisis," National Bureau of Economic Research Working Paper No. 20183. *The Economist* 2012 special report from its October 13 issue, "For Richer, For Poorer," also summarizes much of this recent and ongoing academic work.

[47] Table 2–2 and related discussion of *An Update to the Budget and Economic Outlook: 2014 to 2024,* U.S. Congressional Budget Office, August 2014. *Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, September 2014,* released September 17, 2014.

[48] In this paragraph, the first quote comes from p. xvi of National Research Council of the National Academies, 2012, *Rising to the Challenge: U.S. Innovation Policy for the Global Economy,* Washington, DC: The National Academies Press. The second quote comes from Wuchty, Jones, and Uzzil (2007), p. 1036, who report (p. 1036) that, "Research is increasingly done in teams across nearly all fields. Teams typically produce more frequently cited research than individuals do, and this advantage has been increasing over time. Teams now also produce the exceptionally high-impact research, even where that distinction was once the domain of solo authors. These results are detailed for sciences and engineering, social sciences, arts and humanities, and patents, suggesting that the process of knowledge creation has fundamentally changed." Wuchty, Stefan, Benjamin F. Jones, and Brian Uzzil, 2007, "The Increasing Dominance of Teams in Production of Knowledge," *Science,* May 18.

At another level, however, whether America can benefit from the rising IP strength around the world will depend on whether America can continue to design and implement public policies that maintain America's IP strengths in this rapidly changing innovation world. It is possible that America will succeed in this way, but success is by no means guaranteed. The assessment of many private and public leaders is that America's position is precarious—in large part because U.S. policies across a wide range of areas, including tax policy, do not adequately reflect today's globally-competitive reality. A recent report by a distinguished panel of government, business, and academic leaders framed the innovation challenge thus.

> At the same time that the rest of the world is investing aggressively to advance its innovation capacity, the pillars of America's innovation system are in peril. . . . It is not just policies directly addressing the development and deployment of new technologies but also policies concerning tax, trade, intellectual property, education and training, and immigration, among others that play a role in innovation. . . . In this dramatically more competitive world, the United States cannot return to a path of sustainably strong growth, much less maintain global leadership, by living off past investments and its capacity for innovation. . . . Nor can the U.S. compete on the basis of a policy approach that is the legacy of an era when American advantages were overwhelming and innovative activity tended to remain within our borders. . . . The U.S. has every opportunity to secure its economic leadership and national security well into the future. But it will require a fresh policy approach, one that ensures that the United States can compete, cooperate, and prosper in this new world of competitive innovation.[49]

Whether America can restore its innovation strength will depend largely on whether America can craft IP-supporting public policies that reflect the competitive global economy of today—not the world economy of much of the 20th century when America was largely unrivaled in IP. That time of American predominance has passed. Today calls for policies—including tax policies—that reflect the reality of how America's IP-intensive companies and industries actually operate in the 21st century global economy. To this reality we now turn.

America's Most Innovative, IP-Intensive Companies Tend To Be Multinational Companies

What do we know about the relationship between the IP, innovation, and productivity performance of companies and their global engagement?

Start with the following first important fact: there is now a large body of evidence for many countries that plants and/or firms exhibit large and persistent differences in innovativeness and productivity.[50] A second important fact that researchers have documented in recent years is a robust correlation between productivity and global engagement: plants and/or firms that export or, even more so, are part of a multinational enterprise tend to have higher productivity—and a bundle of other good-performance characteristics, such as innovative intensity and wages—than their purely domestic counterparts.[51]

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[49] National Research Council of the National Academies (2012), p. 12, as cited in note 48.

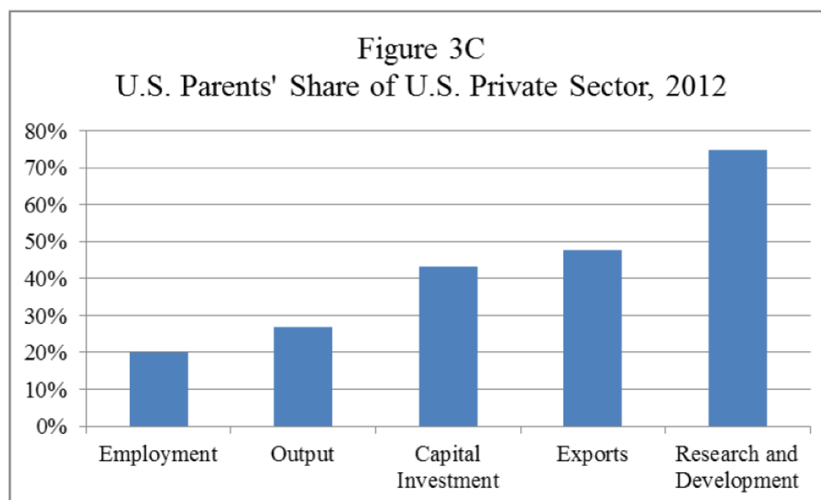
[50] In their survey of micro-level studies of productivity, Bartelsman and Doms (2002, p. 578) state that, "Of the basic findings related to productivity and productivity growth uncovered by recent research using micro data, perhaps most significant is the degree of heterogeneity across establishments and firms in productivity in nearly all industries examined." This heterogeneity in productivity and other characteristics (*e.g.,* size) appears in both developed countries (*e.g.,* Olley and Pakes, 1996, and Syverson, 2004 for the United States) and developing countries (*e.g.,* Cabral and Mata, 2003). Bartelsman, Eric J., and Mark Doms, 2002, "Understanding Productivity: Lessons from Longitudinal Microdata," *Journal of Economic Literature,* 38. Olley, G. Steve, and Ariel Pakes, 1996, "The Dynamics of Productivity in the Telecommunications Equipment Industry," *Econometrica,* 64(6). Syverson, Chad, 2004, "Market Structure and Productivity: A Concrete Example," *Journal of Political Economy,* 112(6). Cabral, Luís M. B., and José Mata, 2003, "On the Evolution of the Firm Size Distribution: Facts and Theory," *American Economic Review,* 93(4).

[51] Superior productivity of U.S. exporters is usefully summarized in studies including Lewis and Richardson (2001) and Bernard, et al (2007), which states the following (pp. 110–111): "Firms that export look very different from non-exporters along a number of dimensions . . . even in the same detailed industry. Exporters [in 2002 were] significantly larger than non-exporters, by approximately 97 percent for employment and 108 percent for shipments; they are more productive by roughly 11 percent for value-added per worker and 3 percent for TFP; they also pay higher wages by around 6 percent. Finally, exporters are relatively more capital- and skill-intensive than non-exporters by approximately 12 and 11 percent, respectively." Lewis, Howard III and J. David Richardson, 2001, *Why Global Commitment Really Matters!* Wash-

Continued

Multinational companies are an important segment of globally engaged companies. *Multinational companies tend to exhibit even higher productivity than just exporters or importers do, and thus tend to appear at the very top of the productivity distribution of firms. They also tend to be very trade-intensive, capital-intensive, innovation-intensive, and high-wage not just relative to purely domestic companies but also just exporters and importers.*[52]

The superior performance of U.S. parents of U.S.-headquartered multinational companies is shown in Figure 3C, which reports the share of important activities in the overall U.S. private sector accounted for by the U.S. parent operations of U.S.-headquartered multinationals in 2012, the most recent year of available data.[53]



ington, DC. Institute for International Economics. Bernard, Andrew B.; Jensen, J. Bradford; Redding, Stephen J.; and Peter K. Schott, 2007, "Firms in International Trade," *Journal of Economic Perspectives,* 21(3).

[52] Representative evidence of this performance advantage for U.S. multinationals appears in Doms and Jensen (1998), who documented how plants that are part of multinational companies—both U.S. parent companies of U.S.-based multinationals and U.S. affiliates of foreign-based multinationals—tend to exhibit higher TFP, labor productivity, and other performance characteristics such as capital intensity, skill intensity, and wages. This superior performance of multinationals has also been documented in many other countries: *e.g.,* Criscuolo, Haskel, and Slaughter (2010) for the United Kingdom. Doms, Mark E., and J. Bradford Jensen. 1998. "Comparing Wages, Skills, and Productivity Between Domestically and Foreign-Owned Manufacturing Establishments in the United States." In R. Baldwin, R. Lipsey, and J. D. Richardson (eds.), *Geography and Ownership as Bases for Economic Accounting.* Chicago: University of Chicago Press. Criscuolo, Chiara, Jonathan E. Haskel, and Matthew J. Slaughter. 2010. "Global Engagement and the Innovation Activities of Firms," *International Journal of Industrial Organization,* 28(2).

[53] In Figure 3C and the supporting text, BEA data on U.S. multinational companies have been matched as needed with private-sector economy-wide data from appropriate government sources. The BEA data are available online at *www.bea.gov.* Details on the source and definition of these non-multinationals data are as follows, where all data—in Figure 3C and all subsequent figures—were obtained online or from Barefoot (2012). Employment: Bureau of Labor Statistics, U.S. Department of Labor—U.S. private-sector nonfarm payroll employment. Output: BEA—Private-sector value-added output adjusted to exclude value added in depository institutions and private households, imputed rental income from owner-occupied housing, and business transfer payments. Investment: BEA National Income and Product Accounts—Table 5.2.5 (Gross and Net Domestic Investment by Major Type) Line 10 (Nonresidential gross private fixed investment). Research and Development: National Science Foundation—Total R&D performed by the industrial sector, current dollars. Exports and Imports of Goods—BEA National Income and Product Accounts, as reported in Barefoot and Mataloni (2011). Compensation Premium for U.S. Multinational Companies: The national measure of private-sector labor compensation comes from the BEA National Income and Product Accounts Table 6.2 (Compensation of Employees by Industry) Line 3 (Private Industries). Employee compensation as measured in the BEA data includes wages, salaries and benefits—mandated, contracted and voluntary. Finally, note that at the time of writing NSF R&D data for 2012 were not yet available, so in Figure 3C shares of U.S. private-sector R&D for 2011 are reported.

The parent operations of U.S.-headquartered global companies perform large shares of America's productivity-enhancing activities—capital investment, international trade, and R&D—that create tens of millions of well-paying jobs for their American workers.

- *Output:* Parent companies produced 26.8 percent of all private-sector output (measured in terms of GDP)—over $3.2 trillion.
- *Capital Investment:* Parent companies purchased $584.4 billion in new property, plant and equipment—43.3 percent of all private-sector capital investment.
- *Exports:* Parent companies exported $728.1 billion of goods to the rest of the world. This constituted 47.7 percent of the U.S. total.
- *R&D:* To discover and develop new products and processes, parent companies performed $220.3 billion of R&D. This was a remarkable 74.9 percent of the total R&D performed by all U.S. companies.

All these innovative activities contribute to millions of well-paying jobs in America. In 2012, U.S. parent companies employed more than 23.1 million U.S. workers, 20.0 percent of total private-sector payroll employment. Total compensation at U.S. parents was $1.77 trillion—a per-worker average of $76,538, over a quarter above the average in the rest of the private sector.

Moreover, the important contribution of U.S. parent operations to the overall U.S. economy has been quite stable for decades. In 1988, for example, U.S. parents' R&D spending was 72.5 percent of the economy-wide private-sector totals—not much above the 2010 share of 68.8 percent. This stability over time demonstrates their ongoing contributions to the overall U.S. economy.

The important fact that globally engaged companies—exporters, importers, and especially multinationals—exhibit higher innovativeness and productivity than do purely domestic companies begs the question about causation. Do high-productivity companies tend to become globally engaged? Or does global engagement trigger productivity gains? The answer is, "some of both."

First, there is clear evidence that high-innovation, high-productivity companies tend to select into being globally engaged—and, if particularly productive, being a multinational company.[54] This resonates with much of the discussion above. More-innovative companies tend to be able to crack into foreign markets—and they also want to do so to boost returns on their IP investments.

Second, there is also clear evidence that global engagement spurs the productivity performance of companies. Some of the most comprehensive research on this issue has been conducted by the McKinsey Global Institute, which over the past generation has examined thousands of firms and industries. A repeated finding is that exposure to "global best-practice firms" via trade and FDI stimulates firm productivity. A clear statement of this globalization-to-productivity link appears in the work of Nobel laureate Robert Solow.

> A main conclusion of the studies . . . has been that when an industry is exposed to the world's best practice, it is forced to increase its own productivity. . . . The more a given industry is exposed to the world's best practice high productivity industry, the higher is its relative productivity (the closer it is to the leader). Competition with the productivity leader encourages higher productivity.[55]

This integration into the world economy boosts productivity in companies through many channels. One is the competitive pressure to reduce costs via innovating processes, creating or shifting firm scope towards new products, and becoming more capital intensive. Another is the spread of knowledge by learning from customers, suppliers, and competitors.

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[54] "Results from virtually every study across industries and countries confirm that high productivity precedes entry into export markets. These findings are suggestive of the presence of sunk entry costs into export markets that only the most productive firms find it profitable to incur" (Bernard, *et al,* 2007, p. 111). This fact of high-productivity companies selecting into global engagement has spurred a large and ongoing literature in international economics with a variety of new general-equilibrium models built on the foundation of this fact. For example, a now standard research framework of multinational firms assumes these firms obtain high-productivity knowledge assets that are transferred from home-country parents to host-country affiliates.

[55] Pages 166–167 of: Baily, Martin Neil, and Robert M. Solow, 2001, "International Productivity Comparisons Built from the Firm Level," *Journal of Economic Perspectives,* 15(3).

It is also important to stress that global engagement boosts industry-level productivity by spurring the reallocation of workers, capital, and other resources from struggling companies to more-productive innovators—often exporters and multinationals. As discussed in Section II, countries boost average productivity by reallocating resources across industries. Recent research has documented a very important second dimension of resource-reallocation gains: within all industries—regardless of the pattern of exports and imports—across companies towards the higher-productivity, globally engaged firms. An important part of this industry-level resource allocation is the contraction of low-productivity firms, along with the faster expansion of firms already engaged in international trade and investment. This reallocation from low- to high-productivity firms as a result of trade liberalization raises average industry productivity, a process that has been documented for the United States and for many other countries as well.

In addition to having very high productivity levels, for decades globally engaged U.S. companies have played an outsized role in driving aggregate U.S. productivity growth. This is the key finding of an important recent study that focused on productivity growth "because, even though studies of [multinational] performance based on microeconomic data have tended to identify effects on the *level* of productivity, if these underlying productivity-enhancing effects are spreading and/or filtering in over time, productivity aggregates will be affected in terms of growth rates (as well as levels)." Their results they rightly describe as "quite striking."

> Although the MNC [multinational corporation] sector accounts for only 40 percent of the output of nonfinancial corporations (NFCs) between 1977 and 2000, MNCs appear to have accounted for *more than three-fourths* of the increase in NFC labor productivity over this period. Moreover, MNCs account for *all* of the NFC sector's pickup in labor productivity in the late 1990s; accordingly, they account for *more than half* of the much-studied acceleration in aggregate productivity. And, while MNCs involved in the production of IT contributed significantly toward this acceleration, MNCs in other manufacturing and nonmanufacturing industries contributed significantly as well.[56]

Foreign Activity by IP-Intensive Companies Complements, not Substitutes for, U.S. IP Investment

How exactly are American IP-investment and employment affected by the global reach discussed above? It is important to understand that U.S. IP jobs and investments are created not only by exporting to foreign markets but also by producing and selling in them through FDI in foreign affiliates. Contrary to what is often presumed, expansion abroad by globally engaged U.S. companies tends to complement, not substitute for, their domestic activity.

The link between exports and American jobs is clear. When companies in America gain new customers abroad for their goods and services, meeting this demand creates new American jobs in these companies. Because of the rich variety of goods and services America exports and the rich variety of production methods used by companies in America, the link from exports to jobs varies across companies, industries, and time. That said, research has documented the many ways in which exporting companies tend to be stronger than nonexporters.

Less well understood is the link between jobs and IP investment in America and business growth abroad. Much of the public policy discussion surrounding U.S. multinationals assumes that engagement abroad necessarily substitutes for U.S. activity—in particular, for employment and R&D investment. This substitution concern misses the several channels through which the global engagement of U.S. multinationals tends to support, not reduce, their operations in America. As studies presented below have found, foreign-affiliate activity tends to complement, not substitute for, key parent activities in the United States. Three crucial features of how multinationals work that belie the substitution idea are complementarity, scale and scope.

- For some given level of firm-wide output, when firms employ many kinds of workers and many non-labor factors of production, affiliate and parent labor can often be complements in which more hiring abroad also means more hiring in the United States. Complementarity is quite common in global production net-

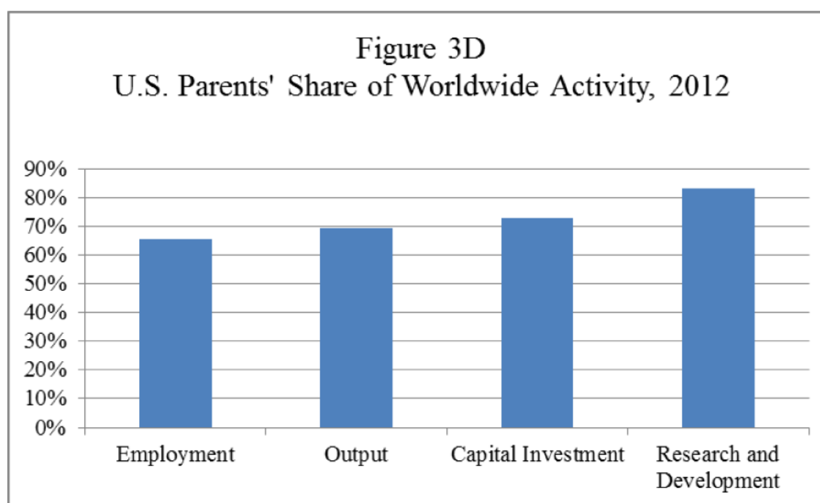
[56] Page 333 of: Corrado, Carol, Paul Lengermann, and Larry Slifman, 2009, "The Contributions of Multinational Corporations to U.S. Productivity Growth, 1977–2000," In Marshall B. Reinsdorf and Matthew J. Slaughter (eds.) *International Flows of Invisibles: Trade in Services and Intangibles in the Era of Globalization,* NBER and University of Chicago Press.

works, in which U.S. workers operate not in isolation but rather in close collaboration with colleagues around the world.

- When affiliates are expanding abroad to boost their revenues, the resulting reduction in costs and boost in profits (thanks to greater scale and richer returns on IP) often spurs higher output in the company around the world, which can mean more U.S. hiring.
- Affiliate expansion often not only boosts firm scale but also, as discussed previously, refines the mix of activities performed across parents and affiliates. U.S. parents' employment can rise as they shift their scope into higher value-added tasks—especially R&D and other IP investments.

The concern that global expansion tends to hollow out U.S. operations is not supported by the facts of existing research—now presented below. Rather, the scale and scope of U.S. parent activities increasingly depends on their successful presence abroad.

To see this, start with the often-heard claim that globally engaged U.S. companies have somehow hollowed out their U.S. operations, leaving only activity abroad. Is that true? What about the magnitude of U.S. parent activities relative to the scale of their foreign affiliates? Figure 3D reports the share of U.S. multinationals' 2012 worldwide employment, output, capital investment, and R&D that was accounted for by their U.S. parent operations.[57]



The key message of Figure 3D is that *the worldwide operations of U.S. multinational companies are highly concentrated in America in their U.S. parents, not abroad in their foreign affiliates.*

- *Employment:* U.S. parents account for 65.6 percent of worldwide employment of U.S. multinationals—23.1 million parent workers versus 12.1 million at affiliates. This translates into a ratio of nearly two U.S. employees for every one affiliate employee.
- *Output:* U.S. parents account for 69.6 percent of worldwide output (in terms of value added) of U.S. multinationals—over $3.2 trillion versus about $1.4 trillion.
- *Capital Investment:* U.S. parents undertake 72.7 percent of worldwide capital investment by U.S. multinationals—$584.4 billion versus $219.8 billion. For every $1 in affiliate capital expenditures, parents invested $2.66 worth in the United States.
- *R&D:* U.S. parents perform 83.2 percent of worldwide R&D by U.S. multinationals—$220.3 billion versus $44.6 billion, or $4.94 in parent innovation and knowledge discovery and development for every $1 by affiliates.

[57] In Figure 3D, data for the shares were obtained from the BEA multinationals data online at *www.bea.gov.*

The United States, not abroad, is where U.S. multinationals perform the large majority of their operations. Indeed, this U.S. concentration is especially pronounced for R&D, which reflects America's underlying strengths of skilled workers and legal protections such as IP rights that together are the foundation of America's IP strengths, as discussed earlier.

This much larger scale of U.S. parents than foreign affiliates has been present for decades. A generation ago, the share of U.S. parents in the worldwide activity of U.S. multinationals was slightly higher. In 1988, U.S. parents accounted for 78.8 percent of U.S. multinationals' worldwide employment and 79.2 percent of their worldwide capital investment. So over the past generation, the foreign-affiliate shares of employment and investment have risen by about 0.5 percentage points per year. As this report documented above, however, this rise has been driven mainly by ongoing expansion of parents that was outpaced by even faster expansion of affiliates, not by parent contraction. Faster affiliate expansion, in turn, has been driven mainly by faster economic growth abroad and thus faster growth in customers there.

The bottom line is that the United States firmly remains where globally engaged U.S. companies locate the majority of their operations—especially their innovation activities—even as they have been growing more quickly abroad.

What does the evidence show about the key question of complementarity: has that foreign expansion complemented or substituted for their U.S. activities? Aggregate, industry and company-level research to date shows that foreign-affiliate expansion tends to complement U.S. parent employment, investment, sales—and innovation efforts via R&D.

One such recent study examined industry-level data for 58 U.S. manufacturing industries from 2000 through 2007. It found that the productivity gains and cost savings from expanding global production networks tended to boost overall U.S. employment in these industries—albeit with changes in the scope of U.S. activities being performed. Similar studies to this one have repeatedly found that when American manufacturing industries invest more abroad, this outward investment stimulates U.S. exports.[58]

Another study examined industry-level data for dozens of U.S.-based multinational companies in services over recent decades. It found that greater foreign-affiliate employment and sales correlated with greater U.S.-parent employment as well, consistent with the idea that affiliate and parent activity tend to, on net, complement each other.[59]

A third important study, conducted at the level of individual companies, carefully analyzed all U.S. multinationals in manufacturing from 1982 to 2004. It found that a 10 percent increase in foreign-affiliate capital investment causes a 2.6 percent increase, on average, in that affiliate's U.S. parent capital investment. It similarly found that a 10 percent increase in foreign-affiliate employee compensation causes a 3.7 percent increase, on average, in that affiliate's U.S. parent employee compensation. These links were clearest when analyzing the changes in affiliate jobs and investment driven by changes in affiliate sales.

Their findings of complementarity were especially compelling for how U.S.-parent R&D is supported by foreign-affiliate sales. They found that 10 percent faster sales growth in foreign affiliates raises U.S.-parent R&D spending by somewhere between 3.2 percent and 5.0 percent. The authors concluded, "Since foreign operations stand to benefit from intangible assets developed by R&D spending, it is not surprising that greater foreign investment might stimulate additional spending on R&D in the United States. . . . These results do not support the popular notion that expansions abroad reduce a [multinational] firm's domestic activity, instead suggesting the opposite."[60]

[58] Ottaviano, Gianmarco I.P., Giovanni Peri, and Greg C. Wright, 2010, "Immigration, Offshoring, and American Jobs," National Bureau of Economic Research Working Paper No. 16439. Studies that find a link from outward investment and U.S. exports are well summarized in: Moran, Theodore, 2009, *American Multinationals and American Economic Interests: New Dimensions to an Old Debate,* Washington, DC: Peterson Institute for International Economics.

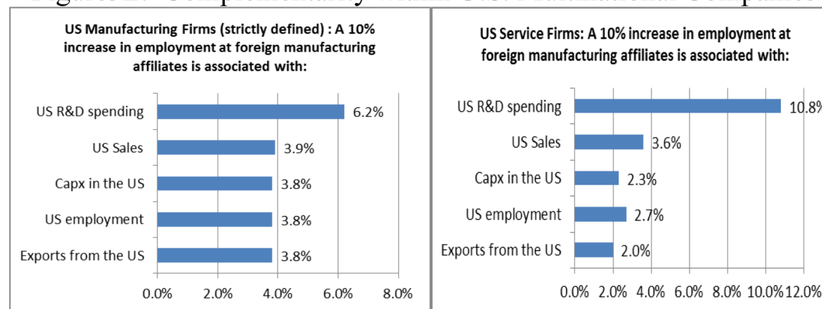
[59] United States International Trade Commission. 2011. *U.S. Multinational Services Companies: Effects of Foreign Affiliate Activity on U.S. Employment.* Washington, DC: Office of Industries.

[60] Page 195 and page 181 of: Desai, Mihir A.; Foley, C. Fritz; and James R. Hines, Jr. 2009. "Domestic Effects of the Foreign Affiliates of U.S. Multinationals." *American Economic Journal: Economic Policy,* 1(1).

A fourth important study also examined individual companies, but this time European-based multinationals. It linked within these multinationals the employment and patenting activity of these companies' inventors across both parent and affiliate countries, to enable them to ascertain the effect of companies' expanding use of researchers abroad on their use of researchers at home. Contrary to the common presumption that foreign researchers will substitute for parent researchers, this study found the opposite: "Our main result suggests that a 10 percent increase in the number of inventors abroad results in a 1.9 percent increase in the number of inventors at home." [61]

One final important study also examined individual U.S. multinational companies—not just in manufacturing but also in services, and for the generation 1990 through 2009. As with the above earlier study of U.S. multinationals, this very recent analysis also found consistent and strong evidence that expansion abroad by foreign affiliates tends to expand, not contract the activities of these affiliates' U.S. parents. Figure 3E, taken from this study, summarizes its key findings.[62]

Figure3E: Complementarity within U.S. Multinational Companies



For U.S. parent companies in manufacturing as well as U.S. parent companies in services, expanded foreign-affiliate employment is associated with economically and statistically significant increases in parent employment, capital investment, output, exports, and—most of all—R&D expenditures. This latter correlation is especially notable here: expanding foreign affiliates trigger more, not less, parent efforts to discover IP and other such innovations.

All of the strengths of the U.S.-headquartered multinational companies at the heart of America's IP-intensive industries would be curtailed, not supported, by tax policy that discriminates against the IP income of the foreign affiliates of these companies.

The clear conclusion from research to date is that, on average, foreign affiliates and U.S. parents expand together—driven by the dynamism of complementarity, scale and scope. In particular, foreign-affiliate growth tends to stimulate, not reduce, U.S.-parent IP investments. In the current environment of sharply slower productivity growth, America now more than ever needs policies that support, not constrain, the dynamic energies of its most innovative companies. Tax reform that penalizes IP income and activity is precisely the wrong policy direction for helping America reaccelerate economic growth through innovation and the resulting growth in U.S. jobs and incomes.

Conclusions

Intangible property has long played a central role in driving growth in U.S. output, jobs, and incomes. Discovering and developing ideas with value boosts output in existing companies and industries and creates entire new industries. This innovation

[61] Page 1 of: Abramovsky, Laura, Rachel Griffith, and Helen Miller, 2012, "Offshoring High-Skilled Jobs: EU Multinationals and Domestic Employment of Inventors," Center for Economic Policy Research Discussion Paper No. 8837.

[62] *The U.S. Manufacturing Base: Four Signs of Strength,* by Theodore H. Moran and Lindsay Oldenski, Peterson Institute of Economics Policy Brief No. 14–18, June 2014.

has long created new jobs and higher standards of living for all American workers and their families.

Maintaining IP's many contributions to the U.S. economy will require smarter public policy now and in the future, however, given the breadth of indicators that America's innovation strength is waning. In particular, policymakers must understand the value of a tax system that does not discriminate against the IP performed by American companies.

Such a tax system needs to recognize the global nature of America's IP innovators. U.S.-headquartered multinational companies, which create the large majority of America's IP, increasingly rely on their global operations to maximize the creativity and benefits of their U.S. inventions. These globally engaged U.S. companies have long performed the large majority of America's IP discovery and development. Increasingly central to America's IP success is the ability of its multinational companies to deploy that IP abroad. Connecting foreign customers with U.S. ideas tends to complement, not substitute for, American IP investments—both in terms of the quantity and the quality of U.S. innovation.

The potential is great for American IP activity to connect with global markets. Tax policy should support, not inhibit, this potential. Unfortunately, the tax-reform proposals in the Discussion Draft would undermine this potential. The Discussion Draft would fundamentally shift the measurement and tax treatment of IP income earned by the foreign affiliates of U.S.-based multinational companies—and in so doing would discriminate against these affiliates' IP income relative to their non-IP income.

The U.S. tax burden on foreign-affiliate IP income under the Discussion Draft would be higher in three important comparisons: relative to current law, relative to other business activities under the Draft, and relative to foreign competitors under Draft. From all three of these perspectives, U.S.-headquartered multinational companies would be disadvantaged by the treatment of foreign-affiliate IP income—and thus would be discouraged from investing in IP.

This legislation would incentivize U.S.-headquartered multinationals to invest less in new ideas and innovation, to invest more in non-IP assets, to make those non-IP investments outside America rather than inside, and to be acquired by a larger foreign company or to acquire a smaller foreign company and invert. It would advantage foreign-headquartered multinationals not subject to its worldwide taxation in bidding for IP assets around the world, and it would discourage the start-up of new IP-intensive companies in America.

America stands much to gain from broad and fundamental policy reform to create an internationally competitive tax system. But that reform should not discriminate against IP and its increasingly important contributions to the U.S. economy of growth, good jobs, and opportunity.