

EMBARGOED UNTIL DELIVERY - December 1, 2015

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U.S. Department of the Treasury
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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/Organization for Economic Cooperation 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 G-20 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 G-20 leaders in September 2013 in St. Petersburg. The OECD has hosted this process, but all G-20 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 FY2016 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 FY2015 and FY2016 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 FY2015 and FY2016 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 FY2016 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 FY2016 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 FY2016 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 FY2016 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 FY2016 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, forty-seven U.S. corporations reincorporated overseas through corporate inversions in the ten-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 ten 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 ten-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.