

# TAX REFORM OPTIONS: INTERNATIONAL ISSUES

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## HEARING

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

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SEPTEMBER 8, 2011  
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## **TAX REFORM OPTIONS: INTERNATIONAL ISSUES**

**THURSDAY, SEPTEMBER 8, 2011**

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

The hearing was convened, pursuant to notice, at 9:39 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus, (chairman of the committee) presiding.

Present: Senators Bingaman, Wyden, Stabenow, Nelson, Carper, Cardin, Hatch, Grassley, Snowe, Enzi, Cornyn, and Thune.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Lily Batchelder, Chief Tax Counsel; and Jeff VanderWolk, International Tax Counsel. Republican Staff: Chris Campbell, Staff Director; Jim Lyons, Tax Counsel; Theresa Pattara, Tax Counsel; and Maureen McLaughlin, Detailee.

### **OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE**

The CHAIRMAN. The committee will come to order.

The Roman poet Ovid wrote, "A horse never runs so fast as when it has other horses to catch up to and outpace." Advances in technology have resulted in a world in which business is more global. Today, a local business in my home State of Montana competes not only with the shop down the street, but with a company across the world. We need to ensure that our international tax rules help U.S. businesses outpace their competitors and succeed in this global economy. This increased competition from around the world can, and must, lead us to be better.

American businesses increasingly sell their goods and services overseas, and foreign-based businesses compete aggressively for a share of the American market. Today, U.S.-based multinational companies generate, on average, nearly half their income from foreign affiliates compared to just 17 percent in 1977. The United States' exports have more than doubled as a percent of GDP since 1960.

Foreign investment in the U.S. and the continued success of American business in the global marketplace are both essential to the health of the U.S. economy. Over the past 10 years, foreign direct investment in the U.S. has totaled \$1.7 trillion, supporting 5 to 6 million American workers.

Foreign markets like Brazil, China, and India all offer lucrative new opportunities for U.S. workers and businesses. From 1990 to 2008, emerging economies grew at an average annual rate of 4.6

percent. We need to have an international tax system that helps U.S. businesses to take advantage of these opportunities to create more jobs here at home.

The tax code should not deter potential foreign investment in the U.S., and it should not hamper American competitiveness overseas, nor should our tax code discourage companies from employing Americans abroad. In July, we heard from U.S. business leaders who urged us to make our tax system more like the territorial tax systems of some of our major trading partners. I look forward to hearing from our witnesses on that issue today.

In addition, we have heard a great deal about U.S. multinational corporations avoiding taxation of their foreign earnings, often using tax havens. I hope our witnesses will be able to discuss ways to address that issue.

No one doubts that our tax code should encourage economic growth and job creation. It should be fair, simple, efficient, and certain. This is particularly true in the international area, where the current rules are among the most complex, and the most uncertain.

Right now we are confronting a massive debt problem, due in part to the 2008 financial crisis. As we work to emerge from that crisis, we must understand how our tax code affects international business and investment. We must make sure our tax code does not encourage American businesses to relocate jobs overseas. At the same time, the tax code must not put U.S. business at a disadvantage in foreign markets.

So, let us work together to address these issues. Let us make our tax code more competitive and fair, helping our economy grow, and creating more jobs for Americans in the global economy. Let us find creative solutions to help American business men and women outpace the competition.\*

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

Senator Hatch?

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

Senator HATCH. Well, thank you, Mr. Chairman. I want to thank you for calling this hearing today. Working our way through the—

The CHAIRMAN. If I might just say, Senator, I apologize for interrupting. I apologize to the panel, to the witnesses, my colleagues. I have another meeting I must be present at at 10, and I'm going to have to leave early. But, when I do leave, as is our customary practice, Senator Hatch, you can take over.

Senator HATCH. Well, thank you, Mr. Chairman.

The CHAIRMAN. And I apologize for the interruption.

Senator HATCH. To work our way through the international tax system is a critical step on the road toward comprehensive tax reform. The United States' international tax system dates back to the period between 1918 and 1928.

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\*For more information, *see also*, "Present Law and Issues in U.S. Taxation of Cross-Border Income," Joint Committee on Taxation staff report, September 6, 2011 (JCX-42-11), <http://www.jct.gov/publications.html?func=startdown&id=4355>.

As part of the Revenue Act of 1918, the United States became the first country to enact a system in which income taxes paid to a foreign country on income earned outside of the United States could be credited against U.S. income taxes. Ten years after that, in 1928, the League of Nations introduced draft model income tax treaties, the basis of which are still used today by the United States.

Well, I have to say a lot has changed since the 1920s. At that time, the United States had been the world's largest economy for only about 30 years, having surpassed Great Britain in 1894. Today, the United States still has the world's largest economy, but just last year China supplanted Japan as the world's second-largest, with predictions that China's economy will approach the size of the U.S. economy within 20 years.

Throughout the 1920s, the U.S. was running budget surpluses. Today, of course, the U.S. is running huge budget deficits. In the 1920s, in the aftermath of World War I, the United States was a net creditor Nation. By the mid-1980s, the United States became a net debtor nation, a status that it retains today. During the 1920s, Federal revenues averaged about 4 percent of GDP. In recent history, from 1971 to 2010, revenues have averaged about 18 percent of GDP.

Yet, despite the changes that have taken place in the United States and around the world since the 1920s, the basics of our international tax system have pretty much remained the same now for over 80 years.

In any discussion of international tax reform, the fundamental issue remains unchanged. When income is earned in one country by a resident of another country, both the country where the income is earned and the country where the resident resides have legitimate claims to tax the income. Some tax scholars have referred to this issue as "the essential dilemma of international taxation."

Arguably, one of the basic goals of an international tax system is to resolve the competing claims of the source country and the residence country in order to avoid the double taxation that can result when both countries exercise their taxing powers.

In the 1960s, the competing international tax theories of capital export neutrality and capital import neutrality were developed. Capital export neutrality occurs when the overall burden of taxation on capital owned by residents of a particular country is the same whether that capital is invested at home or abroad. Capital export neutrality has generally been associated with worldwide taxation, coupled with a credit for foreign income taxes.

In contrast, the theory of capital import neutrality holds that the international tax system should have equal tax treatment for all capital investment within a particular country, regardless of the residence of the investor. Capital import neutrality has generally been associated with territoriality, the idea that a particular country, as a general rule, should only tax income earned within its borders.

Other international tax treaties have developed over time, including the theory of national neutrality, emphasizing the importance of American economic well-being in tax policy, and more re-

cently the theory of capital ownership neutrality, the goal of which is to have tax rules that do not distort ownership patterns.

Today we are reading and hearing about some of the tax issues that U.S. multinational corporations face when doing business abroad—issues that many believe are due to our outdated international tax system.

To illustrate, many U.S. multinational corporations earn money overseas and typically want to bring that money back home to the United States. However, our current international tax system discourages and, some would say, penalizes U.S. multinational corporations from repatriating foreign earnings by imposing a 35-percent residual U.S. tax at the time of repatriation. As a result, several high-profile U.S. multinational corporations are sitting on large piles of cash earned from foreign operations, yet these same corporations are actually borrowing money.

One of the reasons for this borrowing is that their cash is trapped offshore, and these corporations will be subject to a 35-percent U.S. tax for repatriating their cash back to the United States. One way of alleviating the problem of cash that is trapped offshore is for the U.S. to reform its international tax rules by, for example, adopting a territorial tax system.

Now, I am very interested to hear what our witnesses have to say today with regard to our international tax system and how reform of the system will advance the goals of simplicity, fairness, and economic growth, while increasing the competitiveness of U.S. companies.

In the modern global economy, we simply cannot afford to perpetuate policies that put our companies at a competitive disadvantage. We need to recognize that the world has changed, and we need to institute a tax system that will encourage companies to locate in our great Nation. We certainly do not need to place those that do so at a competitive disadvantage.

Again, Chairman Baucus, thank you very much for this important hearing, the latest in a series of critical discussions about tax reform, and I think one of the more important hearings we are going to have this year.

The CHAIRMAN. Thank you, Senator, very much.

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

The CHAIRMAN. I would like to introduce the witnesses now.

Our first witness is Mr. Phil West. Mr. West is chair of the tax practice and a partner in the Washington office of Steptoe and Johnson. He previously served for 4 years as the Treasury Department's International Tax Counsel.

Second, Dr. James Hines. Dr. Hines is a professor of law and economics at the University of Michigan. He also serves as the research director of the Office of Tax Policy Research at Michigan's Ross School of Business.

Our next witness is Mr. Scott Naatjes. Is that correct? Thank you. He is vice president of tax and general counsel at Cargill Corporation. In his position, he is responsible for Cargill's worldwide tax planning, audit, and compliance functions.

Finally, we have Dr. Reuven Avi-Yonah. Dr. Avi-Yonah is professor of law at the University of Michigan Law School, where he specializes in corporate and international taxation.

Thank you all for coming. I think our colleague from Michigan would like to say a few words of introduction about some of the witnesses as well.

Senator STABENOW. Well, thank you, Mr. Chairman. I just wanted to say, I know this is going to be an extraordinary panel because we have two people from the University of Michigan on the panel.

Dr. Avi-Yonah and Dr. Hines, welcome to both of you. I think it is important to note they will have different perspectives, which is what this debate is all about. I look forward to hearing from both of them. But, Mr. Chairman, we just thank you and your staff for your wisdom in recognizing talent. So, thank you.

Senator HATCH. Is that typical of the University of Michigan?

Senator STABENOW. We have free thinkers. We are open and believe in free thinking and free speech.

Senator HATCH. We have noticed that about you as well. [Laughter.]

Senator STABENOW. Well, thank you.

The CHAIRMAN. Thank you very much.

Mr. West, why don't you begin?

**STATEMENT OF PHILIP R. WEST, PARTNER,  
STEPTOE AND JOHNSON, LLP, WASHINGTON, DC**

Mr. WEST. Thank you, Chairman Baucus, Ranking Member Hatch, and distinguished members of the committee. My name is Philip R. West, and I am chair of the tax practice and a partner at Steptoe and Johnson. I have practiced tax law for over 25 years, predominantly in the international tax area. As the chairman said, I served as the Treasury Department's International Tax Counsel in the late 1990s.

I appear before you today on my own behalf, not on behalf of my firm, or any client. I appreciate the opportunity to testify. I would ask that my full written statement be included in the record.

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

Mr. WEST. A tax system that raises little revenue but imposes high compliance and administrative burdens on taxpayers and the IRS is the very definition of a bad tax system. Unfortunately, that is the international tax system we have: it raises little revenue, with high compliance and administrative burdens.

When considering whether to change the rules to improve the system, we should compare the current system to the proposed rules on five grounds: revenue raising, fairness, economic efficiency, simplicity, and competitiveness. Our current international tax rules do not score well. We can do better. The question is, how?

In our current economic environment, a core issue is the impact of any reform proposal on job creation. If the government cannot create jobs directly, the private sector must do so. If the private sector needs additional incentives, in my view those incentives should be provided. In the international tax world, perhaps the most significant incentive would be to move to a territorial tax system.

But will this push jobs abroad? In my experience, most tax planning involves shifting income abroad, not shifting jobs abroad. That is a crucial distinction. Job location decisions are made primarily for non-tax reasons. When tax is a factor in job location decisions, it is primarily because the U.S. tax is higher than the tax in the other jurisdiction, although we could eliminate this differential by repealing our anti-deferral rules and taxing all foreign income currently in the United States.

In my opinion, that would adversely affect a multinational's appetite for taking on the risk of hiring additional workers in an uncertain economic climate. Therefore, moving to a territorial system is not likely to adversely affect U.S. job creation compared to where we stand today, while a repeal of deferral might.

Will moving to a territorial system increase the deficit? Shifting to a territorial system can raise or lose revenue depending on the system's design. But a system that reduces tax burdens and therefore loses revenue could incentivize corporations to hire, while a system that increases taxes and raises revenue would not.

Despite a potential revenue loss, I agree with those who favor stimulus now—this can be viewed as a form of stimulus—and disagree that austerity is the right answer for a recession economy. But, if there is no political appetite for tax reform that loses revenue, there are numerous offsets that could be found in the corporate area, and also an increase in the individual tax rates, especially on higher-income earners, and I include myself among them.

Compared to historic standards, our individual tax rates today are low, and raising them would move our tax system closer to those other economic systems, those other economies that have historically been the best performers. They have lower corporate rates, lower rates on mobile capital, and they have higher individual rates. If you look around the world, that characterizes many of the more successful economies. Therefore, moving to a territorial system does not have to increase the deficit, and, if it does, we should be willing to live with that in the short term.

I would like to close by mentioning two related sets of international tax rules that highlight the extraordinary compliance burdens that our system can impose. The rules, collectively known as the Foreign Account Tax Compliance Act (FATCA), were enacted to help the United States fight tax evasions, but they are imposing huge compliance costs, even where the opportunities for tax evasion are remote. In a cruel irony, FATCA is causing much of that money to be spent outside the United States, not here where we need the jobs.

Lastly, the United States' unique system of taxing U.S. citizens on a worldwide basis, even if they have very few contacts with the United States, ought to be reconsidered.

I see my time is up. Thank you for the opportunity to testify today, and I look forward to answering your questions.

Senator HATCH. Well, thank you so much. We appreciate you.

Dr. Hines, we will turn to you.

**STATEMENT OF DR. JAMES R. HINES, JR., L. HART WRIGHT  
COLLEGIATE PROFESSOR OF LAW, UNIVERSITY OF MICHIGAN  
LAW SCHOOL, ANN ARBOR, MI**

Dr. HINES. Thank you, Senator.

There are three goals that many of us share and are thought to be in conflict in thinking about the design of the tax system in general and its international provisions in particular. What are these goals? We want the tax system to help promote the well-being of American workers, we want the tax system to help promote the competitiveness of American industry, and we want the tax system to generate revenue.

Well, these three goals are not in conflict. If you adopt an efficient tax system, it simultaneously advances all three of these. The question is, what constitutes an efficient system in the modern world, in 2011? An efficient tax system is one that would not tax the active foreign business income earned by resident companies. That is the system that is adopted by virtually every high-income country in the world other than the United States, and every significant capital-exporting nation in the world other than the United States. It is also known as the territorial system.

Why is that an efficient system? It is efficient because, if you are in a competitive business environment, then it is a mistake to think in terms of just what the tax rules do only to American companies. You have to think about what they are doing as well to the foreign competitors, to the companies from other countries, all of whom virtually are coming from countries that do not tax active foreign business income.

As a result of the United States having a very different system than the rest of the world, we have put American companies at a comparative disadvantage and made it burdensome for them to own productive assets in foreign countries, particularly in lower tax rate foreign countries.

Is that a problem? Yes, it is a problem because it impedes the efficiency of the way in which American firms conduct their operations. As a result of that, it makes all of their productive factors less productive, including American workers whom these companies employ in the United States.

If you want to help American workers, you have to adopt policies that make them more productive, and you certainly want to avoid policies that make them less productive because, in a market economy like ours, workers are paid their wage according to their productivity. So, things that we can do that make them more productive will enhance their wages and improve job prospects.

In order for workers to be fully productive, the firms that employ them have to do so in an efficient manner, and so we all have an interest in these firms being efficient, and what "efficient" means in the modern era is to be competitive.

In order to be competitive, you have to operate on a playing field that is commensurate with the playing fields that your competitors are operating on, and that is not the current U.S. situation. We have a burdensome system of taxing foreign income. It does not generate very much revenue. It does cause a lot of distortion to business activities. As a result, we have made our firms less productive and our workers less desirable for firms because they are

less productive as a consequence of distorting the ownership patterns of international assets.

If we were to adopt a territorial system of a type that other countries have adopted, what would be the consequences? We would have more rational allocation of business assets, it would increase productivity of factors that are located in the United States, primarily labor. Should we be concerned that business would flow abroad, that firms, instead of hiring American workers, would hire foreign workers? We should not be concerned about that.

Here is why we should not be concerned about that. Anything that improves the efficiency, the operations of domestic business activity, and in particular the hiring of domestic workers, if we improve the efficiency of that, it is going to be better for American workers. The evidence that we have indicates that, when American multinational firms, and other countries' multinational firms, when they expand abroad, expand their foreign business operations, that is accompanied by expanding their domestic business operations.

For the United States, firms that increase by 10 percent their foreign workforces increase their domestic workforces at the same time by 3.7 percent. That is because so much of the world's economic activity is foreign these days, so much of the profit opportunity is foreign. In order for American workers to have the best prospects, they have to be associated with businesses that are highly profitable and that are exploiting their U.S. operations in order to generate foreign profits.

Prosperity is not automatic. We have to adopt policies that encourage prosperity. We are so out of step with the rest of the world right now, it is important for us to adopt a territorial tax system.

Senator HATCH. Well, thank you so much.

[The prepared statement of Dr. Hines appears in the appendix.]

Senator HATCH. Mr. Naatjes, we will take you now.

**STATEMENT OF SCOTT NAATJES, VICE PRESIDENT AND GENERAL TAX COUNSEL, CARGILL, INCORPORATED, WAYZATA, MN**

Mr. NAATJES. Ranking Member Hatch and members of the committee, thank you for inviting me to testify today. I am Cargill's general tax counsel and vice president of tax.

Cargill is a U.S. corporation with global sales in excess of \$120 billion. Roughly 60 percent of those sales are from active business operations outside of the U.S. We employ over 130,000 people in 63 countries; nearly 50,000 reside in the U.S., including close to 5,000 who work in our headquarters in Minnesota. Cargill builds plants and facilities around the globe. We compete for opportunities to serve suppliers, customers, and markets. We build infrastructure to support our investments and enhance the communities where we do business.

The world has changed since the U.S. adopted its international tax system. Strong foreign companies with access to global capital markets now challenge us in virtually every market we serve. The vast majority of our competitors are organized in jurisdictions with territorial tax systems that allow them to compete in any country, unfettered by possible home country tax costs.

With more than \$200 trillion of capital traded in global capital markets today and \$70 trillion held in funds, every competitive project in the world will be funded by someone. If a foreign country is the optimal location for any particular investment, capital markets will ensure that the investment is eventually going to be made there. U.S. tax policy cannot prevent the investment from happening, it can only stop U.S. companies from participating.

Much is at stake for our Nation. The knowledge gleaned from managing business in all corners of the world provides us with the business intelligence we need to compete and win. Enhanced competitiveness attracts capital. Management of that capital at U.S. headquarters creates high-paying knowledge-based jobs. It also creates support jobs and businesses, all of which strengthen our economy and country. These employees and companies pay a lot of the taxes that sustain our Federal, State, and local governments. Income tax collections from Cargill's 5,000-person headquarters all by itself can equal several hundred million dollars in a single year.

The U.S. now stands nearly alone as the last developed Nation trying to impose tax on the active foreign income of its resident companies. We add to it nearly 100 pages of convoluted expense allocation rules that often cause real U.S. expenses to become economically non-deductible. With these added burdens, U.S. companies have to be that much better than their foreign competitors to succeed. Some academics have questioned their disadvantage, but no tax advisor would ever allow a new global enterprise to have a U.S. parent company.

Many of America's largest and most important global companies are trapped in a system that no advisor would choose and for which there are many good alternatives. In response, some have proposed trying to bring foreign multinationals into the U.S. tax net by taxing them based on place of management. But this would only put at risk highly mobile headquarters jobs and all the economic benefits they create for our Nation. We need to invite, rather than repel, headquarters jobs from multinationals.

Some have worried that a territorial system will motivate U.S. companies to locate jobs and income overseas to chase lower tax rates, but the foreign capital investment and economic growth will happen with or without us. We can only attract a strong U.S. investment base through our system of taxing U.S. domestic income, not foreign income.

Academics and policymakers question whether overseas investment by U.S. companies helps or hurts U.S. investment in jobs. The answer is interesting, but it is the wrong question. The only question is, who gets to manage the capital? It will always be better for American workers when that investment opportunity is won and managed by our market-leading U.S. companies. When American companies win, their domestic and global footprint grows and our Nation gains a greater share of global income.

The pace of global development and growth is staggering. Even Japan and the U.K. have moved to a territorial tax system to allow their people to participate in this growth. Nearly one-third of the 500 largest companies in the world change every 4 years. We cannot afford to delay. Our Nation needs long-term tax policy that is competitive and favorable to both capital deployed here, and to cap-

ital deployed abroad but managed here. Both types of capital create U.S. jobs and growth.

Congress should adopt a territorial system that is consistent with international norms, and, while we figure out overall reform, Congress should extend the controlled foreign corporation (CFC) look-through rules and other expiring provisions of our international tax laws now to ensure we do not become even less competitive.

The idea of revenue-neutral corporate income tax reform should not be our goal. The burden of corporate tax is borne by some combination of capital providers, customers, and labor, all of whom are in the end real-life, flesh-and-blood individuals. Since people bear all the tax burdens, the objective for corporate and business tax reform should be distributional equality for Americans as a whole. Our tax system should maximize the economic pie that we as a Nation all share. We can then achieve our vision of fairness within that system. Thank you.

Senator HATCH. Thank you, Mr. Naatjes.

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

Senator HATCH. Dr. Avi-Yonah?

**STATEMENT OF DR. REUVEN S. AVI-YONAH, IRWIN I. COHN  
PROFESSOR OF LAW, UNIVERSITY OF MICHIGAN LAW  
SCHOOL, ANN ARBOR, MI**

Dr. AVI-YONAH. Thank you very much, Senator Hatch, and thank you, members of the committee.

I am sorry to have to disagree, but I do not believe that we should go to a territorial system. As you pointed out in your opening statement, the United States has traditionally been the leader, not the follower, in international tax matters. We were the first one to adopt the foreign tax credit; we were the first one to adopt the CFC rules. I think we should continue to lead.

I do not think there is any evidence that U.S. multinationals are significantly hampered in their competitiveness by our current set of rules. U.S. multinationals have been doing extremely well, both recently and before, despite the fact that they now have more global competitors.

The main reason for that is that, if you look not at our nominal rate but rather at an effective rate, U.S. multinationals pay about the same effective rate as do our major competitors, and they typically pay a much lower effective rate on the foreign-source income than our major competitors, despite the fact that it is true that our major competitors have a so-called territorial system and we do not.

The reason for that is that our major competitors' CFC rules, such as subpart F, are much tougher than our subpart F. For example, Japan, which has been mentioned, taxes automatically, with few exceptions, every income in a foreign country that is earned by a CFC of a Japanese multinational. It is subject to an effective tax rate of less than 20 percent. If that rule applied to Cargill or any other U.S. multinational, then they would pay much more U.S. tax on the foreign-source income. They do not.

Now, it is true that there is a problem with the particular issue of repatriation that has been mentioned repeatedly. U.S. multina-

tionals have a lot of income that is trapped overseas, \$1.4 trillion according to one estimate, and that might be back on-shore if we did not have the 35-percent tax on dividends from active business income.

I think that that is a real problem that is evidenced by the fact that they do not bring it back. However, territoriality is not the only solution to that. There is another solution, and the solution is that we should tax currently all income of all U.S. multinationals from the CFCs at the same time that we reduce our corporate tax rate dramatically by about 10 percentage points.

If we do that, then that means that our multinationals will be able to compete because they will still face the same overall effective tax rates that our foreign competitors do, except that our foreign competitors pay their 25-percent effective tax rate on the foreign income as well as the domestic income, and others pay 35 percent on domestic income and much less than 25 on foreign income. All I am trying to do here is level the playing field.

In the end, this issue of repatriation has nothing to do with competitiveness. There is no evidence whatsoever that the tax on repatriation affects U.S. multinationals' competitiveness for the simple reason that they do not repatriate. A tax that you do not pay cannot affect competitiveness. Competitiveness is affected by taxes that you do pay, and the taxes that you do pay are not higher than that of our trading partners.

Now, just to say a little bit about inbound taxation, which has been mentioned. You also mentioned in your opening statement that the U.S. now is the world's leading capital importer. I think we do need to pay more attention to inbound taxation. I think there is a lot of evidence that foreign multinationals operating in the United States underpaid their taxes for access to the American market.

That is because of a variety of reasons. Our earnings stripping rules are too lax, we allow full deduction of royalties, we do not tax capital gains even in large participations, and our treaty policy is even more residence-oriented than the OECD ones. For example, we do not have withholding on interest, whereas the OECD model does. I think it is high time that we focus more resources on this.

I think we should amend our inbound rules to, for example, have tougher rules on the deductibility of royalties. We should tax capital gains in large participations, such as the sale of T-Mobile by Deutsche Telecom to AT&T, which is not taxed either in Germany or in the United States under current rules. We should also enhance enforcement of transfer pricing, and, if we abolish the deferral as I suggested before, we could focus all the IRS transfer pricing resources on inbound transfer pricing.

Finally, I should mention that we should, in my opinion, police the line between foreign and domestic multinationals better by adopting a management and control standard, which is the general standard in the rest of the world. With all due respect to the other witnesses, I do not think that this would lead to significant movement of headquarters. If that were true, then under the current system all of our competitors should move their headquarters to the United States, because currently we do not tax based on management and control, and the other countries do.

But they do not, and the reason for that is, with all due respect to the tax function, normally companies will not put their headquarters where they do based on taxes, they put them based on many, many other factors. I do not see any evidence that U.S.-based headquarters are not being established because of tax reasons, and I think that, if we do that, then at least we should not have this problem, which is the famous double Irish sandwich, which has two completely empty companies. That is the way in which Google underpays taxes on its foreign operations, and I think we should at least deal with that.

Thank you very much.

Senator HATCH. Well, thank you.

[The prepared statement of Dr. Avi-Yonah appears in the appendix.]

Senator HATCH. Let me ask a question for the entire panel. Now, some have raised concerns that moving to a territorial system would risk exacerbating transfer pricing issues, which would thereby potentially shift profits and jobs overseas. But it seems that substantially reducing our corporate tax rate, at the same time, would go a long way towards mitigating those concerns.

I mean, presumably, if the U.S. corporate tax rate was more competitive with other countries, there would be less incentive to forum shop due to tax rates. Now, I would just like to hear the panel's thoughts on this. Should any change to a territorial system be linked to a reduction in the corporate tax rate?

We will start with you, Mr. West.

Mr. WEST. Well, there is no question that, if you reduce the U.S. rate, you are reducing the incentive to avoid the U.S. tax. That is pure logic and common sense as well. Insofar as transfer pricing is concerned, our system is a mess. No one likes it. The IRS does not like it; taxpayers do not like it. They may not like it for different reasons. Taxpayers may not like it for compliance and administrative reasons, while the IRS does not like it because they cannot enforce it well, and the Treasury does not like it because they do not think the rules are adequate.

So I think it is worth rethinking those rules. It is worth revisiting them, and we ought to do that. A territorial system may put more pressure on those rules. I do not think we should make the perfect the enemy of the good and fail to enact reform because it might exacerbate a transfer pricing concern. As you have observed, reducing the rate would take pressure off that concern. Would it eliminate it? No. Is it still worth looking at those rules? Yes. That is my response.

Senator HATCH. Thanks.

Dr. Hines?

Dr. HINES. A lower statutory corporate tax rate would certainly reduce the pressures on transfer pricing. I think everybody agrees on that. If the question is, is it necessary to have a lower corporate tax rate to accompany a move to territorial taxation, I believe the answer is no. That is, if it is not possible to lower the corporate rate, even though lowering the corporate rate would be a good idea, but, if it is not possible to lower the corporate rate, we should nonetheless embrace a territorial tax system, even though it would put a little more pressure on the transfer pricing issue.

We should be wary of letting the transfer pricing tail wag the tax policy dog in this context. We should adopt the tax policy that is the most sensible. We have sensible transfer pricing rules. The difficulty is that, in application, it is very challenging, and that is why there is a problem. If that is the problem, we could adopt a territorial system and increase enforcement at the IRS. It would be much better than fearing to adopt a territorial system because of potential problems associated with it.

Senator HATCH. Well, thank you.

Mr. Naatjes?

Mr. NAATJES. Yes. Two thoughts on that. First, we have to separate in our minds our domestic system for taxing domestic source income and the system for taxing foreign income. The rates we choose to implement here, the deductions we allow in our overall tax footprint, deal with our competitiveness to attract capital here for investment and base investment here. The second tax system is for whether or not we can compete abroad in managing the capital abroad. Both have to be competitive, both are important; you should separate them in your mind. Both can be done right.

Now, regarding transfer pricing and the rate differential, we will never be able to successfully chase low rates around the world, so there is always going to be a difference between foreign tax rates in some country and U.S. tax rates. Multinational planning opportunities are vast.

The question we have to answer is, whom do we want to have a transfer pricing battle against? There will always be multinationals. The question is, will they be foreign or U.S. multinationals? If our system is non-competitive, we will increasingly see foreign multinationals where we will be the satellite jurisdiction for a subsidiary.

Foreign multinationals rarely keep their intellectual property here, they rarely keep their headquarters here, and most of the brains and backbone of the business are kept offshore. Transfer pricing rules that follow an arm's-length standard, at the end of the day, will follow where the economics lie, and, if you want to have the greatest possible shot at the overall economics, and therefore the most income, you want to have the most multinationals.

So, having a territorial system gives us the hub and capacity to stay strong as a multinational corporate headquarters' jurisdiction and, in the end, will be better for us for transfer pricing disputes. Think only of one small thing: just how you get information to have a transfer pricing battle. A U.S. multinational has its officers, its books and records, all of its foreign companies, subject to all the reporting here. All the information you need to engage in the dispute, you have. Matching that abroad would not be easy.

Senator HATCH. Dr. Avi-Yonah?

Dr. AVI-YONAH. Well, in this case, I agree with a couple of you at least. I agree with Mr. Naatjes that I do not think we can chase rates overseas. I mean, the basic problem is, even if we reduce the corporate tax rate to, let us say, 20 percent, which is going to be very hard, we are dealing with jurisdictions where the corporate rates are at zero. There still will be a significant incentive.

If you look at this structure, as I mentioned before, it is entirely built around reducing the shifting of profits from Ireland where the

tax rate is 12.5 percent, to Bermuda where the tax rate is zero. So reducing our tax rate will not eliminate transfer pricing problems. I do think, with all due respect, that transfer pricing is the key to the issue because, if we adopt territoriality, there will be a significant tendency—not necessarily to shift jobs, as Mr. West says, but to shift profits overseas, because, at the moment, the only disincentive to shift more profits overseas is the fact that they cannot be brought back home easily without having to pay tax. If we adopt territoriality, there would be a significantly increased incentive to shift those profits overseas. Thank you.

Senator HATCH. Thank you so much. My time is up.

Senator Bingaman?

Senator BINGAMAN. Thank you all very much. Let me just focus on this suggestion that Dr. Avi-Yonah has made here that, regardless of what we wind up doing or not doing in shifting to a territorial system, we should modify the definition of residence for domestic corporations, the suggestion being that that on its own at least would be a step forward and would avoid or eliminate some of the tax avoidance that currently exists. I would be interested in your view on that, Mr. West, and the rest of you as well.

Mr. WEST. Sure. There is no question that basing the distinction between worldwide taxation and source taxation on where you are organized is arbitrary. It does not make a whole lot of sense. So, the fact that a U.S. corporation happens to have been born here, filed its organizational documents here, and is taxed so differently than other corporations, seems pretty arbitrary. But we have to assess what the alternative is.

What is the point of a managed and controlled test? Well, it is somewhat less arbitrary, but it is also somewhat manipulable. When we think about the three things it is going to do, it was proposed to address initially inversion transactions in which U.S. corporations move outside the U.S. and set up headquarters in Bermuda or Ireland or Switzerland. Those transactions have effectively died because of legislation passed by the Congress, section 7874, and before that section 367. You do not see a lot of inversion transactions any more. It is also aimed at hedge funds and offshore funds.

Our historic tax policy has been to encourage offshore collective investment vehicles to invest in the United States and to be managed in the United States. To say now that we want to flip that, and, if they are managed in the United States, we want to tax those pools of capital, it is really a reversal of our historic posture towards those pools of capital, and I would suggest not one that we should undertake.

The third impact of a managed and controlled test would be on, as Mr. Naatjes said, large multinational corporations that base significant management here in the United States. If you have a large foreign-based multinational that has a large management component here in the United States and that corporation becomes at risk of U.S. taxation because their management contingent is too large, they are not going to locate those high-value management jobs here. I am not sure that is something we want to pursue. So is the current rule bad? It is. Is the alternative better? I am not sure.

Senator BINGAMAN. Dr. Hines, did you have a thought on this?

Dr. HINES. Yes, I do. I think the alternative of adopting a management and control criterion for residency is a bad idea, for two reasons, the first of which has been mentioned. The first reason is, we should be concerned, if we were to adopt such a system, that we would lose management and control jobs, that management and control would flee to other countries. Would that happen? There is evidence in the case of Great Britain that, when they announced a proposal to tighten their CFC rules, British companies began expatriating to Switzerland their management jobs, because they have management and control, and to Ireland.

Britain wound up backing off of the proposed tightening of the CFC rules as a consequence. Would that happen in the United States? Surely it would. Would that be a quantitatively large phenomenon? There is no evidence that it would be a large phenomenon, but there is no evidence it would be a small one either.

But that is only the first concern. The second concern is, even if no management job moved as a result of adopting this system, so all the managers wound up staying put where they are currently, it still would be problematic because the companies that were managed in the United States, as a result of adopting the system, would wind up smaller and less productive than they would be otherwise.

The reason is that those companies, if their site of incorporation is currently outside the United States but they are managed within the United States, would then be subject to U.S. international tax rules and, as a result, would be subject to all the problems and distortions we have been talking about today.

I think it is a mistake to think about the management and control option simply in terms of, will management jobs move. You also have to think about, what will be the character of the management jobs that stay in the United States, and will they be managing smaller, less productive companies if you adopt that system? The answer is yes, so that is why we should not do it.

Senator BINGAMAN. I think my time is about up. Mr. Naatjes, did you want to make a comment on this?

Mr. NAATJES. I will just say it is outside international norms. Other companies that do management and control, vest that control in a board of directors, and the test is easy to manage. It has no teeth, so it would not be consistent with international law for us to have a system that was based on who does the operational activities of a business day to day. We operate overseas in lots of these jurisdictions and know how the rules work.

Senator BINGAMAN. Thank you, Mr. Chairman.

Senator HATCH. Senator Grassley?

Senator GRASSLEY. Mr. Naatjes and Mr. West, financial accounting and tax accounting have two different goals. Financial accounting principles focus on the proper matching of income and expenses to provide the most accurate, and generally most conservative, picture of the company's financial health.

In contrast, tax accounting generally focuses on reducing the company's tax costs and improving cash flow. I refer to Mr. Naatjes's highlighting the discussion about how effective tax rates can be misleading because of differences between financial account-

ing and tax accounting. Some differences result from a book tax, differences in accounting, and for inventory and capital costs.

I understand that the companies, and countries that have adopted international financial reporting standards are not permitted to use LIFO inventory accounting methods. Separately, a reduction in tax rates may lead to significant financial statement adjustments.

So to you two, I would like your thoughts on whether financial accounting principles create any disincentives for tax reform, also, what, if any, international accounting standards should be considered as we consider tax reform.

Mr. WEST. Thank you, Senator. A couple of things. As you have observed, it is correct that financial accounting tries to achieve a different objective than tax accounting, and in many instances those two objectives are inconsistent with each other. Financial reporting attempts to conservatively estimate income tax reporting, not understate income, and in many cases maximize the amount of revenue that is appropriately reported.

So your ultimate question is, does a calculation based on accounting income accurately reflect taxable income? In many instances it would not. We are working with a group of companies—and full disclosure, Mr. Naatjes's is one of those companies—on the question of figuring out what the right measures of income are for this public debate. Is it the marginal effective tax rate? Is it the effective tax rate? Is it the statutory rate? We have some academic work under way to try to assist, or potentially assist, participants in the debate on that question.

Senator GRASSLEY. Mr. Naatjes?

Mr. NAATJES. Some have alleged that U.S. taxpayers operating abroad do not have a higher effective tax rate, and part of it is, what is missed in the data? You have to know a company really well to understand its ETR. Another flaw of looking at ETR, when looking at international tax reform, is that companies cannot take their average rate and use it to compete on a marginal basis. You would never go out and buy a municipal bond, and then a regular priced bond, and believe that you are getting a blended rate on your regular bond. If you stayed in business that way, you would go out of business.

So when I compete in China, the fact that I get a tax incentive in Thailand or a section 199 deduction in the U.S. does not make me competitive in China. China has to rise or fall on its own competitiveness for Cargill and any investment when you go to make it there. So the idea that an overall ETR means you do not have a burden is simply a logical mistake.

Beyond that, for U.S. multinationals, because of the Accounting Principals Board opinion number 23—which allows us, if we do not have a plan to repatriate, to not accrue the U.S. tax—this means in some ways our ETRs are always, always understated because we bear significant risk of losing that deferral if the rules change, if subpart F gets worse, if business exigencies change. All of that is contingent.

Foreign multinationals have a low ETR that is permanent, and we can do a lot of work to defend that rate. The idea that the system is not burdensome, I told you before, nobody, no advisor could keep their job who would allow a multinational company to form

a U.S. parent company. There is no tougher jurisdiction to do foreign tax planning in, and saying anything to the contrary means you have not been in tax practice.

So the ETR, it matters. It is evidence of something. It shows overall efficiency, but it should not be mistaken for competitiveness in any particular country, and it should not be believed that a U.S. multinational's ETR is the same as a foreign multinational's ETR.

Senator GRASSLEY. Thank you, Mr. Chairman.

Senator HATCH. Senator Cardin?

Senator CARDIN. Thank you, Mr. Chairman. I appreciate that, and I appreciate our witnesses and their views. I also understand the strong preference for a territorial tax structure.

Let me, though, bring us back to some of the considerations that this Congress may in fact be looking at. We have seen recommendations come in from Simpson-Bowles and from others that are suggesting trying to, within the corporate tax, reduce the rates and spread the tax burden, given the fact that we have high marginal rates but the effective tax rates are significantly lower. But because of the high marginal rates, it acts as a disincentive to American companies.

So, Mr. West, if I could start with you, when you take a look at tax expenditures within the corporate code—and we are looking solely within the corporate code to flatten things out—do you have any suggestions of where we might be able to flatten this code out in order to get revenue to reduce rates?

When I look at the largest tax expenditures, I see section 199, which seems to be a very popular provision. Accelerated depreciation—another popular provision—the R&D credit. Do you have any suggestions that might be used in order to try to reduce the rates by flattening the tax?

Mr. WEST. Senator Cardin, from the perspective of any particular taxpayer, whether reducing the rates in exchange for eliminating expenditures is a good or bad idea, of course, depends on what those expenditures are, and how they use them, and what the impact is on their particular tax position. As a general proposition, as you know, the best tax policy is one that has low rates and a broad base, with fewest tax expenditures, the fewest exemptions.

So, if you wanted to start from a clean slate and say, let us get the rate as low as possible and eliminate all the expenditures, and you did not shift the burden with respect to a particular company, what you would have done is, you would have hewed more closely to good tax policy, and you would have simplified the code. Those are both laudable objectives.

Whether, beyond that, you effect competitiveness or revenue raising or economic efficiency depends on whether you are going to raise or lose revenue, and whether a particular taxpayer's taxes are going to go up or down. That, of course, is a function of where you stand, it is a function of where you sit, and where any particular taxpayer is on that can be a function of whether their bill is going up or down, to state the obvious.

Senator CARDIN. Well, I think you sufficiently dodged the question. We are where we are. We are not going to rewrite the corporate tax code and pretend it did not exist before the reform. I would just be curious if there are any parts of the tax expenditure

areas that could produce enough revenue to make a significant reduction in the rates that could get consensus within the business community as being something that could help U.S. competitiveness and create jobs.

Yes, sir?

Dr. HINES. I cannot speak to what would generate consensus in the business community, but coming from the academic community, two of the provisions that you mentioned, the section 199 domestic production activities deduction and the accelerated depreciation that we currently have, are viewed with skepticism. That is if, in return for lowering the statutory rate, one were to repeal section 199 and to repeal the bonus depreciation provisions we currently have for large companies investing in equipment, that would be an appealing combination.

Senator CARDIN. Mr. Naatjes, one second. I want to bring you into this discussion, because section 199 actually was passed as a way to try to deal with the fact that our business taxes were not border-adjusted, whereas Europe and Asia have the consumption taxes that are border-adjusted. With your experience, would we avoid many of these problems if we considered either reducing or eliminating our corporate income tax and instead use a consumption-based tax?

Mr. NAATJES. There is no question that I think almost every economist would prefer some form of consumption tax over more income taxes. The effect on an economy of an income tax is almost always viewed as negative by economists, so the general proposition that more consumption tax and less income tax is a good thing, is true.

With regard to broadening the base, I have sat with many tax directors, and the special provisions that we pass are calculated after the year ends in back offices by CPAs for months on end, and they hardly motivate anything in corporate board rooms. What they do is spawn an industry to capture them, another one to lobby for more, and at the end of the day they are not as effective as low rates.

Senator CARDIN. Thank you.

Dr. Avi-Yonah, I have about 15 seconds. You can take it and respond.

Dr. AVI-YONAH. Well, I mean, I think if we do the 199 depreciation and abolish deferral and let the Bush tax cuts expire, we could reduce the tax rate by 12 points, and that is significant.

Senator CARDIN. Thank you, Mr. Chairman.

Senator HATCH. Thank you, Senator Cardin.

Senator Enzi?

Senator ENZI. Thank you, Mr. Chairman. A question for Dr. Hines and Mr. Naatjes, primarily. Tax reform could have a significant impact on the organizational structure and operations of both small and large U.S. multinationals as well as a potentially significant financial statement impact. Given this, it seems prudent to include appropriate transition rules in any tax reform effort. In your view, what should this committee take into consideration as part of a potential transition plan if we go to the international tax reform?

Dr. HINES. It depends on the nature of the international tax reform what sort of transition rules you want to adopt, of course. There have been various proposals, if we were to move to a territorial system, to think about, how are we going to treat the income that has currently accumulated abroad by American companies, that was accumulated under the current system where there was a reasonable expectation that there would be a heavy tax burden upon repatriation.

The question is, should that currently accumulated income be subject to some kind of a tax when repatriated, or perhaps even subject to a tax prior to repatriation? One of the difficulties that the transition rules encounter is that now you are relying on years and years of past tax returns and earnings and profits calculations and spreadsheets that go back many decades in some cases. It becomes extremely difficult to apply a transition rule to that income.

It is not impossible, but it is extremely difficult and challenging. I urge the committee to be wary of such proposals. Part of the reason is the difficulty of enforcement, the other reason is that it is extremely hard to know exactly what tax burden taxpayers anticipate currently, given their ability to pool income and use worldwide averaging.

So one possibility is to do what other countries have done when they have moved to territorial systems, which is just not to have transition rules at all, just adopt the territorial system. Many other countries have done that. Their fiscs have not fallen apart as a result, and it does seem the most practical alternative.

Senator ENZI. Thank you.

Mr. Naatjes?

Mr. NAATJES. Yes, a couple of thoughts. Number one, I think it needs to be tied, whatever we do if we shift to a territorial system, the recognition of any U.S. tax on the offshore income has to be tied to a recognition event. To simply impose tax on static business activity, I do not think, would be fair, and could cause huge economic distortions.

I think, second, that every other country that I am aware of, when they went territorial, simply stopped the system: no more credits, no more tax on foreign income, and they just transitioned. Today we have to pool our income and credits from 1987 until today to try to understand the tax credits attached to a single dividend. The bookkeeping and recordkeeping are unbelievable.

The adjustments in a little tiny company over a more than 20-year period are a huge burden, and to create another layer or another pool would be yet another burden on corporate America. Again, I understand the incentive to not let the low taxpayers get away Scott-free, but it is a difficult thing to make a transition rule that no other country has done.

Senator ENZI. Thank you.

I will throw out another question here just for anyone. Several countries recently revised their tax systems to provide a preferential tax rate on certain royalty and/or intangible property income. These jurisdictions have referred to this tax incentive as a patent box or innovation box regime.

Would the United States be well-served to implement such a regime to incentivize the exploitation of intangible assets from the

United States? Would this help to alleviate the transfer pricing pressures that some have indicated might result from a movement to a territorial tax regime? Do countries that have patent box regimes also have research and development incentives like the R&D tax credit? Mr. Naatjes, you are making a lot of notes there.

Mr. NAATJES. Yes. I think what other foreign countries have seen is that, if you do not allow a regular low tax rate on income earned in a different foreign country, what you are going to do is motivate structuring, and you are not going to collect the tax anyway.

What they said is, you know what? We understand that we have granted the right to country X outside of us to decide how much to withhold on or give a deduction for a royalty payment or interest; to try to then capture the excess tax on that is chasing something you will never catch. They said, you know what? Let us instead leave it here. Do not move the intellectual property jobs offshore, do not move the management offshore, do not move the marketing offshore. Leave it here, and we will give you the kind of rate you could get abroad so you can keep the jobs. That has been the direction of the U.K., the Netherlands, and many countries.

Senator ENZI. My time has expired. Thank you.

Senator HATCH. Well, thank you, Senator.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. This has been an excellent panel, and I want to thank all of you.

Dr. Avi-Yonah, I just want to make sure that I am reading correctly something that you offer up in your testimony. It is at page 4, and it seems to me what your testimony there is saying is that the effective tax rate of many U.S. multinationals on their foreign income is lower than that of their multinational competitors. Is that correct?

Dr. AVI-YONAH. That is right.

Senator WYDEN. All right. So given that—and I think that is exceptionally important—would it be fair to say that, if the Senate were to significantly alter deferral, or abolish it as Senator Gregg, Senator Coates, and I have done over the last 5 years, that it would be possible to use that money to dramatically slash rates for all American businesses, multinationals, small businesses, all of our businesses. Is that correct?

Dr. AVI-YONAH. That is exactly what I mean. I think that would be an excellent move. I think we should not really favor our businesses that operate offshore against the businesses that operate primarily domestically at the moment. Our corporate tax rate is extremely high, and the effective rate on businesses that operate primarily on-shore, that is domestic business, is very, very high as a result of that, and we could significantly lower the tax rate for everybody if we tax both of them.

Senator WYDEN. And in doing so, approaching it that way, we could finally set aside all of these gaming kinds of questions, how you game the system with transfer pricing. I think all three of you who discussed territorial taxation, I have great respect for your views. I have always said I am open on this question of a territorial system.

I will tell you, Senator Gregg and I probably spent a gajillion hours—and that is barely an exaggeration—trying to figure out

how to do this territorial question without the gaming, where someone generates a sale in one country and books the profit in another. We just could not figure out how to do it. I came away with the theory that competitive rates, which means lower rates, solve just about all the problems.

I want to make it clear, I am open to you all in looking through these territorial questions, but I think Dr. Avi-Yonah has really, in effect, pulled the rock up to really show what is there underground. That is, his testimony and the figures that he offers at page 4 that show that the effective tax rate of many U.S. multinationals on their foreign income is lower than that of their competitors, (A) and (B), if we look at the fundamental question here, which is deferral, which is the big pot of money, boy, what an opportunity to lower rates for American business. Senator Coates and I have come in at 25 percent. I think we could go lower. That was always the question in 1986.

Now, there is one other question I wanted to ask of all four of you. One of the aspects of the tax debate that troubles me today is that virtually everything is temporary. The *Wall Street Journal* had a good piece the other day where they basically said, the only thing that is permanent about the American tax system is it is temporary.

I would like to maybe just go down the row. How important, in your view, is it that this whole issue of the tax debate now move to permanent changes, so as to bring about some certainty and predictability? Because I think if we can get that idea across, even the super committee, recognizing that they are not going to be able to write a whole tax reform bill in a matter of 6 or 8 weeks, but they could get started on it and at least offer the underpinnings so that the Finance Committee could pick it up in a bipartisan way, we would make some headway if we accepted the importance of now making permanent changes. If we do not, my concern is we will have the same debate in the lame duck session of the 2012 Congress that we had in the 2010 Congress and talk about the Bush tax rates and back and forth, and the like.

So I guess I have 20 seconds, and I can get this one in. The question of permanence, and how important that is, the certainty, and predictability for business investment.

Mr. WEST. I can be brief: I agree.

Senator WYDEN. Beautiful. I will quit while I am ahead.

Dr. HINES. I agree also. One of the costs of the temporary stuff is that you are discouraging business activity and you are not generating any revenue. As a result, people are just worried about the future.

Mr. NAATJES. It creates a lot of planning to decide how to react to things that may change or may not change, and it wastes corporate resources. It is a huge issue, but being fast and making it worse could be worse still.

Senator WYDEN. Put me down as being against doing dumb things at any point.

Dr. AVI-YONAH. I agree with all of the above.

Senator WYDEN. All right.

Thank you, Mr. Chairman.

Senator HATCH. Thank you, Senator.

Senator Nelson?

Senator NELSON. Thank you, Mr. Chairman.

When trading partners such as China offer tax holidays, and some tax havens in the Caribbean basically do not tax multinational companies, is this a game that we can still play and win in which we have to compete on tax rates and incentives with places like the Cayman Islands, Monaco, and other tax havens? Yes, sir?

Dr. AVI-YONAH. I do not think we can compete with the Cayman Islands. I do not think we should compete with the Cayman Islands. I do not think we offer the level of services that the Cayman Islands does. I do think we should compete with places like China, India, and Brazil. It is inaccurate to say that China offers a lot of tax holidays. China abolished most of the tax holidays. They tax their multinationals with CFC rules that are tougher than our rules. They have a significantly lower corporate tax rate than ours, and that is important.

Brazil, on the other hand, has a higher rate than ours, and they do not have deferral at all, and they have been managing to grow very nicely. So does India. So, in that sense I think that those are our real competitors. I think that it would really be helpful if we reduced our corporate tax rate to more or less where the average rate now is, both in the OECD and in the large and growing developing countries. But we cannot compete with the Cayman Islands.

Mr. NAATJES. We make a mistake when we think about tax burden in terms of income tax only. Every country extracts from every multinational and business what it needs to fund itself. Most countries rely on indirect taxes, and multinationals play a huge role in that and bear a heavy burden.

So, when you see a tax holiday, you will also almost always see a major corporation building its own roads and bridges, being the withholding agent for the government, and bearing almost all the risk of doing everything correctly, or losing almost everything on audit. So, the burdens are large when you see an under-developed country with a tax holiday. You are not chasing rates, you are chasing growth.

With regard to the Cayman Islands, people are not doing the active operations there, so the idea of a territorial system largely does not touch that. Multinationals today only use those as a place to block and defer U.S. taxation of already active earnings.

So it is not that we are making money in the Caymans, it is the money that we made in China, Germany, and Brazil that is sitting in the Caymans, so U.S. tax is not collected on it. But we could just as easily use Spain, the Netherlands, Luxembourg, the U.K., Canada; all those holding company structures would also impose no tax. The point is, they have territorial regimes. The islands are simply easier than going to a country and having to incur more costs, but we could.

Dr. HINES. Every time a foreign country offers an American company a tax holiday, I am happy. The reason I am happy is that it is a lower cost for Americans to do business in some place. We do not want foreigners to impose heavy taxes on Americans; we benefit if the taxes are lighter, because it makes companies more prof-

itable and it lowers the foreign tax credits that they claim, and it is a big win for the United States.

So, tax holidays, per se, as offered by foreign governments, are not a bad thing. The question, Senator, that you addressed is, how should we think about this in a competitive framework? The United States has to be competitive. We cannot ignore what the rest of the world is doing. A country like the Netherlands has a very competitive tax system, and as a consequence there are a lot of Dutch businesses doing competitive business around the world.

Should we think in terms of, how is our tax system stacking up to that of the Netherlands, Canada, India, Brazil, and other countries? Absolutely, we should. We are always going to have a different system than these very small islands, like the Cayman Islands. It is just a totally different economy in a place like that. But from the standpoint of the United States, look over your shoulder at Canada and the Netherlands. Look at what they are doing. We need to think hard about that.

Mr. WEST. We cannot, and should not, chase the Cayman Islands rate. But the question of how multinationals use tax havens, as alluded to by Mr. Naatjes, is a complex question, and largely they are not doing anything other than what the laws enacted by Congress allow them to do. It is dangerous to look at this issue simplistically.

What we should do with the staffs, who are excellent, is to sit down and figure out how they are used, why they are used, and whether that is a problem, and, if it is a problem, how to address it. But, on the one hand, we should not be chasing their rate, and, on the other hand, I think there is a perception that, if a tax haven is there, something illicit and illegitimate is going on, and we need to look more closely at how they are used.

Senator NELSON. Mr. Chairman, I have one second left, and I just want to get on the record the question that we should be concerned that we develop intellectual property in this country and then it is transferred in its ownership to wholly owned subsidiaries in tax havens of low-tax jurisdictions and what we should do about it. That is my question I want to put on the record.

Senator HATCH. Well, thank you, Senator.

Senator Thune, we will go to you.

Senator THUNE. Thank you, Mr. Chairman. I want to thank our panel today for their good answers to some complicated questions. We obviously want to figure out how to get this right and move to a system that makes us competitive in the world, and I think that is the goal everybody has here. Obviously today I do not think we are. I think the tax systems of our competitors around the world have moved away from us and have put us at a competitive disadvantage.

I want to direct this question to Mr. Naatjes, if I might. In your testimony, you described the global reach of a company like Cargill and the advantages that you bring to U.S. agricultural producers by being on the ground in markets around the world. Could you describe how your company helps farmers in places like South Dakota that produce large quantities of commodities such as wheat, soybeans, and corn, how what you are doing there helps them access global markets?

Mr. NAATJES. Cargill has a footprint wherever food is produced and consumed, and it is all over the world. Access to knowledge and intelligence related to that helps us understand global commodity markets. It helps us move all the commodities and goods that feed the world to the right place at the right time, to ensure that the cost of food is reasonable for people, and efficient. All that helps efficient farmers and great growers find markets for their commodities and crops and the food that comes from them.

Senator THUNE. And what would a more favorable U.S. tax environment mean to these farmers?

Mr. NAATJES. I think in every case where you see efficiency growing, where you see the best owners of foreign assets owning those assets of production, you will find greater efficiency for all players in the market. But what you are going to get with the right company owning the right investments globally is better economic outcomes for the globe, for producers, for consumers, for everybody who is touching those industries.

Senator THUNE. As you know, our tax system, I think, was designed at a time for a world really where our U.S. companies were largely competing against other U.S. companies. Who are your major competitors today, and are they U.S. or foreign-based? What will a tax system that you describe as putting you at a competitive disadvantage in the global marketplace mean for Cargill over the long term?

Mr. NAATJES. Cargill has a tremendous global footprint and great know-how. We compete well with our burdens. I model our burdens deal by deal, country by country as we spread around the world. I have a 240-person tax department, very sophisticated lawyers and accountants who try to figure out the U.S. burden for the expense allocation rules, and our deferral. I am telling you, it costs a lot of money. Everywhere we go, we have a major impediment to how we compete.

Companies have sprung up in places like Asia that did not exist only 20 years ago, that are larger than us today, in their overall footprint. Are we competing still and winning sometimes? Yes. But to give you a sense of some of our competitors: Wilmar, organized in Singapore; Bunge, organized in Bermuda; Glencore, organized in Switzerland; Noble, organized in Hong Kong; and Tate and Lyle, organized in the U.K. with a territorial system. We also have ADM organized here, and Unilever. So we have competitors. Some are still in worldwide systems, but for the most part they are territorial, and they have very low effective tax rates.

Senator THUNE. If investments are going to be made in developing economies in order to capture the growth in these markets, why does it matter if these investments are made by U.S. or foreign companies?

Mr. NAATJES. It makes a huge difference. So, if you imagine the difference between Cargill's footprint and Cargill's headquarters, and, if we grow and spread—I told you we have 5,000 people in our headquarters offices. The charities they sustain, the taxes they pay, the society they develop is what builds places like Minnesota and the surrounding communities; the people they hire, the people that support them, it makes the economy thrive.

Winning around the world gives us the intelligence to compete in other places and grows our synergies. So, if we are the best owner for a crush plant in Paraguay to harvest and help bring the soybeans to market from Paraguay, then you want Cargill there. Nothing could be better for America than having us do it rather than a company organized in a different place without the headquarters here and without the jobs.

Senator THUNE. Yes.

Mr. Hines, in your testimony you made some interesting points about who really bears the burden of high U.S. corporate tax rates. You stated that in today's economy where capital is very mobile, it is labor that actually feels the burden of taxation the most. You also state that workers benefit the most from a system that taxes businesses efficiently. Could you just expand upon that a little bit?

Dr. HINES. Sure. The reason that works is that, because capital is so mobile internationally, not just American capital, but German, French, Dutch, everybody's, the capital is going to get its rate of return regardless of where it invests. If the United States has a really high tax rate, there will be less investment in the U.S. to the point where capital can earn its necessary rate of return. But the consequence of less investment to the United States is that workers will be less productive, and their wages will fall.

The thing that makes up the difference for the companies, the thing that keeps any investment in a high-tax place, is that wages wind up falling as a result and therefore businesses can break even or turn a small profit. But the theory clearly states that, in an environment of mobile international capital, workers wind up bearing the burden of business taxes. There is as well empirical evidence to support that.

Senator THUNE. Thank you.

Thank you, Mr. Chairman.

Senator HATCH. Thank you, Senator.

Senator Carper?

Senator CARPER. Thank you, Mr. Chairman.

Gentlemen, welcome. Thanks for being here today and sharing your thoughts with all of us. I missed your testimony. We have been having a separate—we call it a mark-up—on the Environment and Public Works Committee on an extension of the transportation program for our country, so I missed what you had to say. I gather that there are some things you agree on, and maybe some things you do not.

One of the things that I look to on a panel like the one assembled here is, we have smart people who have some good ideas to share with us. I always look to see where you agree, and are there some major points of agreement on which there is unanimity? If so, what are they?

Dr. AVI-YONAH. I think we all agree that we should reduce the corporate tax in the United States. The 35-percent rate is too high by international norms. I do not think anybody on the panel would disagree with that.

Senator CARPER. All right. Thank you. Well, that is a good starting point.

Mr. NAATJES. I think everyone is agreed as well that flattening, again, the basic base and making sure that special exemptions are

out and making the rate as low as possible actually provides the greatest business motivation and does the best good for America and its workers.

Senator CARPER. All right.

Dr. HINES. I am hopeful that in time we will come to agree that a territorial system is the best system, but we have not agreed on that yet today.

Mr. WEST. A little commercial announcement. I would refer you to an article which I published recently in which I have probably 15 or 20 points that I think are generally broadly agreed on. The problem is, they conflict with each other in many cases. But they are broad areas of agreement, and I will send you a copy of the article so you have it, Senator.

[The article appears in the appendix on p. 74.]

Senator CARPER. All right. Thanks.

I understand that my wingman here, Senator Cardin, spoke earlier to maybe ask you a question regarding a value-added tax, which he has some interest in. Professor Graetz who sat, I think, right about where you are sitting this morning, he was here a couple of months ago and spoke in favor of moving in that direction and called for lowering corporate and individual rates, but also trying to make sure that there is some progressivity that remains, at least on the individual income side.

Senator Cardin may have asked you to share your views on that approach. I would ask you, whether you did or not, about the compatibility of that approach embraced by Dr. Graetz with the territorial approach. Are they compatible, incompatible? How can they be reconciled?

Dr. AVI-YONAH. It seems to me that they are separate issues, because certainly I am in favor of the value-added tax. I think every other developed country—most other developing countries in the world—have the VAT. We are really the only OECD member that is left without one. It is a very efficient tax. It is a great tool of revenue collection, and it would enable us to reduce the burden on businesses and on individuals.

It has been suggested, for example, that if we had a 15-percent rate VAT, we could reduce the corporate and individual top tax rates to 15 percent altogether, which is a pretty radical move. That would be even better than the 1986 Tax Reform Act. But I think that it is a separate issue than this question of a territorial tax system, although, in my opinion, if we had a 15-percent corporate income tax rate, nobody would seriously argue that we are not competitive, even if we taxed worldwide income of our multinationals, and that would be a significantly simplifying move.

Senator CARPER. All right. Thanks.

Others, please?

Mr. NAATJES. Again, international norms would dictate that you have a territorial system and a VAT, so they are consistent. It has been done by many. Economists support a VAT for all the reasons you have heard from Professor Graetz. I think it is consistent with what our trading partners do, so it equalizes the tax burdens our goods bear when they cross borders. Overall for the economy, again, it is the way foreign countries collect tax and defend their

tax base. They do not tend to worry about the income taxes much; it is a much smaller revenue source for them.

When you deal with new U.S. lawyers and send them into a big, multinational company, they have this tragic flaw of always doing income tax planning. But it is the VAT that is most of the burden, and most of the rate, and most of the issues going on around the world everywhere else.

Senator CARPER. All right. Thank you.

Dr. HINES. A VAT has enormous appeal. More than 140 countries have value-added taxes; of course the United States does not. We are the only—

Senator CARPER. Why do you suppose not?

Dr. HINES. Well, that is because we have not legislated one, and we should. There were no VATs until the late 1950s, and, depending on your definition, the mid-1960s. We just have not caught up with the times, and we need to. The VAT and territorial taxation, I agree with Dr. Avi-Yonah, are conceptually separate, however they share the feature that they are both the kind of tax that a country that is worried about competitiveness would adopt. If you are worried about competitiveness, you want a value-added tax and you also want a territorial system, but you could have one without the other.

Senator CARPER. All right. Thank you.

Please?

Mr. WEST. I agree with what everyone has said. At some risk, when you ask why we do not have one, I think it was Professor Graetz who made the observation that we do not have one because Democrats think it is regressive and Republicans think it is a tax increase, and we will get one when Democrats realize it is a tax increase and Republicans realize it is regressive.

Senator CARPER. That is a good note to end on. Thank you.

Senator HATCH. Well, I can tell you why I do not want it: it is because it just becomes a big government money spending machine, that is why. But I am very interested. I would be happy to read materials from any of you who would care to tell me why a value-added tax should work better than tax reductions and spreading the base and keeping revenue neutral and so forth. But I am not very enthusiastic about value-added taxes, to be honest with you. I am very interested that these experts are, so maybe I am missing something here.

Senator CARPER. When people this smart actually agree on something, we ought to drill down on it and listen to them.

Senator HATCH. Well, I know a lot of smart people do not agree, too.

Senator CARPER. I am sure that is true.

Senator HATCH. With that statement, I think we will end this hearing. Thank all of you for excellent testimony here today. I really have enjoyed listening to all of you. Each of you deserves a lot of credit for the intelligence that you have, and the ability to explain these matters to us lesser mortals up here on the committee. Thank you so much for being here, and we appreciate your testimony.

We will keep the record open for questions to be submitted and for anything you would care to submit to the committee that would

help us to understand these matters better. I have certainly enjoyed all of you and appreciate what you have done. Thanks so much.

With that, we will recess until further notice.

[Whereupon, at 11:02 a.m., the hearing was concluded.]

# APPENDIX

## ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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### TESTIMONY OF PROF. REUVEN S. AVI-YONAH HEARING ON INTERNATIONAL TAX ISSUES

U.S. Senate Committee on Finance

September 8, 2011

Chairman Baucus, Ranking Member Hatch, and distinguished members,

Thank you for inviting me to testify at this hearing. My name is Reuven Avi-Yonah and I am the Irwin I. Cohn Professor of Law and the Director of the International Tax Master of Law program at the University of Michigan Law School.

In this testimony, I would like to address options to reform the US international tax rules for both US corporations investing overseas ("outbound" taxation) and foreign corporations investing in the US ("inbound" taxation). I would like to make three points:

1. For outbound taxation, the preferred method of addressing the "lock out" problem is abolishing deferral while lowering the corporate rate to preserve competitiveness.
2. For inbound taxation, we should strengthen the thin capitalization rules and adopt other steps to preserve US taxing jurisdiction as the source country.
3. To police the boundary between US and foreign corporations, the definition of residence of US corporations should be changed to include all corporations managed and controlled from the US.

#### 1. Outbound Taxation

Several current proposals to reform the US international tax regime envisage permanently exempting dividends from foreign subsidiaries of US-based multinationals from the income of their US parents. This is a somewhat limited version of territoriality because Subpart F would still apply to some passive income of those Controlled Foreign Corporations (CFCs) (although the current tax rules, particularly the check the box rules, seriously limit the effectiveness of Subpart F).

This type of limited territoriality has recently been adopted by the United Kingdom and Japan, so the US is one of the few members of the OECD to continue to tax its multinationals on world-wide income. Thus, it is argued that the US should follow suit to maintain the competitiveness of its multinationals and to prevent US-based multinationals from moving to other countries.

However, the territoriality issue is not relevant to competitiveness. To the extent that taxes influence competitiveness (which is primarily determined by other factors), the competitiveness of US-based MNEs is determined by the overall

effective tax rate they face compared to the overall effective tax rate faced by multinationals based in our major trading partners. In particular, many of our competitor countries have much stricter CFC rules than the United States, so that their multinationals do not enjoy a competitive edge because of the limited territoriality that is allowed. Those who argue for territoriality for the United States, but who would leave today's holes in subpart F, are seeking much more than competitiveness – they are instead seeking a back-door exemption from the U.S. income tax that would cause U.S. multinationals to be taxed at much lower rates than the multinationals of competitive countries.

**There is no good data indicating that the effective tax rate faced by US-based MNEs is significantly higher than that faced by MNEs based in other OECD countries.** Moreover, there is reason to believe that the effective tax rate faced by US-based MNEs is **lower** than that faced by MNEs based in our trading partners.<sup>1</sup>

It is important that the much-overused word, “territoriality,” not be misunderstood. Territoriality is about whether US-based MNEs will pay taxes on dividends distributed by their CFCs. Since US-based MNEs typically do not receive such dividends unless the US tax is covered by foreign tax credits, this tax has no impact on their competitiveness because they do not pay it. There is no reason to believe that US-based MNEs face any limitations in transferring funds either among their CFCs (since such transfers are now exempt from Subpart F), or on their ability to raise capital in the US. Most US MNEs are presently accumulating large amounts of cash, and they can easily access the capital markets for more, at very low interest rates. The territoriality debate has no impact on these funding decisions.

If competitiveness is not a reason to adopt territoriality, is there another reason? The answer is a qualified yes: Territoriality (i.e., exempting dividends from CFCs) can address the trapped income problem. US-based MNEs have a significant amount of foreign source income (as much as \$1 trillion, based on financial statements) that they do not repatriate because it is earned in low-tax jurisdictions and will therefore trigger a US tax without foreign tax credit under current rules.

There are good reasons to believe that the trapped income problem is real. First, it is clear that US-based MNEs are leaving a lot of income permanently reinvested overseas. Second, when a temporary amnesty from the dividend tax was declared in 2004, over \$300 billion in such earnings were in fact repatriated. Third, the IRS has been combating various schemes (“Killer Bs”, “Deadly Ds” etc.) that were designed to repatriate foreign earnings while avoiding the dividend tax. These facts suggest

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<sup>1</sup> Reuven Avi-Yonah and Yaron Lahav, A Comparison of the Effective Tax Rates of the Largest 100 US and EU Multinationals, paper to be presented at the American Tax Policy Institute Conference on International Taxation and Competitiveness, Washington, DC, October 17, 2011. For a summary of earlier literature reaching the same conclusion see Jane G. Gravelle, International Corporate Tax Rate Comparisons and Policy Implications, Congressional Research Service Report (March 31, 2011).

that the tax on foreign source dividends impacts behavior while collecting little revenue.

However, this does not mean we have to adopt territoriality. The trapped earnings problem would also be solved if we repealed deferral, since then the foreign earnings would be subject to current US tax and there would be no tax on repatriations. We could do this without affecting competitiveness if we also reduced the corporate tax rate, as suggested by Senators Wyden and Coats in their tax reform proposal. Moreover, if we repealed deferral, our major trading partners may follow us, just like they followed us in adopting CFC legislation. The result would be a much better world, in which all major MNEs are subject to a single low tax on their worldwide earnings, without incentives to shift income to tax havens. The spread of CFC legislation (over 30 countries and counting) shows that there can be a race to the top in international tax, not just a race to the bottom.

In choosing between the two potential solutions to the trapped income problem (territoriality and ending deferral with a lower rate), the key consideration has to be protecting the US domestic corporate tax base. The main problem with territoriality is that it will significantly increase the incentives to shift income to low-tax jurisdictions. Currently, US-based MNEs know that such income shifting will result in more trapped income, and so they leave some income in the US. If there is no tax on dividends and foreign source income is exempt, the pressure on transfer pricing and the source rules will increase exponentially.

But what about our trading partners? The key point here is that our major trading partners in fact tax foreign source income more than we do, because their CFC rules are stricter. The typical CFC rules in the OECD, including the UK and Japan as well as the large continental European countries, take into account the effective tax rate in the source jurisdiction while determining whether the parent must include the income on a current basis. Thus, in our major trading partners, if (a) the source country has a low effective rate and (b) the CFC has no real business activities in that source country, the result is current taxation.

Our Subpart F, especially with the recent (post 1994) additions, is much more porous. It does not take the effective foreign tax rate into account (except to exclude “high taxed” income, which almost never happens) and it counts as “active” financial income and royalty income that can easily be earned in tax havens. Moreover, Subpart F (IRC 954(c)(6)) actively encourages the artificial shifting of income from high to low tax jurisdictions. As a result, despite our “world-wide” system and our trading partners’ “territorial” system, **our major trading partners tax the foreign source income of their MNEs more than we do.**<sup>2</sup> That is the reason they could

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<sup>2</sup> Avi-Yonah and Lahav, *supra*.

adopt territoriality without fearing too much income shifting, and also the reason US MNEs never migrate to any of our major trading partners.<sup>3</sup>

If we adopt territoriality without reforming Subpart F, the source rules (e.g., the passage of title rule) and transfer pricing, the result will be a significant erosion of the US domestic corporate tax base. Deferral is already one of our largest corporate tax expenditures (\$114.2 billion over 10 years).<sup>4</sup> We cannot afford to expand it further by converting it to an exemption, and the best course would be to get rid of it altogether in the context of an overall corporate tax reform. Such a reform should be done in a revenue neutral manner, and if the corporate rate is set low enough (e.g., 25%), it should not adversely affect the competitiveness of US-based multinationals.<sup>5</sup>

## 2. Inbound Taxation

Several recent studies have pointed out that while the US imports more capital than it exports, our international tax rules have focused primarily on preventing outbound profit shifting and paid insufficient attention to protecting the US corporate tax base when it is the source jurisdiction.<sup>6</sup> Thus, US subsidiaries of foreign multinationals are typically able to avoid paying significant amounts of US tax, while exploiting the US market.

There are several reasons for this problem:

- a. The thin capitalization rule (section 163(j)) is too generous and enables US subsidiaries of foreign multinationals to eliminate up to

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<sup>3</sup> Japan, for example, recently adopted much stricter CFC rules which tax all undistributed profits of a CFC if it is subject to an effective tax rate of less than 20%. Germany eliminated accelerated depreciation, made local taxes not deductible for federal tax purposes, and imposed an "interest barrier rule" under which interest expense incurred by a German parent corporation is deductible only if the parent on a standalone basis is no more highly leveraged than its CFCs. Brazil has completely abolished deferral since 2002. See papers by Takeshi Fujitani, Friedhelm Jacob and Linneu Mello, to be presented at the ATPI conference, *supra*.

<sup>4</sup> Estimate by the joint Committee on Taxation as reported in Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 10, 2011).

<sup>5</sup> The average effective tax rates for our major trading partners (weighted by the size of their economies) range from 27.2% to 28.7%. Gravelle, *supra*, summarizing earlier studies. As noted above, in most cases these effective rates reflect current taxation of low-taxed foreign source income of their CFCs. According to Gravelle's calculations, eliminating corporate tax expenditures and repealing the 2003 rate reductions for dividends and capital gains would permit a revenue neutral 10% reduction in the corporate tax rate. Gravelle, *supra*, Table 10.

<sup>6</sup> See, e.g., Bret Wells and Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, *Tax L. Rev.* (2011, forthcoming).

- half their gross income via the interest deduction, with no withholding under our tax treaties.
- b. There is no limit to the ability of US subsidiaries to pay deductible royalties to their foreign parents, again with no withholding under our treaties. Transfer pricing enforcement in this regard is not helpful because it is virtually impossible to find adequate comparables.
  - c. In general, the transfer pricing rules are enforced more strictly in the outbound than in the inbound context, and most of the IRS resources are devoted to outbound transfer pricing.
  - d. The ability of foreign multinationals to sell their US subsidiaries at a gain without paying US or foreign tax (e.g., the current sale of T-Mobile by Deutsche Telekom to AT&T) is another way of avoiding tax on what is economically US source income.<sup>7</sup>

One possibility to address this issue is to levy a compensatory base protecting surtax whenever deductible payments (including cost of goods sold) erode the US inbound tax base beyond a given point.<sup>8</sup> Alternatively, we could take several smaller steps:

1. The thin capitalization rules should be strengthened by imposing an overall debt to equity limit (e.g., 3 to 1), which is the thin capitalization rule adopted by most of our major trading partners.
2. The same limit could be applied to royalties.
3. Transfer pricing resources should be devoted to inbound as well as to outbound transactions. If we abolished deferral as suggested above, all the IRS transfer pricing resources could be devoted to this issue.
4. The US should impose tax on inbound capital gains of large participations, like many of our most important trading partners (e.g., China and India). US treaty policy should be changed to permit this.<sup>9</sup>
5. We should reconsider our treaty policy of being more residence oriented than the OECD model. Given that we are the world's leading capital importer and are likely to remain so for a long time, a more balanced approach that permits for example withholding

<sup>7</sup> See Reuven S. Avi-Yonah, Money on the Table: Why the U.S. Should Tax Inbound Capital Gains, 63 Tax Notes Int'l 41 (July 4, 2011).

<sup>8</sup> Wells and Lowell, *supra*.

<sup>9</sup> The following US treaties permit source taxation of capital gains from the sale of large participations: Australia, Bulgaria, Chile, China, India, Israel, Jamaica, Kazakhstan, Mexico, Norway, Russia, Spain, Sri Lanka, Thailand, Trinidad and Tobago, Turkey. In all of those cases, under our current rules the other country gets to tax these capital gains but we do not.

on interest paid to related parties (as in the OECD model) should be considered.

### 3. Corporate Residence.

In the new version of his Stop Tax Haven Abuse Act, Senator Levin once again proposed to modify the definition of residence for domestic corporations (IRC 7701). Section 103 of the Act seeks to “[s]top companies run from the U.S. claiming foreign status by treating foreign corporations that are publicly traded or have gross assets of \$ 50 million or more and whose management and control occur primarily in the United States as U.S. domestic corporations for income tax purposes.”<sup>10</sup>

This is not a new suggestion: In response to the inversions of the early 2000s, the Joint Committee on Taxation made a similar proposal.<sup>11</sup> Moreover, the “managed and controlled” test is well established in the jurisprudence of our trading partners (e.g., the UK) and is similar to the “place of effective management” which is included in all tax treaties based on the OECD model (e.g., in Article 8).

The original point of the managed and controlled proposal was to combat inversions, i.e., artificial migrations of US companies to offshore locations such as Bermuda. However, it is not clear that managed and controlled is necessary to combat inversions, for two reasons. First, IRC 7874 was enacted in 2004 and puts significant roadblocks in front of inversions, although it has loopholes that can be exploited. Second and more importantly, recent empirical research suggests that inversions are difficult for most US companies for both tax and non-tax reasons (e.g., shareholder reluctance to switch Bermuda for Delaware law for corporate governance purposes).<sup>12</sup>

Does “managed and controlled” still have a role to play in US tax policy if it is not needed to stop inversions? In my opinion the answer is a resounding yes. As Willard Taylor has shown, shell corporations are ubiquitous in US inbound and outbound international tax planning.<sup>13</sup> Adopting “managed and controlled” would be a significant deterrent to this type of planning, because it would require all foreign

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<sup>10</sup> Stop Tax Haven Abuse Act, S. 1346, section 103, 2011 WTD 134-37.

<sup>11</sup> Staff of the Joint Committee on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-02-05, TA Doc. 2005-1714 (Jan. 27, 2005). For the history of the idea see generally NYSBA Tax Section, Report on the Management and Control Provisions of the International Tax Competitiveness Act of 2011, 2011 TNT 21-22 (Jan. 31, 2011).

<sup>12</sup> Eric Allen and Susan Morse, Firm Incorporation Outside the U.S.: No Exodus Yet (2011).

<sup>13</sup> Willard Taylor, “Blockers”, “Stoppers”, and the Entity Classification Rules, 64 Tax Law. 1 (2010).

corporations to be actually run from abroad to avoid being re-defined as US corporations.

A recent UK case illustrates some of the anti-abuse potential of “managed and controlled.”<sup>14</sup> In that case, a Netherlands company was owned by a UK non-domiciled individual, who also served sometime as director (but not at the time of the relevant transaction). The UK CFC rules were inapplicable because the individual was not a UK resident for tax purposes. The Board met overseas and had full legal control of the company. Nevertheless, the UK court (including Commissioner John Avery Jones, a very tax-sophisticated judge) found that because the UK shareholder exercised de facto control of the company it was managed and controlled from the UK, and therefore was resident in the UK for tax purposes.

Imagine the consequences of adopting such a de facto control test in the US. It would further deter inversions, and would make it difficult for US-based hedge funds and nonprofits to use “blockers” to avoid effectively connected income and UBTI without actually operating the blockers offshore.<sup>15</sup> These are significant improvements over the current system.

But the biggest impact will be on Subpart F. If we abolished deferral, Subpart F would be unnecessary. But realistically, the debate between opponents and proponents of deferral and territoriality seems unlikely to produce real reform anytime soon. If we adopted “managed and controlled”, however, it would become much more difficult for US multinationals to avoid Subpart F merely by creating shell companies overseas and using one of the myriad loopholes in the existing rules.

To name some recent examples: Microsoft and Google would have to really run their Irish, Dutch and Bermuda CFCs from those countries to avoid having them recharacterized as US corporations. Caterpillar would not be able to avoid the base company rule by putting a shell operation in Switzerland while running the actual buying and selling of spare parts from Peoria. Using IRC 954(c)(6) to shift profits from high to low tax countries overseas (which in turn encourages shifting from the US to the high tax ones) would become much more difficult because the tax haven subsidiaries would really have to be run from the tax havens.

No loophole closer is ever perfect. There will, of course, be situations in which the tax benefit is so great that companies will in fact pay executives the extra compensation needed to persuade them to live in Bermuda. But in many other cases the hassle will be too much. I worked on a transaction once in which the entire carefully planned tax structure was jeopardized by the unwillingness of the designated CEO of an offshore joint venture to live outside the United States. Moving people is harder than creating corporate shells.

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<sup>14</sup> *Laerstate BV v. Commissioners*, [2009] UKFTT 209 (TC).

<sup>15</sup> See Taylor, *supra*.

Recent news reports as well as the careful Joint Committee study of transfer pricing from last summer have shown the extent of tax avoidance by US multinationals.<sup>16</sup> As stated above, the best solution would be to abolish deferral in conjunction with lowering the corporate tax rate. A second best solution would be to condition deferral on the foreign tax rate being about as high as the US rate.<sup>17</sup> But in the absence of such major reform, Congress would be well advised to at least adopt the managed and controlled test for US corporate residency. Such a test would make corporate tax avoidance by US multinationals significantly more expensive for the actual individuals who make the decisions to engage in such behavior. As indicated by the outcry against the personal responsibility provisions of Sarbanes-Oxley, putting the onus personally on the decision makers is the best deterrent.

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<sup>16</sup> Joint Committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing, JCX-37-10 (July 20, 2010).

<sup>17</sup> See Reuven S. Avi-Yonah, Testimony on Territoriality and Competitiveness, House Ways & Means Committee, May 24, 2011.



**Hearing Statement of Senator Max Baucus (D-Mont.)  
Regarding Tax Reform and International Taxation**

The Roman poet Ovid wrote, "A horse never runs so fast as when it has other horses to catch up to and outpace."

Advances in technology have resulted in a world in which business is more global. Today, a local business in my home state of Montana competes not only with the shop down the street, but with the company across the world.

We need to ensure that our international tax rules help U.S. businesses outpace their competitors and succeed in this global economy. This increased competition from around the world can – and must – lead us to be better.

American businesses increasingly sell their goods and services overseas, and foreign-based businesses compete aggressively for a share of the American market. U.S.-based multinational companies generate, on average, nearly half their income from foreign affiliates, compared to just 17 percent in 1977. And U.S. exports have more than doubled as a percent of GDP since 1960.

Foreign investment in the U.S. and the continued success of American business in the global marketplace are both essential to the health of the U.S. economy. Over the past ten years, foreign direct investment in the U.S. has totaled 1.7 trillion dollars, supporting five to six million American workers.

Foreign markets like Brazil, China and India offer lucrative new opportunities for U.S. workers and businesses. From 1990 to 2008, emerging economies grew at an average annual rate of 4.6 percent, but we need to have an international tax system that helps U.S. businesses take advantage of these opportunities to create more jobs here at home.

The tax code should not deter potential foreign investment in the U.S., and it should not hamper American competitiveness overseas. Nor should our tax code discourage companies from employing Americans abroad.

In July, we heard from U.S. business leaders who urged us to make our tax system more like the territorial tax systems of some of our major trading partners. I look forward to hearing from our witnesses today on that issue.

In addition, we have heard a great deal about U.S. multinational corporations avoiding taxation of their foreign earnings, often using tax havens. I hope that our witnesses will be able to discuss ways to address that issue.

No one doubts that our tax code should encourage economic growth and job creation. It should be fair, simple, efficient and certain.

This is particularly true in the international area, where the current rules are among the most complex and uncertain.

Right now, we are confronting a massive debt problem due, in part, to the 2008 financial crisis. As we work to emerge from that crisis, we must understand how our tax code affects international business and investment.

We must make sure our tax code does not encourage American businesses to relocate jobs overseas, and at the same time, the tax code must not put U.S. businesses at a disadvantage in foreign markets.

So let us work together to address these issues. Let us make our tax code more competitive and fair, helping our economy grow and creating more jobs for Americans in the global economy. And let us find creative solutions to help American businessmen and women outpace the competition.

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**STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER  
U.S. SENATE COMMITTEE ON FINANCE HEARING OF SEPTEMBER 8, 2011  
TAX REFORM OPTIONS: INTERNATIONAL ISSUES**

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following opening statement at a committee hearing examining effective solutions for international tax reform:

I would like to thank Chairman Baucus for calling this hearing today.

Working our way through the thicket of the international tax system is a critical step on the road toward comprehensive tax reform.

The United States international tax system dates back to the period between 1918 and 1928. As part of the Revenue Act of 1918, the United States became the first country to enact a system in which income taxes paid to a foreign country on income earned outside of the United States could be credited against U.S. income taxes. And ten years after that, in 1928, the League of Nations introduced draft model income tax treaties, the basis of which are still used today by the United States.

Well, a lot has changed since the 1920s.

At that time, the United States had been the world's largest economy for only about 30 years, having surpassed Great Britain in 1894. Today, the United States still has the world's largest economy, but just last year China supplanted Japan as the world's second largest, with predictions that China's economy will approach the size of the U.S. economy within 20 years.

Throughout the 1920s, the U.S. was running budget surpluses. Today, of course, the United States is running huge budget deficits.

In the 1920s, in the aftermath of World War I, the United States was a net creditor nation. By the mid-1980s, the United States became a net debtor nation — a status that it retains today.

During the 1920s, federal revenues averaged about four percent of GDP. In recent history, from 1971 to 2010, revenues have averaged 18 percent of GDP.

Yet despite the changes that have taken place in the United States and around the world since the 1920s, the basics of our international tax system have pretty much remained the same for over 80 years.

In any discussion of international tax reform, the fundamental issue remains unchanged. When income is earned in one country by a resident of another country, both the country where the income is earned and the country where the resident resides have legitimate claims to tax the income. Some tax scholars have referred to this issue as "the essential dilemma of international taxation." Arguably, one of the basic goals of an international tax system is to

resolve the competing claims of the source country and the residence country in order to avoid the double taxation that can result when both countries exercise their taxing powers.

In the 1960s, the competing international tax theories of capital export neutrality and capital import neutrality were developed. *Capital export neutrality* occurs when the overall burden of taxation on capital owned by residents of a particular country is the same whether that capital is invested at home or abroad. Capital export neutrality has generally been associated with worldwide taxation coupled with a credit for foreign income taxes.

In contrast, the theory of *capital import neutrality* holds that the international tax system should have equal tax treatment for all capital invested within a particular country regardless of the residence of the investor.

Capital import neutrality has generally been associated with territoriality – the idea that a particular country, as a general rule, should only tax income earned within its borders. Other international tax theories have developed over time, including the theory of *national neutrality* emphasizing the importance of American economic well-being in tax policy and, more recently, the theory of *capital ownership neutrality*, the goal of which is to have tax rules that do not distort ownership patterns.

Today, we are reading and hearing about some of the tax issues that U.S. multinational corporations face when doing business abroad — issues that many believe are due to our outdated international tax system. To illustrate, many U.S. multinational corporations earn money overseas, and typically want to bring that money back home to the United States. However, our international tax system discourages, and some would say penalizes, U.S. multinational corporations from repatriating foreign earnings by imposing a 35 percent residual U.S. tax at the time of repatriation.

As a result, several high-profile U.S. multinational corporations are sitting on large piles of cash earned from foreign operations. Yet these same corporations are actually borrowing money. One of the reasons for this borrowing is that their cash is trapped offshore, and these corporations will be subject to a 35 percent U.S. tax for repatriating their cash back to the United States. One way of alleviating the problem of cash that is trapped offshore is for the U.S. to reform its international tax rules by, for example, adopting a territorial tax system.

I am very interested to hear what our witnesses have to say today with regard to our international tax system and how reform of the system will advance the goals of simplicity, fairness, and economic growth, while increasing the competitiveness of US companies. In the modern global economy, we simply cannot afford to perpetuate policies that put *our* companies at a competitive disadvantage. We need to recognize that the world has changed, and we need to institute a tax system that will encourage companies to locate in our great nation.

We certainly do not need to place those that do so at a competitive disadvantage.

Again, Chairman Baucus, thank you very much for this important hearing, the latest in a series of critical discussions about tax reform.

Testimony before the Committee on Finance,  
United States Senate  
Washington, DC  
September 8, 2011

**Statement of James R. Hines Jr.**

Mr. Chairman and Members of this distinguished committee, it is an honor to participate in these hearings on international tax reform. I teach at the University of Michigan, where I am the Richard A. Musgrave Collegiate Professor of Economics in the department of economics and the L. Hart Wright Collegiate Professor of Law in the law school, and where I serve as Research Director of the Office of Tax Policy Research in the Stephen M. Ross School of Business. I taught for years at Princeton and Harvard prior to joining the Michigan faculty, and have been a visiting professor at Columbia University, the London School of Economics, the University of California – Berkeley, and Harvard Law School. I am a Research Associate of the National Bureau of Economic Research, the Research Director of the International Tax Policy Forum, a past Co-Editor of the American Economic Association's *Journal of Economic Perspectives*, and current Co-Editor of the *Journal of Public Economics*.

U.S. international tax policy has multiple objectives that are commonly thought to be in conflict. These objectives include promoting the well-being of American workers, maintaining and enhancing the competitiveness of U.S. firms in the international marketplace, and generating tax revenue necessary to finance government operations. In fact, sound tax policy that encourages the efficient use of economic resources advances all of these objectives simultaneously, so there need be no contradiction whatsoever in attempting to pursue them all – provided that U.S. policy adheres to the principle of efficiency.

The welfare of American workers is an obvious and central concern of U.S. economic policy. In a market economy such as the United States, workers are paid according to their productivities, reflecting that firms have choices about whether or not to hire. If firms can earn profits by employing additional workers at prevailing wages, they will do so; and they will not hire workers otherwise. Since this is simultaneously true of all firms in the economy, in a competitive market economy it follows that tax (and other) policies that enhance labor productivity increase demand for American workers and thereby improve wages and job prospects, whereas policies that reduce labor productivity have the opposite effect.

This fundamental insight of labor economics carries implications for the impact of U.S. international tax policy, since tax reforms will improve the prospects of American workers if they lead to improvements in worker productivity. Worker productivity is in turn a function of the extent to which firms are able effectively to deploy labor to contribute to output. Firms that face efficient incentives are more productive than firms that do not, so to the extent that U.S. international tax policy creates efficient incentives it will increase demand for American labor.

There is a widespread, and perfectly valid, concern that international capital mobility makes it costly and difficult to attempt to tax income earned by mobile business operations. What is less readily recognized outside of the economics literature is that the theory of international capital mobility implies that the burden of U.S. taxes imposed on mobile capital is borne largely if not entirely by factors that are fixed in the United States, of which by far the most important productive factor is labor. In a setting with highly mobile capital, greater business taxes depress labor demand and therefore depress wages, the mechanism being that greater business taxes discourage capital investment, thereby reducing labor productivity and wages. Complete capital mobility implies that wages bear the full burden of business taxes, plus

the burden of any inefficiencies induced by the tax system. Consequently, workers benefit most from a system that taxes businesses efficiently.

Tax revenue is also enhanced by efficient business taxation. This is true almost by definition, since efficient taxation raises revenue with the least collateral damage to the economy, thereby making it possible to generate tax revenue at the lowest possible cost. Since it is inevitably costly to raise tax revenue, and these costs typically limit the government's recourse to tax alternatives, it follows that efficient taxation has the greatest revenue potential of all of the feasible options.

All of this begs the question of what system of international taxation promotes efficiency from the standpoint of the United States. An efficient international tax system shares some features of tax systems in many of the countries with which the United States competes, specifically in exempting active foreign business income from U.S. taxation. Exempting foreign income from taxation would promote efficient ownership of productive assets, domestic and foreign, by U.S. businesses. Such a policy would thereby contribute to the vitality of the U.S. economy, the benefits of which would be felt primarily by U.S. workers in the form of greater employment opportunities and higher wages. Efforts to move in the other direction by limiting deferral of home country taxes or limiting the extent to which taxpayers can claim credits for foreign tax payments unfortunately would have the effect of inefficiently distorting ownership of productive assets, thereby reducing the productivity of U.S. business operations and reducing the welfare of U.S. residents, primarily American workers.

It may appear illogical that the way to contribute to economic activity and economic wellbeing in the United States is to lighten the taxation of foreign income. On further reflection, however, it is clear that the benefits of appropriate taxation of foreign income are simply

applications of commonly accepted (and perfectly valid) market principles that guide other economic policies. In an extreme case, it is obvious that the economic consequences of a policy banning U.S. firms from engaging in any foreign business activity would be disastrous, not only to the firms concerned but also to American workers, since modern businesses rely on foreign operations for significant fractions of their profitability, and these foreign operations contribute to the profitability of domestic operations of the same companies. If American firms were banned from foreign business activity, then they would shortly find themselves unable to compete effectively against British, Japanese, German, Canadian, and other companies not facing the same restrictions. Furthermore, even if they did not face such competition, the primary effect of such a silly ban would be to reduce their productivity and profitability, to the great detriment of everyone connected with American business.

The issue of banning foreign business activity is relevant because some of the very intuitive arguments advanced in favor of taxing foreign business operations more heavily than we do are also arguments that could be used to support banning foreign business operations altogether. We certainly do not want to do the latter, and therefore need to ask ourselves why we want to do the former. Of course these policies differ, and in fairness many of the concerns about taxing foreign business operations stem from an understandable desire to avoid subsidizing foreign business activity at the expense of domestic activity. But here is the point: exempting active foreign business income from domestic taxation is not a tax subsidy. This income is subject to taxation by foreign governments, and in order to earn foreign income, American firms must compete against other firms whose governments generally do not subject their foreign income to home-country taxation. These competitors drive down the rates of return to

investment available in low-tax foreign locations, making them not the bargain they appear from a simple comparison of tax rates.

The opportunity to earn income in low-tax foreign jurisdictions can be thought of simply as the opportunity to do business in places where a certain kind of cost – in this case, foreign tax cost – is lower. As a general matter, the United States benefits when our companies have low-cost business opportunities. If this were a different kind of business cost – the cost of a raw material, for example – there would be no discussion of the need to impose an offsetting charge on the foreign operations of U.S. companies that use low-cost materials abroad. We should think of the tax system similarly, and be appropriately wary about the desirability of subjecting foreign income to U.S. taxation in order to compensate for low tax rates in some countries.

The economic costs of a residence-based income tax system include that U.S. firms lose the opportunity to earn profits in foreign markets from which they are driven, which reduces the rate of return to domestic activities that make foreign operations otherwise profitable. It is this distortion to economic activity that produces the largest component of the efficiency cost associated with the U.S. regime of worldwide taxation. Compared to other countries, the U.S. system of taxing foreign income discourages foreign asset ownership generally, and in particular discourages the ownership of assets in low-tax foreign countries. Mihir Desai and I have estimated the net tax burden on American firms from the U.S. system of worldwide taxation to be in the neighborhood of \$50 billion per year, well exceeding revenue collections, since a significant portion of the net burden comes in the form of the associated efficiency cost.

One of the striking features of U.S. corporate taxes in 2011 is that, putting aside for the moment considerations of deferral and foreign tax credits, the United States imposes a higher effective tax rate on foreign business operations than on domestic operations. The reason is that

many important credits and deductions, including the research credit, immediate expensing of equipment investment, and the domestic production activities deduction, are limited to activities that take place in the United States. It is understandable that the United States wants to encourage business activity by reducing associated tax liabilities, but it is misguided to restrict the benefits to domestic activities – for the same reasons why it would be a mistake to ban foreign business operations altogether. Instead of subjecting foreign income to higher effective tax rates than domestic income, the United States should move in the opposite direction, join the rest of the capital exporting world, and exempt active foreign business income from home country taxes.

What would be the consequence of exempting active foreign business income from U.S. taxation? The greater productivity associated with improved incentives for asset ownership would enhance the productivity of factors that are fixed in the United States, primarily labor, and thereby increase the returns that they would earn. Statistical evidence suggests that the associated rise in outbound foreign direct investment would not reduce the size of the domestic capital stock, but instead increase it. This evidence includes a study of my own with Mihir Desai and Fritz Foley, examining the aggregate behavior of U.S. multinational firms over a number of years, but also includes aggregate evidence for Australia, industry-level studies of German and Canadian firms, and firm-level evidence for the United States, the United Kingdom, and Germany. Mihir Desai, Fritz Foley and I find that for American firms between 1982 and 2004, 10 percent greater foreign capital investment is associated with 2.6 percent greater domestic investment, and 10 percent greater foreign employment is associated with 3.7 percent greater domestic employment. Foreign investment also has positive estimated effects on domestic

exports and research and development spending, indicating that foreign expansions stimulate demand for tangible and intangible domestic output.

Hence there are good reasons to think that exempting active foreign business income from U.S. taxation would stimulate greater economic activity, and greater labor demand, in the United States. It follows that the opposite is also true: reforms that would curtail the ability of U.S. taxpayers to defer home country taxation of foreign profits or the ability to claim foreign tax credits would reduce the productivity of U.S. business operations and thereby reduce economic activity in the United States.

The appropriate scope of U.S. international taxation is another issue, specifically concerning the standard to apply in determining whether a corporation is resident in the United States for tax purposes. The current standard is based on the site of incorporation, which has the virtue of relative legal clarity and conformance with economic principles. Countries around the world differ in the criteria that they apply to determine corporate residence, some using systems similar to that used by the United States, and others basing corporate residence on the site of active management and control.

It would be a serious mistake for the United States to adopt a management and control standard. Quite apart from the knotty issue of determining the site of active management and control, the problem with defining corporate residence in this way is that doing so effectively transforms a portion of the corporate tax from a tax on the return to business assets into a tax on active management and control. This obviously discourages firms from locating management activities in a country that uses such a standard, which is not sensible if management activities are thought to be desirable. Furthermore, even if management activities do not relocate in response to the imposition of the tax, the economic impact of the tax on management activities

can still be substantial, since an activity managed in the United States (say, if the U.S. were to adopt such a system) would have much smaller scope as a result, because by virtue of the U.S. site of management, and therefore U.S. taxation, the burden on foreign operations is thereby increased.

There is an important question of the appropriate tax treatment of domestic expenses incurred by firms with foreign income, particularly costs that are difficult to attribute directly to income produced in certain locations; important examples include expenses for interest payments and general administrative overhead. Practices differ in countries around the world, and indeed, U.S. practice has varied over time, but the current U.S. tax treatment is squarely on the side of allocating domestic expenses between foreign and domestic income based on simple indicators of economic activity. Thus, for example, an American multinational firm with 100 of domestic interest expense is not permitted to claim as many foreign tax credits as is an otherwise-equivalent American firm without the interest expense, reflecting the theory that a portion of the borrowing on which interest is due went to finance foreign investment.

Expense allocation of the variety embodied in current U.S. tax law has a decided intuitive appeal. It carries the general implication that domestic expenses that are incurred in the production of foreign income that is exempt from U.S. taxation (as is the case, for example, of income earned in countries with very high tax rates, for which foreign tax credits are available) are effectively not permitted domestic tax deductions (via an equivalent reduction in foreign tax credit limits). While there is much to be improved in the details of the current U.S. rules governing expense allocation, the general structure of expense allocation is largely consistent with the rest of the U.S. system of attempting to tax foreign income in a manner that vaguely embodies the principle of capital export neutrality.

Taking as a premise that capital export neutrality is an unsatisfactory basis for taxing foreign income, and that the United States would instead prefer to join virtually all other capital exporting countries in exempting foreign income from taxation based on capital ownership considerations, then what kind of expense allocation regime properly accompanies the exemption of foreign-source dividends from domestic taxation? The answer is that domestic expenses must not be allocated at all, but instead permitted to be fully deducted in the country in which they are incurred.

A tax system that allocates expenses has the effect of distorting ownership by imposing a tax cost on foreign investment, since greater foreign asset ownership, or business activity, reduces the deductions a taxpayer is entitled to claim. The only sense in which this tax differs from a more conventional tax on foreign income is that it does not vary with the rate of foreign profitability. The fact that a simpleminded expense allocation rule acts just like a tax on foreign investment might at first suggest that those who design policy should seek alternative expense allocation systems that do not create these incentives. Unfortunately, there is no clever solution available to this problem: any system that allocates expenses based on a taxpayer's behavior will have the effect of influencing that behavior, in the same way that a more conventional tax would. An alternative system of tracing expenses, in which taxpayers determine and report the uses to which deductible expenses are put, does not have this feature but creates ample opportunities for tax avoidance. Hence policies designed to avoid taxing foreign income necessarily must forego allocating expenses incurred domestically.

This implication of foreign income exemption seems to run afoul of obvious objections from the standpoint of tax arbitrage. Why should the United States permit taxpayers to borrow in the United States, using the proceeds to invest abroad, and thereby earn income that is exempt

from U.S. tax while claiming deductions against other U.S. taxable income for the cost of their borrowing? Even the observation that this is exactly what many other countries do has the feel of not fully addressing this issue. The answer lies in the fact that greater foreign investment triggers added domestic investment, so from the standpoint of the U.S. tax system, the borrowing does not simply generate uncompensated interest deductions, but instead a domestic tax base that is equivalent to (quite possibly greater than) the tax base that would be forthcoming if the borrowing proceeds were invested domestically by the same entity that does the borrowing.

If the goal of a tax system is properly to raise revenue while offering appropriate economic incentives, and these are understood to include efficient incentives for capital ownership, then the simple exemption of foreign income from taxation is insufficient without accompanying expense allocation rules. Exempting foreign income from taxation gives taxpayers incentives to allocate their resources to maximize after-local-tax profits only if there is no unwinding of these incentives through expense allocation that depends on where income is earned or where other expenses are incurred. Permitting full deductibility of domestic expenses need not be viewed as a daring step. The same logic that underlies the efficiency rationale behind exempting foreign income in the first place also implies that expenses should be deductible where incurred.

There are sure to be both revenue concerns and other concerns associated with a reform that exempts foreign income from taxation and permits deduction of domestic expenses. Removal of U.S. taxation of active foreign business income would increase the importance of effective enforcement of the transfer pricing rules and other rules designed to protect the U.S. tax base. It would, however, be a mistake to maintain the current regime of taxing foreign income simply out of concern over base erosion of this type, given that there are many ways of

addressing these issues. For example, elimination of U.S. taxation of active foreign business income might be accompanied by allocating significant additional resources to the Internal Revenue Service for use in international enforcement. Given the alternatives before us, it would be a serious mistake to think that enforcement concerns alone dictate the maintenance of an inefficient system of taxing worldwide income.

The inefficiencies associated with the current U.S. system of international taxation include not only distortions to the ownership of productive assets, but also the financing of firm operations. It has been widely documented that the current system of repatriation-based taxation discourages repatriations, as a result of which firm financing is less than optimal, to the detriment of productive management of operations. In a very real sense the U.S. system of taxing international income can be viewed as a tariff on international transactions, with all of the distortions and inefficiencies for which tariffs are known. Economic growth in the modern era, the prosperity of the country and its prospect for future prosperity, relies on international transactions, impediments to which reduce national income, and reduce the prospects for American workers.

Testimony of Scott M. Naatjes  
Vice President and General Tax Counsel  
Cargill, Incorporated

United States Senate  
Committee on Finance

**Tax Reform Options: International Issues**  
September 8, 2011

Chairman Baucus, Ranking Member Hatch, and Members of the Committee, I appreciate the opportunity to testify before you today on International Tax Reform.

My name is Scott Naatjes. I received my Juris Doctorate and Masters in Business Administration from Yale University, and my undergraduate degree in economics from Brigham Young University. I served as a law clerk to the Honorable Judge J. Daniel Mahoney of the United States Court of Appeals for the Second Circuit, worked at a large law firm, and have been a practicing tax attorney at Cargill for 15 years. I currently serve as Cargill's Vice President of Tax and General Tax Counsel. In that capacity, I am responsible for Cargill's global tax planning, compliance, audits, and controversies and oversee a staff of over 240 tax professionals in 30 different countries, most of whom are either CPAs or lawyers, and many of whom also hold graduate tax or business degrees.

In this testimony, I will provide a brief overview of Cargill and its place in the global market. I will then explain how our outdated international tax system and current academic and policy debates about that system fail to fully consider how the world has changed since the system was put in place. Finally, I will outline key principles that should govern efforts to reform U.S. international taxation policies and rules.

I will specifically address the following points:

1. The U.S. economy, wealth, and tax base grow both through capital deployed here and from capital deployed abroad but managed here. We need tax policy that is competitive and favorable to both.
2. Global capital markets are sufficiently large and liquid to ensure that competitive investments in every country will be funded, with or without U.S. MNCs.<sup>1</sup> U.S. international tax policy consequently cannot materially influence whether capital is deployed or business is conducted in a foreign country. It can only influence whether a U.S. MNC, a Foreign MNC, or a different investment vehicle will own or manage that business.
3. The global competition for managing capital invested and businesses conducted outside of the United States should be among the most important U.S. international tax policy considerations. When U.S. MNCs manage foreign investments and businesses, they create U.S. headquarters jobs, domestic economic synergies, and a larger U.S. tax base.
4. Most developed countries have adopted territorial tax systems that do not tax dividends or gains from the active conduct of foreign business operations of their MNCs, because they want to attract and strengthen their MNCs, attract capital from abroad, and create the headquarters jobs and synergies associated with managing a global enterprise in their country.

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<sup>1</sup> A United States multinational corporation (or "U.S. MNC") is a multinational group of companies with a U.S. corporate parent company. A foreign multinational company (or "Foreign MNC") is a multinational group of companies with a non-U.S. corporate parent company.

5. The current U.S. worldwide tax system, anti-deferral rules, and expense allocation rules make U.S. MNCs inefficient investment vehicles for non-U.S. business opportunities.
6. Congress should enact a territorial tax system, reform subpart F,<sup>2</sup> and overhaul the expense allocation rules, all consistent with international norms.
7. Key international tax provisions that make the U.S. international tax system more competitive, such as section 954(c)(6),<sup>3</sup> are scheduled to expire in December. Congress should extend those provisions now while it considers tax reform.

## **Cargill**

### *Background*

Cargill is an international producer and marketer of food, agricultural, financial and industrial products and services. Founded in 1865, our company employs over 130,000 people in 63 countries. Nearly 50,000 of our employees reside in the United States, including approximately 5,000 who work in our headquarters offices located near Minneapolis, Minnesota. With annual sales of close to \$120 billion and earnings close to \$4 billion in our last fiscal year, Cargill is one of the largest private companies in the world and one of the largest U.S. MNCs.

The backbone of Cargill's global business is connecting farmers and ranchers with food companies and consumers. We help farmers grow and then take to market nearly anything that is produced on a farm or ranch, from grains and oilseeds, to palm fruit, cocoa beans and livestock. We turn those products into food and food ingredients that help nourish the world. Our products and services include animal nutrition and feed, commodity trading and processing, energy and transportation, farmer services, and financial and risk management. Many of the foods and ingredients you eat and use every day—from flour, meat and eggs, to cooking oils and sauces, to the specialty ingredients on your food or healthcare labels, like xanthan gum and carrageenans—are made by Cargill or from products Cargill buys and sells.

### *Cargill and the Global Market*

Approximately 60% of Cargill's sales and income are from active business operations outside the United States. As the world outside the United States continues to increase its capacity to produce food and its population grows, Cargill's global footprint will also need to grow.

Like our competitors, we build grain elevators, crush facilities, food production plants, and port facilities around the globe. We compete for the opportunity to serve farmers, customers, consumers, and markets. We pay local taxes, including not only income taxes, but export taxes, value-added tax ("VAT"), and other excise and sales and use taxes. We also build roads, schools and infrastructure to support our investments and enhance the communities where we do business.

Many of our competitors are Foreign MNCs organized in jurisdictions with both low home-country income tax rates and territorial tax systems. Unlike our competitors, Cargill bears home-country tax burdens on its foreign income and investments. First, Cargill is subject to a second layer of income tax on our non-U.S. earnings when we repatriate those earnings to the United States. Second, the U.S. expense allocation rules create U.S. tax costs attributable to our non-U.S. investments even when we do

<sup>2</sup> Chapter 1, Subchapter N, Part III, Subpart F of the Internal Revenue Code of 1986, as amended (the "Code"). See generally sections 951 through 964. Unless otherwise noted or clear from the context, all references to "section" or "sections" in this document are to sections of the Code. All references to "Treas. Reg. §" are to sections of the Treasury Regulations promulgated under the Code.

<sup>3</sup> Section 954(c)(6) is the provision that exempts dividends, interest, and royalties paid from the active income of a non-U.S. affiliate from U.S. taxation under subpart F.

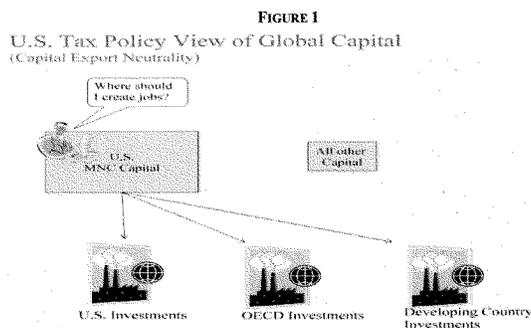
not repatriate earnings from those investments to the United States. Third, the U.S. subpart F rules make deploying and managing risk on our non-U.S. earnings expensive and complex. Those differences constitute a significant disadvantage to Cargill as it tries to compete in the global marketplace.

### The Current U.S. Tax System and the Global Economy

#### *A System for a World that No Longer Exists*

The U.S. income tax system for non-U.S. income was adopted at a time when (i) the United States was the dominant provider of global capital and U.S. MNCs were a dominant vehicle for foreign direct investment (“*FDI*”); (ii) U.S. corporate income tax rates were equal to or lower than the tax rates of our trade partners; (iii) Foreign MNC competitors of U.S. MNCs were also subject to global income taxation; (iv) indirect tax and other local burdens were relatively immaterial; and (v) the United States had the most stable economy and currency and the best educated work force in the world.

Figure 1 illustrates the outdated conception of global capital investment that still drives U.S. tax policy today.



Much has changed. The United States, over the last five years, has provided approximately 20% of global FDI and represents a much smaller portion of total global capital available to fund non-U.S. investment opportunities.<sup>4</sup> U.S. corporate tax rates are nearly 15 percentage points higher than the average rates paid in EU and other OECD-member countries.<sup>5</sup> The United States stands nearly alone in its taxation of worldwide income. Indirect and other local non-income taxes such as the VAT have increased in importance and scope in almost every country. Finally, the economic strength of our Foreign MNC competitors continues to grow as global markets become more efficient. In today’s world, our international income tax system puts us at a competitive disadvantage.

Several commentators have claimed that comparisons of global effective tax rates between U.S. MNCs and Foreign MNCs demonstrate that the U.S. tax system does not create a material disadvantage for U.S. MNCs. At the same time, they sometimes argue that if we adopt a territorial system, jobs and taxable income will flee overseas. But if our system does not prevent U.S. MNCs from matching their non-U.S. competitors’ tax rates, then why would U.S. adoption of a territorial system change behaviors?

<sup>4</sup> Organization for Economic Cooperation and Development, “FDI in Figures,” (Jul. 2011). Note that over the past five years roughly 65% of U.S. FDI has been made in OECD member countries. The U.S. stock of FDI abroad as of 2010 was roughly \$3.6 trillion, less than 2% of the total amount invested through total global capital markets.

<sup>5</sup> European Commission Directorate-General for Taxation and Customs Union & Eurostat, “Taxation Trends in the European Union” (2011), p. 31. This comparison includes U.S. federal and state and local taxation.

On the other hand, if the current U.S. system effectively imposes burdens that hinder U.S. MNCs from growing abroad, then the system, by definition, makes companies like Cargill less competitive.

The reality is that the U.S. tax system puts U.S. MNCs, like Cargill, at a competitive disadvantage *vis-à-vis* our non-U.S.-based competitors. To succeed abroad, U.S. MNCs must maintain sufficient efficiencies and synergies to overcome the additional tax burden of our worldwide international tax system and in most cases pay a cadre of high-priced lawyers and CPAs to help them manage or defer the U.S. tax cost.

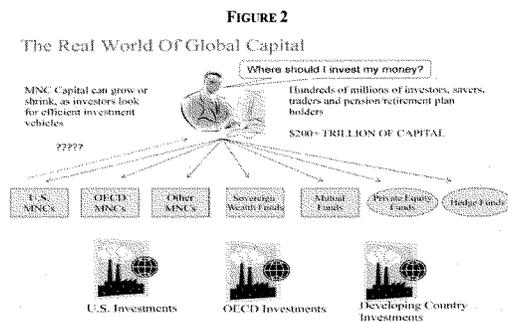
The United States cannot stand still or further expand its worldwide tax system and hope the rest of world will follow. The world has tried our dated tax model and abandoned it for a system that reflects the reality of today's global capital markets.

#### *The Competition to Manage Capital in Today's Global Market*

We live in a world in which barriers to capital mobility and international trade have diminished. If global trade agreements, labor markets, natural resources, business climate, regulatory environment, and cost structures make a country the optimal location for any particular investment, capital markets will ensure that investment is eventually made there.

The total wealth invested through global capital markets exceeds \$200 trillion.<sup>6</sup> Approximately \$80 trillion is held by funds, such as hedge funds, private equity funds, sovereign wealth funds, pension funds, and insurance funds.<sup>7</sup> Every competitive project in the world will be funded by someone—most likely someone from outside the United States.

Figure 2 illustrates how capital is actually allocated and invested today. U.S. MNCs are relatively small players in the rapidly expanding global capital market.



In this worldwide economy, U.S. MNCs like Cargill do not control the world's capital or dictate where it is invested. MNCs are not endowed with capital, they must compete for it. U.S. tax policy cannot materially influence whether soybeans will be grown and processed in South America, textiles will be fabricated in Central America, steel will be made in China, or electronics will be manufactured in Taiwan. U.S. tax policy can, however, determine whether U.S. MNCs, like Cargill, will be competitively positioned to attract or retain the capital to fund and manage such investment opportunities.

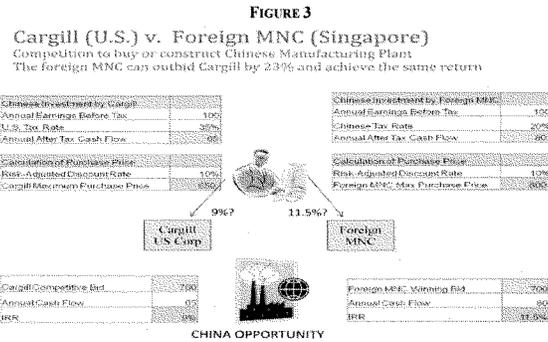
<sup>6</sup> McKinsey Global Institute, "Mapping Global Capital Markets 2011," (Aug. 2011), p. 2.

<sup>7</sup> Marko Maslakovic, "Fund Management 2010," The City UK (Oct. 2010).

*The U.S. Tax System's Impact on Competitiveness*

A simple example illustrates the impact that the current U.S. tax system has on the ability of a U.S. MNC like Cargill to compete for capital and win acquisition contests.

Assume that a business expansion (the "Investment") is being explored by Cargill and a Foreign MNC in China that cannot be economically made in any other country. Assume that Cargill and the Foreign MNC each has a 10% required return on investment and would generate similar pre-tax returns from the Investment. Assume that local tax planning opportunities are available to all well-advised investors so that the profit from the Investment in China is expected to be taxed at approximately a 20% rate. Assume further that Cargill pays 35% U.S. income tax on the earnings from the project, with no deferral on the Investment's return, while the Foreign MNC would pay only the local 20% income tax rate, because it is located in a jurisdiction with a territorial system. As illustrated in Figure 3, Foreign MNC can outbid Cargill by roughly 23% and earn the same 10% rate of return. It could also match any bid offered by Cargill and achieve a higher return.



If Cargill upped its bid to 700 to try to compete, Foreign MNC could equal our bid and promise an after-tax rate of return 2.5 percentage points higher than Cargill's. Even if we assume that Cargill could defer its U.S. tax bill for 10 years and ignore all other possible U.S. tax costs under the U.S. expense allocation or subpart F rules, Foreign MNC could still outbid Cargill by over 13% and generate the same after-tax return.<sup>8</sup> Thus, the efficiencies and synergies of a U.S. MNC like Cargill relative to our Foreign MNC competitors need to be substantial to succeed in today's economy.

*The Consequences of Not Bringing the U.S. Tax System into the 21<sup>st</sup> Century*

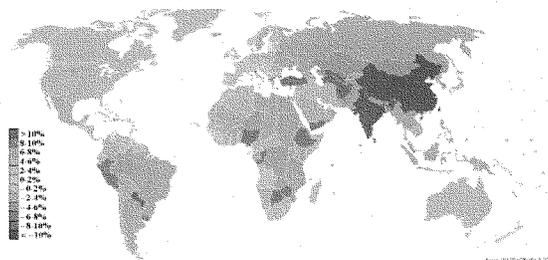
If the U.S. economy could sustain a 3% growth rate, it would double in roughly 25 years. Based upon current growth trends, India and China are expected to double in size every 7 years.<sup>9</sup> According to

<sup>8</sup> After 10 years, Cargill would have accumulated \$800 of earnings & profits and \$200 of income tax credits. The residual U.S. tax of \$150 would be paid in year 10 [(\$800+\$200 gross up) x 35% - \$200 of credits = \$150]. The present value (the "PV") of Cargill's cash flow for the first 10 years would be \$434, using a discount rate of 10%. The PV of the \$80 10-year annuity for Foreign MNC would be worth \$492, using the same discount rate. This \$58 differential is equal to 13.3% [(\$492-\$434)/\$434 = 13.3%].

<sup>9</sup> Central Intelligence Agency, World Factbook 2011 (2011). Map available at [http://en.wikipedia.org/wiki/List\\_of\\_countries\\_by\\_real\\_GDP\\_growth\\_rate\\_\(latest\\_year\)](http://en.wikipedia.org/wiki/List_of_countries_by_real_GDP_growth_rate_(latest_year)).

the *Economist*, in 1960, it took 20 years for one-third of the *Fortune* Global 500 (the “*Global 500*”) to change.<sup>10</sup> Today, it takes 4 years.<sup>11</sup>

FIGURE 4  
Projected Global GDP Growth Rates



In just under 10 years, BRIC-based companies in the Global 500 nearly quadrupled, increasing from 16 to 58.<sup>12</sup> In contrast, the number of Japanese companies in the Global 500 declined by almost 40% during the last decade.<sup>13</sup> The number of U.K. companies declined by 25%.<sup>14</sup> Both countries responded by joining the rest of the world and abandoning their worldwide tax systems for territorial systems.<sup>15</sup>

FIGURE 5  
Global 500 Corporations Resident in the U.S. & Key Trading Partners 2000 vs. 2009

Country	2000		2009		Current Tax System
	Number of Companies	Tax Rate	Number of Companies	Tax Rate <sup>16</sup>	
U.S.	179	39%	140	39%	Worldwide with Credit
Japan	107	43%	68	41%	95% Exemption (enacted in 09)
U.K.	38	30%	27	28%	100% Exemption (enacted in 09)
France	37	38%	40	34%	95% Exemption
Germany	37	52%	39	33%	95% Exemption
Korea	12	31%	14	22%	Worldwide with Credit
Switzerland	11	35%	15	24%	100% Exemption
China	10	33%	37	25%	Worldwide with Credit
Italy	10	40%	10	30%	95% Exemption
Netherlands	10	35%	12	25%	100% Exemption

There were 22% fewer U.S. MNCs in the Global 500 in 2009 than in 2000 (179 in 2000 vs. 140 in 2009).<sup>17</sup> The United States has responded, in part, by passing tax laws to prevent U.S. MNCs from expatriating.<sup>18</sup> This wall-building approach to a non-competitive tax system cannot stem the tide of global growth.

<sup>10</sup> Adrian Wooldridge, “Global Heroes,” *The Economist* Newspaper, Mar. 14, 2009.

<sup>11</sup> *Id.*

<sup>12</sup> Barbara Angus, Tom Neubig, et. al., “The U.S. International Tax System at a Crossroads,” 127 *Tax Notes* 45 at 56-57, Table 2 (Apr. 5, 2010).

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> 2010 top statutory tax rate, including subnational taxes.

<sup>17</sup> *Id.*

<sup>18</sup> See Brett Wells, “What Corporate Inversions Teach About International Tax Reform,” 127 *Tax Notes* 1345 at 1351 (Jun. 21, 2010) (summarizing recent anti-inversion provisions).

For U.S. MNCs, maintaining the innovation and vision to compete and thrive in this rapidly changing world will be difficult. Asking them to do so while subject to current U.S. international tax policies would be imprudent.

#### **Current Tax Policy Debates: Stuck in the Sixties**

##### *Is Offshore Growth by U.S. MNCs Synergistic with or a Substitute for U.S. Jobs?*

Academics and policy makers spend a considerable amount of time worrying about whether overseas expansion by U.S. MNCs is synergistic with or a substitute for U.S. investment and employment.

The answer is interesting, but it is the wrong question. Since global capital markets will ensure that efficient non-U.S. investments are made with or without a U.S. MNC, the correct question is whether it will be relatively more synergistic to U.S. employment and the U.S. tax base to have the non-U.S. investment made by a U.S. MNC or Foreign MNC.

Even if the investment at issue is a non-U.S. manufacturing facility that supplants a U.S. manufacturing facility, U.S. employment and economic strength are enhanced if the investment is owned and managed by a U.S. MNC (rather than a Foreign MNC). Employment income and other economic synergies from managing non-U.S. invested capital and businesses create significant sources of revenue for the U.S. tax base (federal, state, and local) and make our U.S. enterprises stronger and more competitive. Almost all of our major trading partners have understood this reality and modified their tax systems accordingly.

Considerable sums of tax revenue are at stake. U.S. MNCs, like Cargill, maintain staffs of highly paid, highly educated, and uniquely skilled employees at headquarters in the United States. The charitable and educational organizations those employees support have helped create the civil society we enjoy, fund both basic and higher learning, and further important social causes.<sup>19</sup> The associated tax base for individual income tax, social security tax, sales and use tax, estate tax, and property taxes contributes materially to funding local and federal government activities. Income tax collections alone from Cargill's 5,000-person headquarters can equal several hundred million dollars in a single year.

In addition, expansion and acquisition outside the United States increase competitiveness and market intelligence. For Cargill, each successful expansion or acquisition adds to our overall efficiency. The knowledge arising from a presence in all corners of the global market provides us the business intelligence we need to compete and win. Enhanced competitiveness attracts capital. Management of that capital at U.S. headquarters, like ours in Minneapolis, creates high-paying, knowledge-based jobs and related support jobs that strengthen our economy and country.

In many cases, overseas expansion also (i) helps a U.S. MNC grow and profit from its U.S. intellectual property, (ii) creates economies of scale and cost efficiencies for its U.S. plants, (iii) provides access to non-U.S. markets for U.S. production, or (iv) creates knowledge that benefits all other markets. In other cases, a specific manufacturing or other business opportunity may simply be best-placed closer to suppliers or customers. In all cases, we are better off as a nation when our market-leading U.S. MNCs manage the non-U.S. investment and capital associated with those projects.

##### *Misplaced Fear Regarding Transfer Pricing*

Some academics and policy makers have also expressed concern that a territorial system will cause U.S. taxable income to artificially shift overseas through transfer pricing practices that cannot be adequately challenged by the Internal Revenue Service (the "IRS").

<sup>19</sup> Cargill's headquarters donations to United Way exceeded \$4.5 million in 2010 alone.

This concern is legitimate, but should be replaced by a more important consideration. MNCs are here to stay. In the long-run, we can choose either to be home to the headquarters of these far-flung and successful enterprises, or to become a host to satellite subsidiaries of large Foreign MNCs. Foreign MNCs rarely set up their headquarters here, even more rarely own their intellectual property here and only own their non-U.S. subsidiaries through the United States because of historical accident.

Transfer pricing controversies between governments and MNCs are unavoidable. By establishing an international tax system competitive with global norms, we can increase the likelihood that our future disputes will be primarily with U.S. MNCs, rather than Foreign MNCs that would otherwise replace them.<sup>20</sup> The arm's-length standard that governs transfer pricing is not perfect, but it is generally consistent with underlying business economics. The more the economics of a global MNC are controlled and managed from the United States, the greater our likelihood as a nation of enjoying a larger share of the MNC's income. We cannot fear a territorial system for U.S. MNCs because of transfer pricing. It is another reason to embrace it.

*Trapped Cash: A Symptom of a Failed System*

Commentators and policy makers widely view the large offshore cash reserves of many U.S. MNCs as a problem created by our international tax system. Some have then concluded that a worldwide tax system without deferral would solve the problem as effectively as a territorial system, because if all non-U.S. income is taxed at the time it is earned, there would be no tax at the time of repatriation, and therefore no disincentives to paying dividends.

This thinking misses the point. First, while it is true that a surgeon can eliminate the pain of an arthritic knee either through knee replacement surgery or by amputating the leg, the real issue is not the pain, it is mobility. We want our U.S. MNCs to be mobile and competitive, not permanently disabled. The trapped offshore cash is the symptom of the real problem: our antiquated tax system. Simply getting cash home through a more burdensome system only makes it worse.

Second, the offshore capital has not disappeared. It is deposited or invested with global financial institutions and markets. If a competitive project should be funded in the United States, the financial resources are available to any number of global competitors through those institutions and markets. In our current tax system, U.S. MNCs are less efficient than Foreign MNC competitors because they cannot nimbly deploy their cash and therefore service their creditors or shareholders around the globe. However, robust capital markets will ensure that the capital generally finds its way to the correct country. Again, our policy for taxing non-U.S. income will not drive the ultimate allocation of capital between countries. It will only determine whether U.S. MNCs can competitively manage that capital.

Finally, a U.S. MNC is not a repository for capital. It is simply a pass-through vehicle for shareholder capital. Once the cash is returned to the United States, to the extent capital markets are efficient, it is little more likely to be deployed in the United States than when it was deposited with a bank offshore.

*The Effective Tax Rate: Important but Widely Misunderstood*

The media routinely publishes sensational articles about low effective tax rates ("*ETR*"), often alleging that the United States' high statutory rates do not really matter since no company pays them or

<sup>20</sup> The IRS has full access to all financial information, legal documents, books, records, and key officers of the global enterprise and *all* of the records of a U.S. MNC's non-U.S. subsidiaries. Matching this advantage against a Foreign MNC may in some cases be difficult.

that U.S. MNCs are evading tax burdens globally. While a U.S. MNC's ETR, over time, is an important measure of its global income tax burdens, a few clarifications are needed.

First, ETR is a financial accounting concept. It measures income tax on U.S. GAAP income, not tax on U.S. taxable income. Differences between GAAP and taxable income frequently occur. Unless you know a company well, it is easy to misinterpret the significance of a low ETR in any given year. One company's ETR can be inflated by a non-deductible GAAP write-off. Another can have an artificially understated ETR because it wins a tax controversy for which it had taken a prior financial reserve or uses a tax credit or loss carry forward that it thought would expire.

Second, the U.S. GAAP rules in some cases are biased towards showing a low ETR. For example, a U.S. MNC is not required to accrue its future U.S. tax burden on non-U.S. earnings if it has no current plan or need to pay dividends.<sup>21</sup> But plans are uncertain things. A U.S. MNC's low ETR consequently has a material probability of being temporary, while a Foreign MNC with a territorial system is likely to have a low ETR that is permanent. U.S. MNCs might in some cases have ETRs that look like the ETRs of Foreign MNCs in territorial systems. But U.S. MNCs bear possible future tax burdens that Foreign MNCs do not. U.S. MNCs (unlike Foreign MNCs) also bear planning costs and structuring complexities due to those burdens, in addition to the costs related to the U.S. expense allocation rules or accelerated taxation under subpart F.<sup>22</sup>

Third, some have examined the U.S. effective income tax rate on non-U.S. income, erroneously ignoring the non-U.S. income taxes paid.

Fourth, each country in which an active business is conducted extracts sufficient resources from business to fund itself. ETR does not measure the full social burden of doing business. Whether the business system is burdened by a VAT, a wealth tax, an excise tax, social taxes on labor, withholding taxes, turnover taxes, export taxes, an income tax, or public works (including in some cases building roads, homes, utilities and schools),<sup>23</sup> no U.S. MNC running a real business outside the United States operates without helping to fund society. The fundamental error of using ETR as a measure of tax burden, and any worldwide tax system predicated upon *income* tax credits, is that it only takes into account one measure of the social burden.

Finally, the *marginal* tax rate on any given investment is what matters for planning purposes, not the ETR of the enterprise. For example, I am willing to pay more for a lower yielding municipal bond because the income earned is tax-exempt, than I would pay for a bond with otherwise equivalent terms. If I buy both, my ETR is lower than 35%, but the income from the taxable bond is still taxed a 35% rate, and I cannot buy it at an inflated price that assumes a lower rate if I want to stay in business.

<sup>21</sup> Accounting Principles Board, Opinion 23 (Apr. 1972), as amended and codified under ASC 740-30-25.

<sup>22</sup> There are many technical and economic complexities to the U.S. foreign tax credit rules that are beyond the scope of my testimony. One simple example is the unintended double taxation caused by the U.S.'s weak dollar policy. As the dollar devalues, U.S. MNCs bear additional U.S. tax to repatriate earnings because foreign taxes are translated to U.S. dollar in the year paid, while earnings are translated in the year repatriated. Whenever the dollar devalues against the currency of a foreign country, the effective foreign tax credit rate on earnings in that country declines. Paying a high foreign tax rate is no sure protection from double taxation.

<sup>23</sup> The economic burdens of various direct and indirect taxes are borne differently by capital, labor and consumers depending upon a host of local and global economic factors. But U.S. MNCs play a key role and bear real burdens for business and social taxes in many countries by acting as the reporting and withholding agents for governments, often at great cost and risk since the local rules are complex, the reporting requirements difficult, and any error leads to direct liability for not only the tax, but large penalties and high rates of interest. Failure by a few down-stream suppliers to remit VAT to the government can cost a U.S. MNC VAT credits that consume the entire profit from operations for an entire year. In many countries, local tax risks and economic burdens with respect to indirect taxes can be far greater than for income taxes. In some jurisdictions and markets, U.S. MNCs (and other large companies) compete against small local companies that routinely flout the rules, creating unfair competition and causing the U.S. MNCs to economically bear a large measure of the tax burden for what otherwise would be considered a pass-through tax.

Similarly, tax savings in one country cannot compensate for an unequal tax burden in another. A tax incentive in Thailand or a section 199 deduction<sup>24</sup> in the United States both lower a U.S. MNC's global ETR, but do not lower U.S. or local taxes on income earned in China. Stated differently, if my marginal tax cost in China is 35% while my competitor's is 20%, my tax incentive in Thailand or my section 199 deduction in the United States cannot make me more competitive in China. Thus, ETR matters over time and is evidence of efficiency, but it should not be mistaken for competitiveness on any given project or in any particular market.

Income tax is a cost, much like any other. Each investment must stand on the marginal revenues and costs (including tax) that it generates. Global success in business, due in part to lower taxes, may provide business synergies that make a project competitive in China, but a company cannot import its low offshore ETR.

In Cargill's case, we face competitors who routinely achieve ETRs more than 10 percentage points below ours. A material portion of this differential is driven by the U.S. worldwide tax system that burdens our competitive edge abroad.

*Understanding Foreign Holding Companies (Rather than Demonizing Them)*

Like most U.S. and Foreign MNCs, Cargill holds many of its non-U.S. operating companies through holding companies, some of which make and sell goods, but others that primarily hold capital interests (equity and debt) in other non-U.S. subsidiaries. These holding companies further many important commercial, treasury management and tax objectives. A number of popular misconceptions should be cleared up about such companies.

First, large U.S. MNCs like Cargill do not "hide" profits or cash in tax havens. U.S. MNCs like Cargill are subject to full disclosure of all activity and bank accounts associated with non-U.S. holding companies. The IRS annually receives for each non-U.S. controlled company full GAAP financial statements as well as a Form 5471, 8865 or 8858 that disclose the same types of information available from a company organized in the United States. In addition, any passive or portable income earned in those companies is subject to immediate U.S. taxation under our subpart F rules. Large U.S. MNCs (including Cargill) are under continuous audit by the IRS, during which all of that information is reviewed.

Second, in the case of a U.S. MNC like Cargill, the earnings and wealth of the holding companies is almost exclusively derived from dividends, interest, and royalties paid from active foreign business. Thus, although a holding company may not be paying significant tax in its local jurisdiction, all of the earnings distributed or paid to it were subject to the normal tax rules of countries where an active business is conducted.

Third, holding companies often play a vital role in global risk management, providing U.S. MNCs with protection through bilateral investment protection treaties and income tax treaties that reduce both non-U.S. operating and tax risks.

Fourth, because the U.S. tax system imposes a tax on dividend repatriation, U.S. MNCs must either bear the costs of U.S. taxation and complexities of the U.S. foreign tax credit rules, or leave excess equity in a foreign country. Over-capitalizing non-U.S. subsidiaries with equity increases country risks, foreign currency exchange risk, global funding costs, and foreign taxes.

U.S. MNCs like Cargill and their Foreign MNC competitors invest in risky countries where

<sup>24</sup> The "section 199 rules" provide a deduction for income attributable to certain domestic production activities.

currency controls, expropriation risk, and legal volatility necessitate capital mobility. Many of those countries are crucial to the world food supply, so Cargill, in order to compete in its market space, must have a presence in such places. If Cargill were unable to move its capital in and out of such countries when necessary without incurring home country tax costs, then it would be disadvantaged relative to its Foreign MNC competitors that face no such home-country tax costs.

Finally, every host country determines the total tax and social burden it places on a business enterprise. To compete in a country, a U.S. MNC can afford to pay and bear that tax and social burden, and no more. If a host country allows deductions for interest expense on debt equal to two-thirds or less of total capital and arm's-length royalty payments to offshore affiliates, then prudently structured companies will need to earn a portion of their return from business in that country through interest and royalty income offshore, to achieve a competitive return for their shareholders. Many Foreign MNCs in territorial systems can earn this income free of home-country tax. U.S. MNCs, like Cargill, need holding companies and other exceptions to general U.S. international tax rules to achieve that result.

*Check-the-Box Rules and Section 954(c)(6)*

The check-the-box rules and section 954(c)(6) look-thru rules allow U.S. MNCs, through holding companies, to capitalize non-U.S. operating subsidiaries and temporarily operate without imposition of U.S. tax in a manner similar to their Foreign MNC competitors. All of this planning has legal costs and risks. Repealing the check-the-box rules or failing to extend section 954(c)(6) would simply cause U.S. MNCs to pay more non-U.S. tax, which would actually (under our foreign tax credit rules) reduce U.S. tax revenues. At the same time, U.S. MNCs would incur significant internal and external costs and fees to restructure their operations in ways that seek to mitigate the loss of those provisions, in some cases moving back to more complex structures that existed prior to the enactment of those rules. Even Congressional reluctance to make section 954(c)(6) (and other international provisions) permanent forces U.S. MNCs to review and reconsider their structures each year in costly exercises that divert resources from more productive activities. Most Foreign MNCs do not bear similar costs.

Repealing the check-the-box rules or not extending the effective date of section 954(c)(6) would in the long-run cause U.S. companies to pay more foreign tax and expose more capital to foreign risk, making U.S. MNCs less competitive in the global marketplace.

Over time, global capital markets will ensure that the most efficient enterprise manages the business and controls the capital, including the company that can use the optimal tax structure for a country. In the long-run, it benefits the United States if its companies are able to operate in a way that allows them to pay the same amount of non-U.S. tax as their Foreign MNC competitors.

*Misguided U.S. Expense Allocation Rules*

Consistent with international norms, every U.S. MNC must follow transfer pricing rules to recharge expenses of U.S. affiliates to non-U.S. affiliates that benefit from those expenses. Virtually every other country stops here. But the United States goes a step beyond and requires that the expenses of the U.S. affiliates that *could not* be recharged under an arm's-length standard nonetheless be considered related to the generation of non-U.S. source income under formulaic methods prescribed in nearly 100 pages of technical expense allocation rules.<sup>25</sup>

Under our foreign tax credit rules, no U.S. MNC can claim a single penny of foreign tax credits until it generates more non-U.S. source income than all of the formulaically allocated expenses. The foreign tax credit is then limited to 35% of the excess. For companies with significant domestic interest

<sup>25</sup> See Treas. Reg. §§ 1.861-8 through -17.

expense, the annual expense allocation can easily exceed hundreds of millions of dollars in a single year. Until a company with this issue earns more non-U.S. source income in the United States than its allocated expenses, it cannot credit a single dollar of foreign income taxes, and any net deficit carries forward forever. Thus, a portion of that company's interest expense, U.S. management costs, and U.S. R&D expenses often become effectively non-deductible as the company expands outside the United States, even if it incurs greater proportionate expenses in its non-U.S. affiliates. As a result, marginal tax rates on non-U.S. source income are unpredictable and business planning is difficult for the U.S. MNC.

The worst of the formulaic expense allocation rules is our water's edge apportionment of interest expense that allocates U.S. interest expense to foreign source income based on the ratio of (i) non-U.S. assets in the U.S. group (including all retained earnings in non-U.S. companies) over (ii) total assets in the U.S. group.<sup>26</sup> Even if a U.S. MNC has relatively greater debt leverage and interest expense offshore, so that U.S. indebtedness could not be viewed as sustaining foreign operations, the U.S. rules disregard that fact and allocate interest expense to foreign source income anyway. In some cases, the interest expense allocation rules can have the perverse effect of making U.S. MNCs not only less competitive abroad, but at home, since their Foreign MNC competitors can borrow in the United States to fund a U.S. investment and deduct 100% of their interest expense against U.S. source income, while a U.S. MNC cannot.<sup>27</sup>

In 1992, former House Ways and Means Committee Chairman Rostenkowski stated that "[t]he proper apportionment of interest expense may be the number one tax problem for U.S. multinational corporations attempting to conduct business effectively abroad."<sup>28</sup> In 1999, the Chief Tax Counsel of DaimlerChrysler testified that the U.S. expense allocation rules were among the reasons they became a German company.<sup>29</sup> It has been 13 years. Little has changed. Congress passed a global interest expense apportionment rule in 2004, but its effective date continues to be postponed to raise tax revenue.<sup>30</sup>

Some have proposed keeping the U.S. expense allocation rules even if the United States adopts a territorial tax system, and then making the allocated expenses permanently non-deductible.<sup>31</sup> Not surprisingly, that could actually raise U.S. tax revenue relative to our current system. But it would do so with a tax cost based upon rules unrelated to non-U.S. income or business performance, making business planning more difficult and U.S. MNCs even less competitive.

#### *The Burdens of Subpart F*

The U.S. rules for currently taxing income earned by a non-U.S. corporation as though it were distributed to its U.S. shareholder are codified in subpart F of the Code. In my experience, they are the

<sup>26</sup> See Treas. Reg. §§ 1.861-9 through 14T.

<sup>27</sup> Note that there are also contrary examples. The point is that the interest expense allocation rules are un-economic, inconsistent with global norms, and create distortions.

<sup>28</sup> 138 Cong. Rec. H3817-03 (daily ed. May 27, 1992) (statement by Rep. Rostenkowski introducing H.R. 5270, "The Foreign Income Tax Rationalization and Simplification Act").

<sup>29</sup> Hearing on Impact of U.S. Tax Rules on International Competitiveness before H. Comm. on Ways and Means, 106th Cong., 1st Sess. (June 30, 1999) (testimony of John L. Loffredo, Vice President and Chief Tax Counsel, DaimlerChrysler Corporation) ("The U.S. tax system puts global companies at a decisive disadvantage. . . . In many cases, the U.S. taxpayer can NEVER fully utilize all of the foreign taxes paid by its subsidiaries to offset the U.S. tax on foreign earnings. The result is taxation of at least a portion of the earnings twice, by two countries. . . . The main reason for this problem is that a U.S. company has to apportion many of its domestic business expenses (especially interest expense) against its foreign source income.")

<sup>30</sup> Section 864(f)(6) postpones the effective date to tax years beginning after Dec. 31, 2020. Although the provision was originally to come into effect for the first tax year beginning after Dec. 31, 2008, Sec. 3093 of the Housing Act of 2008 (Sec. 3093, PL 110-289, 7/30/2008) delayed the provision so that it was not to come into effect until the first tax year beginning after Dec. 31, 2010. Sec. 15 of the 2009 Assistance Act (Sec. 15, PL 111-92, 11/6/2009) further delayed the provision so that it was not to come into effect until the first tax year beginning after Dec. 31, 2017. The 2010 HIRE Act delays the effective date of the worldwide interest allocation election to tax years beginning after Dec. 31, 2020. (Code Sec. 864(f)(5)(D) as amended by 2010 HIRE Act sec. 551(a), Code Sec. 864(f)(6) as amended by 2010 HIRE Act sec. 551(a)).

<sup>31</sup> See, e.g., Joint Committee on Taxation, "The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses," p. 10 (Jun. 22, 2006).

most far reaching, complex and punitive in the world. A few examples of situations where those rules overreach include the foreign base company sales and foreign base company services rules of subpart F that impose U.S. tax on active sales and services income regardless of the number of employees and assets directly employed in the business. Subpart F's foreign personal holding company rules measure passive income by specific category, making the capital loss or foreign exchange loss on a bond or share of stock non-deductible against the interest or dividend income of the very same bond or stock.<sup>32</sup> The rules allow no carryback or carryforward of losses except in special cases, and separate subpart F income from foreign tax credits if the foreign country has a mandatory tax year different from the rule mandated for U.S. reporting purposes. Timing and character issues create more confusion and difficulty. If the real ETR on a U.S. MNC's subpart F income is only 35%, it's a miracle.

#### *Failed System Based upon Place of Incorporation*

A Foreign MNC could maintain a headquarters in the United States without subjecting its non-U.S. affiliates to the United States' byzantine international tax rules. Some U.S. MNCs that expatriated prior to the tax law changes noted above have done so. This only proves the point that the U.S. international tax system is broken. If the parent company of a MNC group is organized in Bermuda (or any other country), no tax is imposed by the United States on income earned by its non-U.S. subsidiaries. If the parent company of the group is organized in Delaware, then all of the income of its non-U.S. subsidiaries will someday be taxed in the United States and, as noted above, it can never leave without incurring substantial tax costs.

Today, any tax advisor allowing a client to form a U.S. company for the purpose of owning non-U.S. subsidiaries needs to find a new career. An investor putting capital into a new U.S. corporation (that has not yet created global commercial synergies) to fund investments outside the United States may need a new financial advisor. When our largest and most important global companies are trapped in an international tax system that no one would choose and for which there are many good alternatives, it's time for a new tax system. We need not compel a slow death upon our largest and most venerated U.S. MNCs simply because of their historical accident of incorporating in the United States at a time when our tax system was competitive and there was a much smaller global marketplace.

Some might suggest that we tax companies based upon place of management to bring the non-U.S. income of Foreign MNCs into the U.S. tax net. But this would only put at risk their headquarters jobs too. We can't afford to lose the economic synergies created by MNCs' headquarters or the taxes paid by their employees.

At some point, the United States will need to face the fact that it cannot and should not collect tax on active income earned in a different country. We need to invite rather than repel global managers of MNCs.

#### **The Future**

The United States needs a competitive system for taxing non-U.S. income that follows world norms, including adopting a territorial system, repairing subpart F, and abandoning our expense allocation rules.<sup>33</sup> This is not a time for American exceptionalism.

<sup>32</sup> The passive income categories of section 954(c)(6) include (a) dividends, interest, royalties, rents, and annuities, (b) gains from property transactions, (c) gains from commodity transactions, (d) foreign currency gains, (e) income equivalent to interest, (f) income from notional principal contracts, etc.

<sup>33</sup> The worldwide norm for regulating interest expense deductions in both territorial systems and worldwide systems is to rely upon thin capitalization rules. I am not aware of another country that has adopted U.S.-style expense allocation rules. Some countries adopting territorial systems tax 5% of otherwise participation exempt earnings as a simple surrogate for expense allocation.

Some academics and policy makers continue to call deferral of U.S. taxation on active income of a U.S. MNC's non-U.S. subsidiaries a "subsidy" for moving jobs overseas, when other host countries to MNCs never tax such dividends and gains at all. We have also seen recent changes to long-standing international tax rules that allowed U.S. MNCs to compete abroad and proposals to enact many others. Rather than further weakening U.S. MNCs, Congress should extend key expiring international provisions like section 954(c)(6) now, while it considers overall tax reform.

#### **The Difficulty with Revenue-Neutral Corporate Tax Reform**

Meaningful tax reform that enhances the efficiency of our tax system and the future growth and strength of our economy will always have winners and losers. The objective for corporate and business tax reform consequently should not be revenue neutrality by type of tax, but distributional equality (or even greater progressivity) for Americans as a whole. The real goal is to fund our government as fairly and efficiently as possible.

Any changes we make to our system for taxing income earned outside the United States that makes us competitive in managing foreign business and capital will result in an overall U.S. tax reduction on non-U.S. income. It will create many positive effects for our economy and will expand other tax bases. But if such a reform were to keep overall corporate tax revenue neutral, it will shift some of the corporate tax burden to domestic source income, and thus to purely domestic business. This shift in tax burden to domestic U.S. business could reduce U.S. competitiveness with other countries to retain and attract the capital and businesses we want invested and built here in America. As a nation, we consequently may not be happy with either revenue-neutral international or domestic corporate income tax reform.

But the problems do not end here. Any base broadening we do to make a lower tax rate on domestic corporate income revenue neutral will eliminate business tax benefits also available for pass-through entities whose income is taxed to their owners at individual rates. Corporate tax reform that broadens the base and lowers the corporate tax rates will consequently increase the tax burden on domestic income to owners of pass-through entities, many of which are small businesses owners.

Thus, revenue-neutral corporate income tax reform may simply be a misguided idea.

#### **Who Should Pay for International Tax Reform?**

The burden of corporate income tax is borne by capital providers, employees, and consumers. Capital providers, employees and consumers may in some cases be the same people.<sup>34</sup> They may be wealthier or poorer than small business owners or grandmothers, but in every case, at the end of the day, they are people. The distributional effects of adjusting the business tax system can be adjusted through the manner in which we tax real flesh and blood individuals.

Thus, by proposing international tax reform, I am not suggesting that rich people pay less tax while poor people pay more. We need to design our tax system to maximize the economic pie that we, as Americans, all share, and then achieve our vision of fairness within that system. This could mean changes to individual tax rates and preferences, or even the types of tax we all pay.<sup>35</sup> These are hard

<sup>34</sup> We envision corporate income tax borne simply by business executives, Wall Street bankers, and other wealthy capital providers at our peril. The more accurate mental image may very well be a union employee. As capital and product markets globalize, labor's share of the corporate tax burden increases. The extent of this shift is hotly debated, but the direction is not. See William C. Randolph, "International Burdens of the Corporate Income Tax," Congressional Budget Office, August 2006.

<sup>35</sup> For example, it is difficult to find an economist who likes the economic impact of an income tax. A consumption, VAT, or sales tax that replaces parts of the income tax might be more favorable to our long-term economic prosperity. It could be designed to make the overall tax

issues for constituents to understand and difficult issues for economists to model, but they are critical to our long-term fiscal health. If meaningful tax reform were easy, economically or politically, we would have done it already.

#### **Conclusion**

U.S. MNCs do not need to expatriate, be acquired by a non-U.S. competitor, or invert for the era of the U.S. MNCs to end. In today's global economy, capital will migrate to those investment vehicles that can manage and integrate non-U.S. investments with the highest return.

With each non-U.S. investment opportunity lost, each acquisition of new capital by Foreign MNC competitors, and with the emergence of each new non-U.S. competitor with capital not subject to a U.S. tax burden, the U.S. MNCs' relative scale declines and future prospects darken. As U.S. MNCs decline, their domestic suppliers and partners suffer. Their highly compensated, highly skilled headquarters jobs and the associated base for income tax, social security tax, sales and use tax, and property taxes tied to managing a global enterprise diminish.

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system equally or even more progressive than our current system. Again, if the overall type of taxation of any particular economic measure is inefficient, we can change it. We can then use rates and other types of tax to achieve our fairness goals.

**Testimony of Philip R. West****United States Senate  
Committee on Finance****Tax Reform Options: International Issues  
September 8, 2011**

Chairman Baucus, Ranking Member Hatch, and distinguished Members of the Committee:

My name is Philip R. West. I am a partner with the law firm of Steptoe & Johnson LLP and lead the firm's tax practice. I have been practicing tax law for over twenty-five years, predominantly in the international tax area. Although I have spent most of my career in private practice, I served as the Treasury Department's International Tax Counsel from 1997 to 2000, I started my career in tax enforcement at the Justice Department, and I served as a law clerk to the Honorable Judge Carolyn Miller Parr of the United States Tax Court. My testimony today is a product of my experiences in government as well as my experiences advising large and medium-sized businesses, but I appear before you on my own behalf and not on behalf of my firm or any client.

**International Tax Reform Generally**

Near the end of my tenure at the Treasury Department, a wise man said to me: "There is no objective truth in international tax policy. Ultimately, the choices are political." Having lived through years of polarizing arguments about corporate and international tax reform and after considering various arguments from all perspectives, I have come to the view that no one group—whether liberal or conservative; whether business leaders, labor unions, or think tanks; academics, economists, or practitioners—has a monopoly on thoughtful ideas for tax reform.

It has been twenty-five years since the United States was last able to achieve fundamental tax reform. Since then, we have seen periods of sustained discussion and hope for reform, but then retrenchment, as the usual players on all sides continue to take what appear to be pre-determined roles and dig themselves deeper and deeper into positions from which they cannot (or will not) back out. At the same time, the United States' tax code, including its corporate and international rules, has become more out of step with the rest of the world and in need of comprehensive reform.

So how can we advance the debate and achieve fundamental tax reform in the twenty-first century? I believe there are a number of critical components. First, an acknowledgement that there is no clear right or wrong answer, that people come to the debate with competing policy orientations, and that we all may have to sacrifice some sacred cows. In addition, we should consider both (a) empirical research, in particular (if possible) with respect to the macroeconomic effect of alternative policies on domestic job and economic growth, and (b) real-world experiences of those who are responsible for paying taxes and complying with the system. I believe that, with these components, Congress can achieve pragmatic comprehensive tax

reform that encourages economic growth in the United States, helps our corporations compete in overseas markets, and promotes fiscal sustainability.

#### **A Framework for Evaluating International Tax Reform Options**

There are five criteria that are often used to evaluate tax rules:

- Revenue
- Equity, or Fairness
- Economic Efficiency
- Competitiveness, and
- Simplicity

There is widespread agreement that our international tax rules do not score well when measured against these criteria. Although I recognize that Congress is faced with an extremely difficult task when grappling with our international tax rules, and should not be faulted for the laws we currently have, I am confident that we can do better.

#### **Revenue and Simplicity**

A tax system that raises little revenue but imposes high compliance costs is a bad tax system. Our international tax system does both—it imposes little tax on foreign earned income, but taxpayers face high levels of complexity and incur high compliance costs to reach that result. Moreover, the IRS devotes significant and increasing resources to auditing and enforcing the international tax rules despite the modest revenue raised even after those resources have been expended.

The larger point, perhaps, is that corporate revenues overall are a relatively modest percentage of total collected revenue, ranging from around 12 to 15 percent in the past ten years, and comprising 8.9 percent of collected revenue in 2010, the most recent year for which data are available. This figure might suggest to some that corporations should be paying more tax, but what I find most significant about the data is that they show that changes to the corporate income tax system will not have a significant impact on our serious budget problems, at least without unprecedented and probably unsustainable corporate tax increases. In fact, for the reasons discussed below, I believe there is a stronger case that the corporate tax burden should be reduced, although I understand the political difficulties that might be associated with such a result.

## Equity (Fairness) and Competitiveness

### C Corporation Taxation Generally

When considering equity or fairness, the issue is whether those who are similarly situated have similar tax burdens. Under the tax rules, otherwise similarly-situated U.S. businesses may have vastly different tax burdens depending on their form. In general, only incorporated entities (specifically those referred to as “C” corporations under the tax code) pay tax. Other business entities, including partnerships, LLCs, S corporations, mutual funds like regulated investment companies and offshore funds, and real estate investment trusts, generally do not pay tax. Rather, their owners generally pay tax on the earnings of these vehicles.

Over 90% of U.S. businesses operate in non-taxable (pass-through) form, earning almost half of the nation’s business income. The vast majority of the other half of the nation’s business income is earned by large publicly traded entities. So with only minor exceptions, business income is earned by either non-taxable entities or publicly traded entities. One question for policy makers is whether this public trading status warrants such significantly different tax treatment. My view is that it does not.<sup>1</sup>

### C Corporation Taxation of Foreign Income

Starting from this observation, that there is no compelling justification for treating publicly traded U.S. corporations so differently than other businesses, we should next inquire whether U.S. multinational corporations are treated inequitably compared to foreign multinational corporations. In my view the answer is yes, but it is a more complex question.

First, tax rates are but one part of a complex web of costs and other burdens that factor into competitiveness, and the United States consistently ranks high in terms of overall competitiveness. Second, although the statutory tax rates of other countries may be lower, the data is thin regarding effective tax rates of U.S. corporations compared to corporations based in other countries. Perhaps the most comprehensive study found broadly comparable rates on average, but that study produced results comparing large pools of companies differentiated by geography, and there seems to be ample anecdotal evidence that important U.S. corporations have higher effective tax rates than their foreign competitors.

Third, even if overall tax burdens (i.e., on both U.S. and foreign earnings) are higher for U.S. companies, the tax burdens on only foreign earnings may not be. And although there has

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<sup>1</sup> A related point: although we speak of corporations as taxpayers, corporations pass on their tax burdens so that the incidence of the corporate tax falls on others such as shareholders and employees. Just how much of the incidence falls on shareholders and how much on employees is a matter of debate, but the extent to which the literature estimates that the corporate tax is borne by labor appears to be increasing. As I understand the economics, this follows in part from the fact that the world is becoming increasingly globalized. To the extent that labor bears the burden of the corporate income tax, we should be considering the potentially adverse impact of that tax on job creation and wages.

been some work concluding that the U.S. rules for taxing foreign income are more restrictive than those of our competitors, comparisons among countries on that score are complex, requiring not only an analysis of foreign tax rules, but also an analysis of how those rules apply in practice. Despite these limitations, it seems clear that the United States has very limited company for its tax system. It is almost a cliché now, and known even to those who formerly had only the most passing familiarity with international tax, that the United States has one of the highest corporate tax rates in the OECD. Further, very few other countries formally eschew exemption of foreign earnings (although in practice, the U.S. system can operate similarly to and sometimes more advantageously than a formal exemption system).

And finally, even though U.S. tax rates may be higher than in other countries, it can be deceptive to compare tax rates in countries like the United States that provide significant services to tax rates in other countries that provide far fewer services. On the other hand, imposing worldwide taxation on an entity simply because it has filed its organizational documents in the United States does not seem logical. (A “managed and controlled” test would be less arbitrary, but could do more harm than good considering that (a) the corporate inversions it might otherwise stop have already been stopped by other legislation, (b) historic U.S. tax policy for offshore funds that might be caught by the rule has been to encourage them to have U.S. management and investments, and it is not clear why this policy should change, and (c) a managed and controlled test could adversely affect the ability of large non-U.S. based multinationals to locate their managerial talent in the U.S.)

#### Economic Efficiency

Exactly six months ago today, this committee held a hearing at which eminent economists such as Alan Auerbach discussed economic inefficiencies of the corporate income tax generally. In the international realm, discussion of the economic inefficiencies of the corporate income tax has been a history of dueling efficiency ideologies: capital export neutrality and capital import neutrality (with national neutrality and capital ownership neutrality also being less well established neutralities on opposite sides of the debate). Under rules embodying capital export neutrality, foreign business operations of a U.S. corporation are not taxed more lightly than U.S. business operations. Therefore, those rules are said to promote efficient deployment of capital because they remove tax as an incentive to move abroad. Under rules embodying capital import neutrality, foreign business operations of a U.S. corporation are not taxed more heavily than similar foreign business operations of a non-U.S. corporation. Those rules are said to promote efficient deployment of capital because they remove tax as a disincentive to invest abroad.

Michael Graetz and Jim Hines, among others, have questioned the utility of this framework for viewing the issue. One problem I have with it is that it presupposes a degree of influence in the business decision-making process that most of my Tax Director clients would envy. Although in some cases companies may decide for tax purposes whether they will locate a movable business inside or outside the United States, it is more common that companies decide how much they can afford to pay to fund a foreign opportunity that is not logical to be conducted in the United States for business reasons. In a world in which foreign business opportunities are growing faster than domestic business opportunities, this is only going to become more common.

And in such a world, the competitiveness argument in favor of capital import neutrality gains force and the historic presumption in favor of capital export neutrality loses force.

**Specific Recommendation: Territoriality**

It is another cliché that the government cannot create enough jobs to pull us out of a recession; it is the private sector that must do so. In that context, the question arises why corporations are not creating jobs now, when they seem to have enough retained earnings to spend and expand. The answer in my view lies in the corporate analogue to consumer confidence. The greater the confidence that a company's hiring will not lead to overcapacity, the greater its willingness to hire. And where there cannot be a lot of confidence that the economy will be very strong very soon, we should err on the side of providing incentives and creating an environment that is business-friendly. And in the international tax context, one way to do so would be to move further towards a territorial tax system.

**Impact of Territoriality on U.S. Jobs and the Deficit**

Will territoriality push jobs abroad? And will it increase our deficit?

First, most tax planning involves shifting income abroad, not shifting jobs abroad. Job location decisions are made primarily for non-tax reasons. When tax is a factor, it is primarily because the U.S. tax is higher than the tax elsewhere. Admittedly, this is because our system today allows U.S. corporations to effectively exempt from U.S. tax through long term deferral the income generated from their foreign workers. Unless we repeal those rules, however, which would put us even further away from our trading partners, we will not change the incentives to shift jobs abroad by moving to a more formally territorial system. What such a move can do, however, is simplify compliance (although it may well put more pressure on source and transfer pricing rules), and create a more business-friendly environment. And repealing our current system of tax deferral would, in my opinion, adversely affect a multinational's appetite for taking on the risk of hiring additional workers in an uncertain economic climate. Therefore, moving to a territorial system is not likely to adversely affect U.S. job creation, while repeal of deferral might.

Will moving to a territorial system increase the deficit? Shifting to a territorial system can raise or lose revenue depending on the system's design. But a system that reduces tax burdens, and therefore loses revenue, would incentivize corporations to hire, while a system that increases tax and raises revenue would not. Would this be terrible for the deficit? First, I agree with those who favor stimulus now, and disagree that austerity is the right answer for a recession economy. And second, if there is no political appetite for a tax reform that loses revenue, there are numerous offsets that could be found, including an increase in individual tax rates, especially on higher income earners. Compared to historic standards, our individual tax rates today are low, and raising them would move our tax system closer to those of the historically most successful foreign economies, which have a high individual rate and a low corporate rate. Therefore, moving to a territorial system does not have to increase the deficit and, if it does, we should be willing to live with that in the short term.

**Select Inbound and Individual International Tax Issues**

We mentioned above the subject of U.S. exceptionalism in international tax, and I would be remiss not to mention two aspects of our system, one historic and one recent, that put the United States at the high water mark of exceptionalism. These are (1) our system of taxing citizens on their worldwide income irrespective of whether they reside here, and (2) FATCA, or the Foreign Account Tax Compliance Act provisions of the 2010 HIRE Act.

The United States taxes not only domestic corporations on a worldwide basis, but it also taxes its citizens on a worldwide basis, even if they do not live here, even if they have never lived here, and even if they have no connections to the U.S. at all other than a passport, have no underlying U.S. tax liability, and are honestly unaware of their obligation to file a U.S. return. While it certainly can be argued that U.S. tax compliance is a small price to pay for a U.S. passport, it is probably the case that the vast majority of non-resident citizens fall into that category of persons who have no U.S. tax liability but nevertheless have to file U.S. tax returns. And simply giving up U.S. citizenship often cannot be done without creating adverse tax consequences. Therefore, with the IRS making great strides in focusing its resources where they can do the most good, it may be time for the United States to re-examine its tax rules for non-resident citizens.

In doing so, the United States cannot encourage high-income tax evaders, which was the guiding objective of FATCA. FATCA, however, is imposing compliance costs of over a hundred million dollars for each of many institution, even where there is little likelihood that the affected institution has or will encourage tax evasion. And in a cruel irony, little of this money is going to be spent in the United States to create U.S. jobs. Rather, it will be spent abroad, creating jobs there.

**Conclusion**

Our corporate and international tax rules need reform to encourage both U.S. economic growth and to help U.S. companies compete in the global market. Although the United States is an attractive investment environment on many fronts, with a strong legal and regulatory framework, infrastructure, economic stability, and skilled workforce, our tax code does not encourage companies to grow in the United States for several reasons:

- First, the U.S. corporate tax rate is significantly higher than the rates of our trading partners. As foreign markets and labor have become just as important to companies as U.S. markets and labor, it becomes increasingly difficult for the United States to justify such a high corporate tax rate.
- Second, the tax code is complex, with various tax incentives that have high compliance costs, are often a source of companies' disputes with the IRS, and may benefit some industries over others.
- Third, the frequent use of expiring tax provisions, as well as the complexity of the tax code, creates uncertainty for taxpayers. For example, although the United States

offers a tax credit for research and development, the credit is enacted on a temporary basis only. When evaluating potential future investments in the United States, businesses must assume that the credit will expire as scheduled. Thus, when they compare the potential return from an investment in the United States with the potential return from a non-U.S. investment, the potential return from the U.S. investment will not include the potential benefit of the R&D credit, which may make the foreign investment more attractive.

Our tax code also appears to be a detriment in the global success of U.S. companies. Although there is no clear empirical evidence of the extent to which U.S.-based multinationals are at a competitive disadvantage as a result of the current U.S. international tax system, there is substantial anecdotal evidence.

The global economy has changed significantly since the United States' international tax rules were last reformed in 1962. Our international tax rules were adopted when the United States was the dominant world economy and the major market for U.S. companies. Although the United States remains an important force in the global economy, significant growth is occurring outside the United States. Non-U.S. markets are critical to the growth of U.S. businesses. Yet, as markets have changed, our international tax rules have not.

Because the United States' international tax rules have not been adapted to the global economy, our rules look fundamentally different than those of our trading partners. For example, the United States taxes its corporations on a worldwide basis, including taxing foreign source income generated by foreign subsidiaries when that income is repatriated to the United States. This feature of the United States international tax system is more similar to that of developing countries than those of the United States' major trading partners, many of which exempt foreign-earned income.

So how should the United States reform its corporate and international tax rules? I have suggested lowering the corporate tax rate and exempting from taxation a large portion of, but not all, the dividends of active earnings from foreign corporations to U.S. shareholders. The portion of the dividends that would continue to be taxed, say 5-10% of the dividends, would be a proxy for disallowed deductions of expenses incurred in connection with the earning of the otherwise-exempt foreign income. To avoid negative revenue consequences, a number of offsets could be on the table, such as the reduction of tax expenditures, imposition of the corporate tax on all entities with corporate characteristics, and the potential adoption of a value-added tax. The ultimate decision regarding offsets is obviously highly political, but we should not fail at reform because it is too politically difficult to broaden the tax base.

Thank you. I look forward to answering your questions.

## **Across the Great Divide: A Centrist Tax Reform Proposal**

by Philip R. West

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# SPECIAL REPORTS

## Across the Great Divide: A Centrist Tax Reform Proposal

by Philip R. West

Philip R. West is a partner with Steptoe & Johnson LLP in Washington and a former Treasury international tax counsel. This report was funded by clients of Steptoe & Johnson, but the views expressed are those of the author, who acknowledges with thanks the substantial assistance of Amanda Pedvin Varma. Copyright © 2011 Philip R. West. All rights reserved.

### I. Introduction

Near the end of my tenure at Treasury, a wise man said to me: "There is no objective truth in international tax policy. Ultimately, the choices are political." Some years later, in a prominent lecture, a highly respected congressional staff member expressed a somewhat similar sentiment about tax policy more generally.<sup>1</sup>

These views can be interpreted to mean that either there is no objective measure of good business tax policy or there is objective merit in both sides of the debate. Having lived through years of polarizing arguments about corporate and international tax reform, I can only conclude that both sides have merit.

On one hand, the following propositions regarding corporate taxation generally seem compelling:

- a low rate, accompanied by a broad base, is the best foundation for a tax system;
- the corporate income tax is highly inefficient<sup>2</sup>;

<sup>1</sup>John Buckley, 2007 Woodworth Memorial Lecture, "Tax Changes Since Woodworth's Time: Implications for Future Tax Reform," 34 *Ohio N.U.L. Rev.* 1, 15 (2008) ("Laws enacted without regard to politics seldom last long.")

<sup>2</sup>See OECD, *Tax Policy Reform and Economic Growth* (Tax Policy Study No. 20) 22 (2010):

Corporate income taxes are the most harmful for growth as they discourage the activities of firms that are most important for growth: investment in capital and productivity

(Footnote continued in next column.)

- the incidence of the corporate income tax falls on shareholders, employees, or customers, but not ultimately on the corporation itself;
- corporate earnings are taxed twice — once when earned by the corporation and again when distributed to individuals — in the absence of some form of dividend and capital gain relief;
- place of corporate organization is a tenuous ground on which to base significant tax distinctions;
- the lower the corporate tax rate, the less the incentive for planning, sheltering, and other activity creating dead-weight loss in the system;
- job growth is more likely when businesses are more profitable<sup>3</sup>; and

improvements. Also, most corporate tax systems have a large number of provisions that create tax advantages for specific activities, typically drawing resources away from the sectors in which they can make the greatest contribution to growth.

<sup>3</sup>President Obama is reported to have said to business leaders at a meeting: "We want to be boosters because when you do well, America does well." Helene Cooper, "Obama Tries Charm Offensive on Group of Top Executives," *The New York Times*, Dec. 15, 2010. Similarly, former House Ways and Means Committee Chair Charles B. Rangel, D-N.Y., has reportedly stated that he wants businesses to do well because it will be business, not government, that will supply the jobs that keep people working.

## SPECIAL REPORTS

- the more attractive our tax system is to businesses, the more likely we are to attract foreign investment and retain domestic investment.

On the other hand, the following propositions also seem compelling:

- if we reduce corporate tax, we are likely, at least in the short term, to reduce revenue that may need to be recouped through other taxes;
- if corporations do not pay the same tax as other businesses, there will be a bias in favor of doing business in corporate form solely for tax reasons (stated differently, the corporate tax serves as an anti-deferral mechanism);
- if corporations do not bear a specified minimum tax burden, the system may seem unfair, individuals may have less respect for the system, and compliance may suffer;
- although corporate rate reductions may be justified on grounds of competitiveness, there are few, if any, rigorous cross-country comparisons of tax competitiveness, and the United States appears to compare quite favorably with other jurisdictions when competitiveness is evaluated by taking into account all business factors, not just taxes;
- U.S. corporate organization provides some benefits, which may justify the imposition of a corporate income tax; and
- corporate tax rate reductions could be the first step in a race to the bottom that would impair the ability of governments to provide needed services.

Similarly, the following propositions regarding international tax reform seem compelling:

- reduced taxation of foreign earnings would encourage expansion and therefore strengthening of U.S.-based multinationals;
- our current international tax system encourages U.S.-based multinationals to retain earnings abroad;
- our current international tax system appears to put U.S.-based multinationals at a disadvantage compared with competitors in numerous other countries that use a territorial system;
- to the extent that other countries' international tax systems establish an international norm, our current system is inconsistent with that norm;
- our current international tax system is highly complex and appears to encourage planning, sheltering, and other dead-weight loss activity;
- our current system relies on complex and continually tested gatekeepers to prevent existing corporations from expatriating, but encourages new businesses to start abroad; and
- our corporate tax base is mobile and becoming more so, and the challenges to imposing corporate

tax on multinational businesses and capital are growing, perhaps to the point of being not worth the cost.

On the other hand, the following propositions regarding international tax reform also seem compelling:

- the adoption of a more purely territorial system could encourage companies to move some functions (and thus jobs) overseas where the income generated by those functions would not be subject to U.S. tax;
- there is no clear empirical evidence of the extent to which U.S.-based multinationals are at a competitive disadvantage as a result of the current U.S. international tax system;
- repeal of deferral would eliminate the lockout effect just as effectively as a territorial system;
- a territorial system could be easily manipulated without strong transfer pricing, source, and anti-deferral rules for passive income;
- a territorial system without a limitation on deductions for expenses incurred to earn that income could adversely and inappropriately affect the tax base; and
- exemption of foreign income, which will mostly be availed of by large taxpayers, may seem unfair, create disrespect for the system, and result in reduced compliance.

Both sides of the debate have merit. Despite this, it often seems that the usual players on all sides simply continue to take their predetermined roles and dig themselves deeper and deeper into positions from which they cannot (or will not) back out. Perhaps as a result, tax reform has moved slowly.<sup>4</sup>

So how best to advance the debate? I believe there are two critical components. First is an acknowledgment that there is no clear right or wrong answer, that

<sup>4</sup>Perhaps tax reform will move with a quicker pace since President Obama expressed his desire for changes to the tax code in his State of the Union address. He stated:

To help our companies compete, we also have to knock down barriers that stand in the way of their success. For example, over the years, a parade of lobbyists has rigged the tax code to benefit particular companies and industries. Those with accountants or lawyers to work the system can end up paying no taxes at all. But all the rest are hit with one of the highest corporate tax rates in the world. It makes no sense, and it has to change. So tonight, I'm asking Democrats and Republicans to simplify the system. Get rid of the loopholes. Level the playing field. And use the savings to lower the corporate tax rate for the first time in 25 years — without adding to our deficit. It can be done.

Remarks by the President in State of the Union Address (Jan. 25, 2011), available at <http://www.whitehouse.gov/the-press-office/2011/01/25/remarks-president-state-union-address>.

people come to the debate with competing policy orientations, and that we all may have to sacrifice some sacred cows.<sup>5</sup> Second is a determination to inform the debate with both (a) empirical research, in particular (if possible) on alternative policies' macroeconomic effect on domestic job and economic growth, and (b) real-world experiences of those responsible for paying the tax and complying with the system.

To address at least the first of these two components, I submit that we should step back to reevaluate our positions and the assumptions that underlie them.<sup>6</sup> It is from this perspective that I offer the views herein.<sup>7</sup> These views, informed by my experiences evaluating and considering tax policy as well as observing the role of taxes in business decision making, represent an attempt to advance the debate about how the United States should tax businesses in today's international economy — or, better yet, an attempt to change the debate. In this spirit, I offer a pragmatic, centrist approach to reforming our international tax policy.<sup>8</sup>

The balance of this report is divided into two parts. Section II describes why the United States needs fundamental tax reform. It is divided into four main parts:

(A) an examination of where we've been, with an emphasis on the 1962 debate over subpart F and the Tax Reform Act of 1986; (B) a description of where our tax system is today; (C) a description of recent tax reform proposals; and (D) an analysis of where we're going and what our goals for fundamental tax reform might be.

Section III provides a proposal for fundamental U.S. international and corporate tax reform.<sup>9</sup> Central elements of this reform proposal are similar to those considered by the National Commission on Fiscal Responsibility and Reform (the Bowles-Simpson commission). The proposal would lower the corporate tax rate and exempt from taxation a large portion of, but not all, the dividends of active earnings from foreign corporations to U.S. shareholders. The portion of the dividends that would continue to be taxed, for example, 5 to 10 percent of the dividends, would be a proxy for disallowed deductions of expenses incurred in connection with the earning of the otherwise exempt foreign income. Also, safeguards would be included to prevent round-tripping of earnings and to prevent base erosion through artificial cost sharing and other transfer pricing arrangements.<sup>10</sup>

To avoid negative revenue consequences in a period of significant deficits, this proposal suggests several potential offsets.<sup>11</sup> The most significant is one that most economists view as inevitable and most politicians want to believe is off the table: a VAT. But because a VAT can be regressive, it could include exemptions for necessities, as other VATs have done, or the tax could have a broad base but devote a portion of

<sup>5</sup>As former House Minority Leader Dick Gephardt explained in recent testimony before the Senate Finance Committee, one pre-Tax Reform Act of 1986 sacred cow actually involved cows:

Super Dairy Cows were a prime example of [pre-1986 narrow tax benefits that benefited only a few]. There were substantial benefits to taxpayers to invest in dairy cows that could produce higher quantities of milk. Yet, due to dairy programs in the Farm Bill, there was already a glut of milk on the market. There was so much milk in fact, that cheese was literally spoiling in federal warehouses, with no appropriate consumer for the product. Schools, nutrition programs and other users already had their fill. Yet, millions and millions of dollars were invested in these tax shelters — with the federal taxpayer underwriting the benefits — because of some talented lawyers who helped arrange the tax dodge. . . . Nothing should be off-limits in terms of discussion about the design of the code. Remember, until 1986, Super Dairy Cows were also considered sacred." Statement of Dick Gephardt Before the Senate Finance Committee, "Tax Reform: Lessons from the Tax Reform Act of 1986" (Sept. 23, 2010) [Doc 2010-20781, 2010 TNT 183-51.]

<sup>6</sup>The second component, informing the debate with empirical data and real-world experiences about how our system functions and affects the economy, is beyond the scope of this report and, at least as to developing empirical data, is beyond the author's expertise. That work, however, should be undertaken promptly.

<sup>7</sup>Of course, to be consistent with my approach, I must put forward this proposal as only one contribution to the debate; other proposals may prove superior.

<sup>8</sup>I am aware that some believe that finding common ground to move the debate forward is either a fool's errand or inconsistent with our political system, in which progress is made through a sort of tug-of-war conducted by vigorous partisans. See, e.g., Frank Rich, "The Bipartisanship Racket," *The New York Times*, Dec. 19, 2010; Paul Krugman, "Let's Not Make a Deal," *The New York Times*, Dec. 5, 2010.

<sup>9</sup>Although individual tax reform is beyond the scope of this report, there are at least three reasons why it would be preferable to consider corporate and international tax reform only in conjunction with individual tax reform, or at least business tax reform for both corporations and noncorporate businesses: (1) many more businesses are conducted in noncorporate than corporate form (although the economic impact of the corporate sector is disproportionate to its numbers); (2) the budget and revenue implications of corporate tax reform are far smaller than those of individual reform because the individual income tax is, to quote Willie Sutton, "where the money is"; and (3) it is sub-optimal to consider a VAT, as I do below, outside the context of individual reform, because the incidence of any VAT would fall on individuals more clearly than the incidence of the corporate income tax.

<sup>10</sup>Although there are serious problems with the arm's-length standard, the transfer pricing safeguards suggested herein do not extend to abandoning that standard in favor of a formulary apportionment system.

<sup>11</sup>Some believe tax reductions do not need to be paid for, while others believe we should enact tax reform only if it helps significantly reduce the deficit. This report, consistent with its centrist orientation, takes a revenue-neutral approach. Also, because the focus of the report is on revenue measures, it does not consider any contribution to deficit reduction that could be achieved through nontax expenditure cuts.

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the revenue raised to addressing regresivity, for example through reducing the payroll tax and/or providing refundable credits.<sup>12</sup> Other revenue raisers that should be up for discussion include imposition of the corporate tax on all entities with corporate characteristics,<sup>13</sup> changing depreciation schedules, and reforming other corporate tax expenditures, perhaps using a mechanism like that suggested by the Bowles-Simpson commission (eliminating all tax expenditures, with add-backs paid for by increases in the corporate tax rate). The ultimate decision regarding offsets is obviously highly political, but we should not fail at reform because it is too politically difficult to broaden the tax base.

## II. The Case for Reform

The need for tax reform becomes clear from an examination of the assumptions and motivations behind the major features of our current business and international tax system, analyzing whether those assumptions and motivations are true and valid today, and questioning whether the major features of our tax system can successfully accompany the United States into the future.<sup>14</sup>

Section II.A of this article examines the reasons for several major features of the U.S. corporate and international tax regime. It highlights the past assumptions, motivations, and compromises behind those features.

Section II.B examines where our tax system and economy is today. It reviews recent economic trends, including the significant growth of non-U.S. markets and the increased integration of the world economy, and it surveys recent trends in business and international taxation, including the significant growth of flow-through businesses and the tax system's increased divergence from the tax systems of other developed countries. Section II.B also provides a brief overview of several recent proposals to reform the U.S. tax system.

Section II.C analyzes where the U.S. tax system is going and should be going. It surveys projected rev-

enue trends, highlighting the fiscal challenges facing the United States, and it analyzes the role of tax reform in meeting those fiscal challenges. Next, it considers potential goals of tax reform, including encouraging investment in the United States, enhancing the competitiveness of U.S. multinational companies, minimizing economic distortions, and promoting administrability, simplicity, and certainty.

### A. Where We've Been

This section examines the enactment of two pieces of international and corporate tax legislation, respectively, that set the framework for tax reform debate today — the enactment of the anti-deferral rules of subpart F in 1962 and TRA 1986. Examining the context in which subpart F was enacted is useful in evaluating the appropriateness of the current U.S. anti-deferral rules, and the appropriateness of U.S. taxation of foreign income more broadly, in today's economy.<sup>15</sup> Examining TRA 1986 is helpful to understand how the last major tax reform was achieved and what it can (and cannot) teach us about conducting tax reform today.

#### 1. Subpart F

The enactment of subpart F in 1962 was spurred by President Kennedy's 1961 call for changes to the U.S. tax treatment of foreign income. In his 1961 message to Congress on tax issues, Kennedy argued that "changing economic conditions at home and abroad, the desire to achieve greater equity in taxation, and the strains which have developed in our balance of payments position in the last few years, compel us to examine critically certain features of our tax system."<sup>16</sup> He proposed legislation that would tax U.S. corporations on their current share of undistributed profits

<sup>12</sup>See Treasury, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study," 53 (Dec. 29, 2000), *Doc 2001-492*, 2001 *TNT* 1-1; and National Foreign Trade Council, *The NFTC Foreign Income Project: International Tax Policy for the 21st Century: A Reconsideration of Subpart F* (1999), for additional background and analysis on the history and debate over subpart F.

<sup>13</sup>Message of the President's Tax Recommendations (Apr. 20, 1961), *reprinted in* H.R. Doc. No. 87-140. Kennedy described the deferral issue as follows:

Profits earned abroad by American firms operating through foreign subsidiaries are, under present tax laws, subject to United States tax only when they are returned to the parent company in the form of dividends. In some cases, this tax deferral has made possible indefinite postponement of the United States tax; and, in those countries where income taxes are lower than in the United States, the ability to defer the payment of U.S. tax by retaining income in the subsidiary companies provides a tax advantage for companies operating through overseas subsidiaries that is not available to companies operating solely in the United States.

<sup>12</sup>See Eric Toder and Joseph Rosenberg, "Effects of Imposing a Value-Added Tax to Replace Payroll Taxes or Corporate Taxes," at 12-13 (2010), *Doc 2010-7657*, 2010 *TNT* 67-31; see also Rosanne Altshuler, Katherine Lim, and Robertson Williams, "Desperately Seeking Revenue," 63 *Nat'l Tax J.* 331 (2010). Both papers are discussed further below.

<sup>13</sup>See President's Economic Recovery Advisory Board (PERAB), "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation," at 74-77 (2010).

<sup>14</sup>In other words, the case for tax reform can be seen by considering where we've been, where we are, and where we are going. Senate Finance Committee Chair Max Baucus, D-Mont., made a similar statement during a committee hearing: "To consider where we want our tax system to go, we need to understand where we are and understand where we've been." Hearing Statement of Sen. Max Baucus, Regarding Historical Trends in Income and Federal Revenues (Dec. 2, 2010), *Doc 2010-23643*, 2010 *TNT* 232-44.

earned by subsidiaries organized in economically advanced countries, retain deferral for income from investment in developing countries, while "elimin[ating] the 'tax haven' device anywhere in the world" by doing away with deferral for activities "that typically seek out tax haven methods of operation." The president said that "while the rate of expansion of some American business operations abroad may be reduced through the withdrawal of tax deferral[,] such reduction would be consistent with the efficient distribution of capital resources in the world, our balance of payments needs, and fairness to competing firms located in our own country."

The business community strongly opposed Kennedy's tax proposal.<sup>17</sup> This appears to have stemmed at least in part from the fact that most multinationals invested primarily in high-tax jurisdictions. Congress ultimately rejected the Kennedy administration's call to end deferral with limited exceptions for investments in developing countries. The House passed a bill in March 1962 that ended deferral only for specified types of income: (1) income from insuring or reinsuring U.S. risks; (2) income from patents, copyrights, and some intellectual property developed in the United States or acquired in the United States from related persons; (3) specified passive income; and (4) income from purchases or sales involving related persons if the property was produced and sold for use outside the foreign corporation's country of incorporation.<sup>18</sup> The House Ways and Means Committee stated:

Your Committee's bill does not go as far as the President's recommendations. It does not eliminate tax deferral businesses owned by Americans which are located in the economically developed countries of the world. Testimony in hearings before your committee suggested that the location of investments in these countries is an important factor in stimulating American exports to the same areas. Moreover, it appeared that to impose the U.S. tax currently on the U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax.<sup>19</sup>

<sup>17</sup>See National Foreign Trade Council, *supra* note 15, at ch. 2 ("Trade and business interests reacted swiftly and negatively to the Kennedy foreign income proposals").

<sup>18</sup>H.R. 10650 (1962); H.R. Rep. No. 1447 (1962). The House bill also provided that a U.S. shareholder of a foreign corporation would be subject to tax on the foreign corporation's undistributed earnings not falling into the above categories to the extent those earnings were not reinvested in substantially the same business or a foreign corporation organized in a less developed country.

<sup>19</sup>H.R. Rep. No. 87-1337, at 62 (1962).

The Senate Finance Committee adopted the general approach of the House bill.<sup>20</sup> The Senate version was ultimately adopted in conference, and subpart F was enacted in the Revenue Act of 1962.

The debate over subpart F has continued since subpart F's enactment in 1962. Many are dissatisfied with current law, but for different reasons: Some want to eliminate deferral, while others want to eliminate or limit the United States' practice of taxing foreign-source income.<sup>21</sup> Advocates of replacing the current anti-deferral rules with current taxation of the foreign

<sup>20</sup>The Finance Committee modified the House version, however, to exempt U.S. shareholders from current taxation if a foreign corporation paid large dividend distributions on a current basis or if the foreign corporation was subject to high foreign taxes. Also, the Senate version allowed deferral for specified kinds of exports the U.S. government was seeking to promote.

<sup>21</sup>See, e.g., The Bipartisan Tax Fairness and Simplification Act of 2010, S. 3018 (abolishing deferral); Daniel N. Shaviro, "Re-thinking Foreign Tax Creditability," 63 *Nat'l Tax J.* 709 (2010) (full territoriality, no foreign tax credit); Samuel C. Thompson Jr., "Assessing the Following Systems for Taxing Foreign-Source Active Business Income: Deferral, Exemption, and Imputation," 53 *How. L.J.* 337 (2010); James R. Hines Jr., "Reconsidering the Taxation of Foreign Income," 62 *Tax L. Rev.* 269 (2009); J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, "Worse Than Exemption," 59 *Emory L.J.* 79 (2009); Jane G. Gravelle, "International Corporate Income Tax Reform: Issues and Proposals," 9 *Fla. Tax Rev.* 469 (2009); Paul R. McDaniel, "Territorial vs. Worldwide International Tax Systems: Which Is Better for the U.S.?" 8 *Fla. Tax Rev.* 283 (2007); Paul W. Oosterhuis, "The Laurence Neal Woodworth Memorial Lecture in Federal Tax Law and Policy: The Evolution of International Tax Policy — What Would Larry Say?" 33 *Ohio N.U.L. Rev.* 1 (2007); Report of the American Bar Association Task Force on International Tax Reform, 59 *Tax Lawyer* 649 (2006); Joint Committee on Taxation, "Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System" in *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, JCS-3-01 (Apr. 2001), *Doc 2001-12006*, 2001 *TNT* 91-14; Michael J. Graetz, "The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies," 54 *Tax L. Rev.* 261 (2001); Keith Engel, "Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle With Subpart F," 79 *Tex. L. Rev.* 1525 (2001); Peroni, "Deferral of U.S. Tax on International Income: End It, Don't Mend It — Why Should We Be Stuck in the Middle With Subpart F?" 79 *Tex. L. Rev.* 1609 (2001); H. David Rosenbloom, "From the Bottom Up: Taxing the Income of Foreign Controlled Corporations," 26 *Brook. J. Int'l L.* 1525 (2001); Treasury Department, *supra* note 15, at 53; Terrence R. Chorvat, "Ending the Taxation of Foreign Business Income," 42 *Ariz. L. Rev.* 835, 850-853 (2000); Peroni, Fleming, and Shay, "Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income," 52 *SMU L. Rev.* 455 (1999); National Foreign Trade Council, "The NFTC Foreign Income Project: International Tax Policy for the 21st Century: A Reconsideration of Subpart F" (1999), *Doc 1999-11623*, 1999 *TNT* 58-17; JCT, "Overview of Present-Law Rules and Economic Issues in International Taxation," JCX-13-99, section IVD (Mar. 9, 1999), *Doc 1999-9351*, 1999 *TNT* 46-10; Graetz and Michael M. O'Hear, "The 'Original Intent' of U.S. International Taxation," 46 *Duke*

(Footnote continued on next page.)

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income earned by foreign subsidiaries of U.S. companies have argued that deferral provides a significant tax incentive for U.S. companies to locate operations abroad,<sup>22</sup> while advocates of replacing the current rules with a territorial or other system to exempt foreign-source income from U.S. taxation argue that a reduction in tax of foreign-earned income of U.S. companies is necessary for those companies to be competitive worldwide.<sup>23</sup> Opponents of the current deferral regime also argue that it is overly complex and that it creates a lockout effect, discussed below, that discourages U.S. companies from repatriating the earnings of their foreign subsidiaries.

#### 2. Tax Reform Act of 1986

TRA 1986 was the last fundamental reform of the U.S. tax system.<sup>24</sup> The reform focused on individual and corporate taxation, with a general approach of lowering tax rates while broadening the tax base. For individual taxes, the number of tax rates was cut from 14 (ranging from 11 to 50 percent) to 2 (15 and 28 percent), with significant changes to the tax base, including the elimination of the consumer interest deduction, restrictions on charitable contribution deductions, the elimination of the sales tax deduction, and changes to the passive loss rules.<sup>25</sup> Corporate tax rates were cut from a top rate of 48 percent to 34 percent, although, because of base-broadening measures, overall corporate taxes actually went up — the reform raised corporate

taxes by \$120 billion over five years, which was the largest corporate tax increase in history.<sup>26</sup>

TRA 1986 was generally successful in its goal of lowering tax rates and broadening the tax base, which are two necessary goals of tax reform. The general approach of TRA 1986 alone, however, should not simply be copied by current policymakers considering tax reform. Reform today must consider fundamental issues not addressed in 1986 and reevaluate some critical assumptions made in the 1986 reform. First, TRA 1986 did not fundamentally reform the international tax system.<sup>27</sup> As a result, the post-1986 international tax system continued to rely on the motivations, assumptions, and compromises of 1962. Even since 1986, as examined below, the world has fundamentally changed in a way that militates in favor of a reexamination of the U.S. international tax system. Further, although non-income taxes were considered in the years leading up to TRA 1986, the act ultimately assumed that the United States should continue to rely on the individual and corporate income taxes as its major sources of revenue.<sup>28</sup> As discussed below, given the United States' significant fiscal challenges, policymakers should seriously consider whether current revenue sources are sufficient.

#### B. Where We Are

This section examines the current state of the U.S. tax system and the U.S. economy. It first provides a brief overview of the United States' current business and international tax rules. It then considers U.S. economic and tax trends. And because any future tax reform will necessarily build on the reform efforts preceding it, this section also examines several recent proposals to reform the U.S. tax system.

L.J. 1021 (1997); Gary Clyde Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform*, 136 (1992); Stanford G. Ross, "National Versus International Approaches to Cross-Border Tax Issues," *Tax Notes*, Feb. 3, 1992, p. 589; JCT, "Factors Affecting the International Competitiveness of the United States," JCS-6-91 (May 30, 1991), *Doc 91-4597, 91 TNT 121-9*, at 5; Daniel J. Frisch, "The Economics of International Tax Policy: Some Old and New Approaches," *Tax Notes*, Apr. 30, 1990, p. 581; William P. McClure and Herman B. Bouma, "The Taxation of Foreign Income From 1909 to 1989: How a Tilted Playing Field Developed," *Tax Notes*, June 12, 1989, p. 1379; American Law Institute, *Proposals on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons*, 318-320 (1987).

<sup>22</sup>See, e.g., Fleming, Peroni, and Shay, *supra* note 21, at 464-468 (explaining three analytical approaches to describe deferral: an interest-free loan; a device to make the treasury a forced equity investor; or a regime for achieving tax-free reinvestment of retained earnings).

<sup>23</sup>See Statement of Hines, Testimony Before the Senate Finance Committee (June 26, 2008), *Doc 2008-14200, 2008 TNT 125-47* ("What would represent an efficient international tax policy? It would be to do what most of the world does, and exempt active foreign business income from U.S. taxation. Exempting foreign income from taxation would promote efficient ownership of productive assets, domestic and foreign, by American businesses.")

<sup>24</sup>See Jeffrey H. Birnbaum and Alan S. Murray, *Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform* (1987), for a comprehensive discussion of the reform efforts.

<sup>25</sup>*Id.* at 288.

<sup>26</sup>*Id.* at Appendix A.

<sup>27</sup>See Statement of Dick Gephardt, *supra* note 5 (suggesting that Congress needs to "go deeper into some of the areas that the 1986 effort skirted — most important being the international aspects of the tax code. Today, the impact of globalization is felt in all sectors of our society, far more than at that time. Our tax code needs to reflect this fact.")

<sup>28</sup>See Graetz, *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States*, 27 (2008).

The 1986 tax act was based on retaining and strengthening the income tax itself, rather than heeding the calls of many economists and politicians to replace it with some sort of tax on purchases of goods and services. Given the internationalization of economic activity during the past two decades, TRA 1986's reliance on increased taxation of income from capital and corporate income has made the United States economy less competitive with other national economies that tax corporate income at a relatively lower rate.

### 1. Overview of Current Corporate and Int'l Tax Regime

U.S. corporations generally are subject to U.S. corporate income tax on their worldwide income. The taxable income of a corporation is generally the corporation's gross income less deductions, which may include interest expense, salaries, wages, nonfederal income taxes, and various other expenses. When corporations distribute their profits to shareholders, the distribution is generally taxed as a dividend to the shareholder and is not a deductible expense of the corporation.<sup>29</sup> As a result, corporate earnings are generally taxed twice: once when earned by the corporation and again when distributed to the corporation's shareholders.

Rather than organize as corporations, businesses may also operate as a variety of flow-through entities, including S corporations, partnerships, and sole proprietorships. The income of these entities generally is not subject to tax at the entity level — rather, their income is taxable directly to their owners.

As stated above, U.S. corporations generally are taxed on all of their income, regardless of whether that income is earned in the United States or abroad. Income earned abroad by a foreign subsidiary of a U.S. parent corporation is generally not subject to U.S. tax until that income is distributed as a dividend from the foreign subsidiary to its U.S. parent. As a result, in the absence of special rules, a U.S. corporation can defer U.S. taxation on foreign income until repatriating that income to the United States.<sup>30</sup>

The United States has anti-deferral rules that subject U.S. parent corporations to current taxation of specified passive or mobile income earned by foreign subsidiaries.<sup>31</sup> The most significant anti-deferral rules in the U.S. tax code for U.S.-based multinationals are the controlled foreign corporation rules, which are often referred to as "subpart F" because they are in subpart F of the tax code. Under this regime, U.S. 10 percent shareholders of a foreign corporation that is more than 50 percent owned (directly, indirectly, or constructively) by U.S. persons (taking into account only 10 percent U.S. shareholders) are taxed on their pro rata share of subpart F income earned by the CFC. The U.S. shareholder is subject to this tax regardless of whether any income is distributed to it from the controlled corporation. Subpart F income generally includes dividends,

interest, rents, and royalties; insurance income; some income earned from sales involving related parties in which the manufacturing function has been separated from the sales function; income from services performed outside a CFC's country of incorporation for, or on behalf of, a related person; and shipping income.<sup>32</sup> Subpart F income also includes some income earned by a CFC and invested in "U.S. property" (a term including some tangible property in the United States, some stock of a U.S. corporation, some obligations of a U.S. person, and some U.S. intangible property rights).

Because the taxation of a single item of foreign-source income by both the United States and a foreign country would result in double taxation, the United States generally provides a credit for foreign taxes paid or accrued.<sup>33</sup> U.S. corporations may receive a foreign tax credit (which may be used to offset U.S. tax owed on foreign-source income) for foreign taxes paid or accrued on foreign-source income that is earned directly by the domestic corporation or foreign taxes paid or accrued by a foreign subsidiary that are deemed paid by the domestic corporation on an actual or deemed distribution from the foreign subsidiary.<sup>34</sup>

### 2. U.S. Tax and Economic Developments

In considering whether and how fundamental tax reform should be achieved, it is helpful to consider whether the assumptions and motivations that in the past led to the enactment of today's tax system are as compelling today. For example, the world economy is much more integrated than it was when subpart F was enacted in 1962, or even when fundamental tax reform was last achieved in 1986. Non-U.S. markets are growing at a faster rate than U.S. markets. Yet, as business increasingly operates on a global scale, the U.S. tax system appears to be predicated on an assumption that growth abroad to exploit foreign markets should not be encouraged. In this respect, the U.S. system has been unlike those of historically outward-facing economies like that of the Netherlands. Now, as more countries are becoming more outward-facing, the U.S. tax system appears to diverge significantly from the tax systems of many other developed countries.

*a. Increasingly global economy.* In his December 2010 testimony before the Senate Finance Committee, Mark J. Mazur, Treasury deputy assistant secretary for tax analysis, observed that the world economy has become increasingly integrated in the last several decades. According to Mazur:

International trade in goods and services is now more important than it once was, for the world and for the United States. In the United States,

<sup>29</sup>Under the recent two-year extension of the 2001 and 2003 tax cuts, dividend income of individuals continues to be taxed at a reduced 15 percent rate rather than ordinary income rates.

<sup>30</sup>The U.S. corporation's postponement of tax payments for income that, if earned directly by the U.S. corporation, would otherwise be currently taxable, means that the foreign income earned by a foreign subsidiary will generally be taxed at a lower effective rate than U.S. income earned by the foreign subsidiary or any income, foreign or domestic, earned by the U.S. corporation as a result of the time value of money.

<sup>31</sup>See sections 951-964 (subpart F); sections 1291-1298 (passive foreign investment company rules).

<sup>32</sup>Section 951.

<sup>33</sup>Section 901.

<sup>34</sup>Sections 901, 902, 904, and 960.

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for example, the traded sector (exports plus imports) has grown from 20 percent of GDP in 1980 to 24 percent in 2009, but the most dramatic changes have occurred in emerging economies, such as China and India, where it more than doubled. Over the same period, cross border investment (both direct and portfolio investment) has also become significantly more important. For example, U.S. cross border foreign direct investment (FDI) in stocks has increased from about 11 percent of GDP in 1980 to about 55 percent of GDP in 2009. In the other G-7 countries, cross border FDI in stocks has increased from 10 percent of GDP to 65 percent of GDP over the same period.<sup>35</sup>

One important reason U.S. companies invest overseas is that, even though the United States remains a dominant world economy, significant economic growth is occurring in non-U.S. markets. U.S. companies cannot grow if they ignore these markets. U.S. GDP grew at a 2.9 percent annual rate from 1995 through 2008. In comparison, China's economy grew at a 9.6 percent rate, India grew at a 6.9 percent rate, Russia grew at a 4.7 percent rate, and Brazil grew at a 3 percent rate.<sup>36</sup> Consumer spending is also growing at a faster rate in many non-U.S. markets. For example, U.S. real household consumption grew at a 3.3 percent annual rate from 1995 through 2008, while China's consumption grew at a 7.2 percent annual rate, Russia's grew at a 6.7 percent annual rate, and India's grew at a 5.1 percent annual rate. Although these countries have less spending power on a per capita basis than the United States, their significant economic growth will continue to provide significant investment opportunities for global companies.

When U.S. multinational companies do business abroad, they must make investments locally. U.S. multinationals often must establish local operations for legal reasons (for example, local content requirements or tariff barriers) and out of basic logistical necessity (for example, reducing transportation costs). Also, local operations are often necessary to understand and cater to local tastes. For example, on-the-ground employees may be necessary for a consumer products company to understand why its soap can be a local success. Further, the nature of some businesses, such as some financial services, may simply require a local, physical presence.

*b. Increased divergence from tax systems of other developed countries.* Although business has become increasingly

<sup>35</sup>Testimony of Treasury Deputy Assistant Secretary for Tax Analysis, Mark Mazur, Senate Committee on Finance Hearing on Tax Reform: Historical Trends in Income and Revenue (Dec. 2, 2010), *Doc 2010-25646*, 2010 TNT 232-54.

<sup>36</sup>McKinsey Global Institute, *Growth and Competitiveness in the United States: The Role of Its Multinational Companies*, 156-157 (2010).

global, with foreign companies regularly competing with domestic companies in the United States and U.S. companies regularly competing with foreign companies abroad, the U.S. tax system looks very different than the other tax systems of the developed world. As discussed below, many believe the United States' divergence makes U.S. companies less competitive. Many also believe the United States' tax system makes the U.S. a less attractive place for investment, whether domestic or foreign.

The United States last lowered its corporate tax rate with TRA 1986, when the U.S. corporate tax rate was reduced by 14 percentage points. Since then, other countries have lowered their tax rates while the United States has actually increased its highest corporate marginal rate by one percentage point.<sup>37</sup> The average corporate tax rate in the OECD has dropped from 47 percent in 1981 to 37.7 percent in 1994 to 25.9 percent in 2010.<sup>38</sup> According to OECD data, the United States' combined federal and state corporate rate is 39.1 percent, compared with the OECD average (excluding the United States) of 25.9 percent.<sup>39</sup>

Further, the United States is now one of only seven OECD countries with a worldwide corporate tax system — only Chile, Ireland, Israel, Mexico, Poland, and South Korea have similar worldwide systems. Each of these other countries, however, has a significantly lower corporate tax rate.<sup>40</sup>

The United States also relies on income taxes (at all levels of government) for a much greater percentage of its total tax revenues than other developed countries. In 2006 the United States raised 48.3 percent of its revenue from federal, state, and local income taxes, compared with an average of 35.1 percent in other OECD countries.<sup>41</sup> In contrast, OECD countries rely more heavily on consumption taxes, including VATs. Consumption taxes made up 32 percent of the average OECD countries' revenues in 2006, compared with 16.8 percent in the United States. Also, the number of

<sup>37</sup>It should be noted, however, that "these rate reductions have often been accompanied by base-broadening efforts, so that overall corporate tax revenues as well as average and especially marginal effective tax rates have declined considerably less." George R. Zodrow, "Capital Mobility and Capital Tax Competition," 63 *Nat'l. Tax J.* 865 (2010).

<sup>38</sup>OECD, *supra* note 2, at 37.

<sup>39</sup>See OECD Tax Database, Basic (Non-Targeted) Corporate Income Tax Rates (Table H.1), available at <http://www.oecd.org/ctp/taxdatabase> (using 2010 combined corporate income tax rate (adjusted central government corporate income tax rate plus sub-central government corporate income tax rate)).

<sup>40</sup>China, a non-OECD country, also has a worldwide tax system. Like the OECD countries that tax on a worldwide basis, however, it has a significantly lower corporate tax rate than the United States: 25 percent compared with 39.21 percent.

<sup>41</sup>Mazur testimony, *supra* note 35.

**Table 1. Combined Corporate Income Tax Rate of OECD Countries With Worldwide Tax Systems<sup>a</sup>**

Country	Combined Corporate Income Tax Rate
Chile	17%
Ireland	12.5%
Israel	25%
Mexico	30%
Poland	19%
South Korea	24.2%
United States	39.21%

<sup>a</sup>See OECD Tax Database, Basic (Non-Targeted) Corporate Income Tax Rates (Table II.1), available at <http://www.oecd.org/ctp/taxdatabase> (using 2010 combined corporate income tax rate (adjusted central government corporate income tax rate plus subcentral government corporate income tax rate)).

OECD countries with a VAT has increased dramatically in the past 30 years. In 1980, 14 OECD countries had a VAT.<sup>42</sup> In 2011, 33 of the 34 OECD countries (that is, all except the United States) have a VAT. Worldwide, approximately 150 countries have a VAT.<sup>43</sup>

*c. Growth of flow-through businesses.* Another significant U.S. tax trend that should be considered in evaluating whether our current tax rules reflect current realities is the dramatic increase in business income earned by flow-through entities (S corporations, partnerships, limited liability companies, and sole proprietorships), which are not subject to the corporate income tax. In recent years, these flow-through entities included 26 million non-farm sole proprietorships, four million S corporations, and three million partnerships.<sup>44</sup> In contrast, there are slightly less than six million C corporations.<sup>45</sup>

In 2007 94 percent of all U.S. businesses were organized as flow-through entities.<sup>46</sup> These entities earned 47 percent of all total U.S. business income and accounted for 66 percent of U.S. businesses reporting a

profit of more than \$1 million.<sup>47</sup> In comparison, in 1980 flow-through entities also made up a large percentage of U.S. businesses (83 percent) but earned only 21 percent of total business income.<sup>48</sup>

A significant amount of the income earned by flow-through business entities is passed through to taxpayers in the top tax brackets: In 2006 taxpayers in the highest two tax brackets made up only 8 percent of all taxpayers receiving any flow-through income or loss but received 72 percent of the net flow-through income.<sup>49</sup> Four percent of the taxpayers reporting flow-through income fell into the highest tax bracket, accounting for 61 percent of flow-through income.

The amount of business activity conducted by non-corporate businesses in the United States stands in contrast to other OECD countries. In a 2007 OECD study of 15 OECD countries, only Mexico had an unincorporated business sector representing a larger share of the total number of businesses.<sup>50</sup> The United States also has a larger proportion of flow-through businesses among all large businesses. As stated above, 55 percent of U.S. businesses reporting profits of \$1 million or more are not incorporated, compared with 27 percent in Mexico, 26 percent in the United Kingdom, and 17 percent in New Zealand.<sup>51</sup>

A small percentage of flow-through businesses and C corporations earn most of the income earned by all flow-through businesses and C corporations, respectively. In 2007 the 9,597 largest C corporations (that is, those with assets greater than \$500 million; approximately 0.2 percent of all C corporations) earned approximately 84 percent of all corporate income.<sup>52</sup> Approximately, 0.5 percent of partnerships (that is, those with assets exceeding \$100 million) earned approximately 67 percent of all partnership income.<sup>53</sup>

*d. Increased use of expiring tax provisions.* The number of expiring tax provisions appears to have significantly increased in recent years. In his testimony before the Finance Committee, Randall D. Weiss observed that

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> Treasury Conference on Business Taxation and Global Competitiveness, "Background Paper," 15 (July 23, 2007), *Doc 2007-17146, 2007 TNT 142-14*.

<sup>50</sup> *Id.* at 16.

<sup>51</sup> *Id.*

<sup>52</sup> See IRS, 2007 Statistics of Income, Returns of Active Corporations, Table 2 — Balance Sheet, Income Statement, and Selected Other Items, by Size of Total Assets (using total income after credits as income figure).

<sup>53</sup> See IRS, 2007 Statistics of Income, Table 15, "All Partnerships: Total Assets, Trade or Business Income and Deductions, Portfolio Income, Rental Income, and Total Net Income, by Size of Total Assets" (using total net income (less loss) as income figure).

<sup>42</sup> *Id.*

<sup>43</sup> William Gale and Benjamin H. Harris, "A Value-Added Tax for the United States: Part of the Solution" (July 2010), *Doc 2010-16324, 2010 TNT 141-38*.

<sup>44</sup> Nina Olson, "National Taxpayer Advocate Report to Congress: Fiscal Year 2011 Objectives," 10 (June 30, 2010), *Doc 2010-15078, 2010 TNT 130-15*.

<sup>45</sup> IRS, 2007 Statistics of Income, Corporation Income Tax Returns 1 (2007), available at <http://www.irs.gov/pub/irs-soi/07ccocr.pdf>.

<sup>46</sup> Mazur testimony, *supra* note 35.

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"at the beginning of 1985, 25 provisions were scheduled to expire in the next two years. As of early 1989, after the [1986] Act and other legislation resolved some of these issues, there were 14 provisions that expired either that year or the previous one. In contrast, as of early 2010, there were 141 provisions that expired in that year or the previous one."<sup>54</sup>

The frequent use of expiring provisions creates uncertainty for taxpayers. Recently, after Congress failed to extend the tax provisions expiring on December 31, 2009, businesses faced considerable uncertainty in deciding whether to make investments or conduct transactions affected by the provisions, not knowing whether Congress would retroactively extend them. Further, the expiring provisions create administrative burdens for the IRS. As IRS Commissioner Douglas Shulman noted in December 2010 letters to the leaders of the taxwriting committees regarding the pressing need for action on expiring tax provisions:

While I know you and your colleagues have a difficult challenge to enact legislation this year, I want to stress that it would be extremely detrimental to the entire tax filing season and to tens of millions of taxpayers if tax law changes affecting 2010 are deferred and then retroactively enacted in 2011. Specifically, it would be an unprecedented and daunting operational challenge to open the tax filing season under one set of tax laws with respect to AMT and extenders, begin accepting tax returns, and then have the law change.<sup>55</sup>

### C. Recent Reform Proposals

#### 1. 2005 Reform Panel

The 2005 President's Advisory Panel on Federal Tax Reform (the 2005 reform panel) made two alternative business taxation proposals.<sup>56</sup> The Simplified Income Tax Plan would lower the corporate tax rate to 31.5 percent, create a simplified depreciation system, and enact a territorial system (under which dividends paid by a foreign affiliate out of active foreign earnings would not be subject to U.S. corporate tax), and would treat a business as a resident of the United States (and thus subject to U.S. tax) if the business is resident in the United States or if the United States is the business's place of primary management and control.<sup>57</sup>

<sup>54</sup>Statement of Randall D. Weiss, "How Did the 1986 Tax Reform Act Attract So Much Support?" Testimony Before the Senate Committee on Finance (Sept. 23, 2010), *Doc 2010-20794*, 2010 TNT 185-53.

<sup>55</sup>Letter from IRS Commissioner Douglas Shulman to Baucus (Dec. 2010), *Doc 2010-25521*, 2010 TNT 231-17.

<sup>56</sup>See generally President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System" (Nov. 1, 2005), *Doc 2005-22112*, 2005 TNT 211-14.

<sup>57</sup>*Id.* at 124-135.

The 2005 reform panel's Growth and Investment Plan would create a cash flow tax.<sup>58</sup> The base of the tax would be sales or receipts less the cost of materials, labor services, and purchases of business assets. There would be several modifications, including immediate expensing of capital expenditures, special rules for financial institutions, loss carryforwards with accrued interest, and taxation of international transactions under a destination basis principle.

The 2005 reform panel also considered a VAT, but could not reach a consensus on whether a VAT option should be recommended.<sup>59</sup> The VAT proposal studied by the panel would combine a 15 percent VAT, a top individual income tax rate of 15 percent, and a top corporate tax rate of 15 percent. According to the report:

Some members were . . . concerned that introducing a VAT would lead to higher total tax collections over time and facilitate the development of a larger federal government — in other words, that the VAT would be a "money machine." Other Panel members suggested that studies of the international experience and domestic policies realities did not support the "money machine" argument. Some argued that adopting a VAT . . . would make it more likely that higher taxes would be used to solve the nation's long-term fiscal challenges. . . . Others expressed the opposite view and regarded the VAT as a stable and efficient tool that could be used to reduce income taxes, fund entitlement programs, or service as a possible replacement for payroll taxes.

The panel also considered, but rejected, a national retail sales tax.<sup>60</sup> The panel concluded that replacing the income tax with a retail sales tax, absent a way to ease its burden on lower- and middle-income Americans, would not satisfy the panel's mandate that its recommendations be appropriately progressive. Providing cash grants to minimize the burden of the tax on lower- and middle-income Americans would "inappropriately increase the size and scope of government." The tax rate would be at least 34 percent, the federal administrative burden would likely be similar to the current system, and taxpayers would need to continue filing state tax returns, thus limiting potential simplification gains.

#### 2. Wyden-Gregg

In February 2010 Finance Committee member Ron Wyden, D-Ore., and former Sen. Judd Gregg of New Hampshire, introduced the Bipartisan Tax Fairness and Simplification Act of 2010 (Wyden-Gregg).<sup>61</sup> Their

<sup>58</sup>*Id.* at 162-175.

<sup>59</sup>*Id.* at 191-205.

<sup>60</sup>*Id.* at 207-222.

<sup>61</sup>S. 3018.

plan would reform the individual tax system. It would reduce the number of brackets to three (15, 25, and 35 percent), eliminate the AMT, triple the standard deduction, and preserve the mortgage interest deduction, the charitable contribution deduction, the child tax credit, the earned income tax credit, and the dependent care credit. For business tax reform, Wyden-Gregg would reduce the corporate tax to a flat 24 percent, eliminate deferral, provide 100 percent expensing for small businesses, and eliminate the value of inflation from a corporation's interest deduction. The bill would also eliminate many individual and corporate tax expenditures, such as some employee tax exclusion provisions, deductions for moving expenses, deferral of interest on savings bonds, the domestic production deduction, the deduction for punitive damages, and some special expensing provisions.

### 3. 2010 PERAB Tax Reform Subcommittee

Obama tasked the President's Economic Recovery Advisory Board (PERAB) tax reform subcommittee with preparing a report on "options for changes in the tax system to achieve three broad goals: simplifying the tax system, improving taxpayer compliance with existing tax laws, and reforming the corporate tax system."<sup>62</sup> As the subcommittee noted in the preface to its August 2010 report, it "was not asked to recommend a major overarching tax reform. . . . We received many suggestions for broad tax reform, and some members of the PERAB believe that such reform will be an essential component of a strategy to reduce the long-term deficit of the federal government. But consistent with our limited mandate, we did not evaluate competing proposals for overarching tax reform in this report."<sup>63</sup>

The PERAB tax reform subcommittee did, however, make several observations about the U.S. business tax system. It noted that the United States has the second-highest statutory corporate income tax in the OECD but has a relatively narrow corporate tax base compared with the size of the overall business sector.<sup>64</sup> It also noted that "the combination of a high statutory rate and numerous deductions and exclusions results in an inefficient tax system that distorts corporate behavior in multiple ways."<sup>65</sup>

The tax reform subcommittee discussed the advantages and disadvantages of several corporate tax reform measures to reduce marginal corporate rates or broaden the tax base, but consistent with its mandate, it did not make any recommendations on which option may be preferable. Regarding reducing marginal corporate rates, the report considered reducing the statutory

corporate tax rate and increasing incentives for new investment/direct expensing. Regarding broadening the tax base, the report considered providing more level treatment of debt and equity financing, reviewing the boundary between corporate and noncorporate taxation, and eliminating or reducing tax expenditures.

The tax reform subcommittee also described options for reforming the international tax system, observing that international tax reform involves consideration of:

sometimes competing policy goals: increasing the attractiveness of the U.S. as a production location for U.S. and foreign companies; reducing the tax disadvantages of U.S. [multinational corporations] operating in low-tax jurisdictions compared to their foreign competitors; reducing the incentives for U.S. [multinational corporations] to shift activities and reported profits abroad to avoid paying U.S. corporate tax; reducing the costs of administration and compliance; and reducing the erosion of the U.S. tax base and the loss of corporate tax revenues that result from tax avoidance measures.<sup>66</sup>

The subcommittee considered four major options for international tax reform: (1) moving to a territorial system; (2) maintaining the current system of worldwide taxation but lowering the corporate rate and eliminating deferral; (3) tightening or ending deferral with no change in the corporate tax rate; and (4) retaining the current system but lowering the tax rate.

### 4. Ryan 'Roadmap for America's Future'

House Budget Committee Chair Paul Ryan, R-Wis., has proposed a "Roadmap for America's Future."<sup>67</sup> In addition to reforming healthcare, Medicare, Medicaid, Social Security, job training programs, and the budget process, Ryan's plan would reform the individual and business tax systems. Regarding individual taxation, Ryan's plan would allow taxpayers a choice between the current system and a new system, referred to as the "simplified" system. Under the simplified system, the first \$100,000 (for joint filers) or \$50,000 (for single filers) of a taxpayer's adjusted gross income would be subject to a 10 percent rate while the balance of a taxpayer's AGI would be taxed at 25 percent.<sup>68</sup> Interest, capital gains, and dividends would not be taxed. For business taxation, the Ryan plan would eliminate the

<sup>62</sup>*Id.* at 81-82.

<sup>63</sup>See Roadmap for America's Future Act of 2010, H.R. 4529; Senate Budget Committee Republicans, A Roadmap for America's Future, available at <http://www.roadmap.republicans.budget.house.gov/>.

<sup>64</sup>Under the Ryan plan, the standard deduction would be \$25,000 for joint tax filers and \$12,500 for single filers. The personal exemption would be \$3,500. Nearly all individual tax expenditures would be eliminated.

<sup>62</sup>PERAB, *supra* note 13, at V.

<sup>63</sup>*Id.*

<sup>64</sup>*Id.* at 65.

<sup>65</sup>*Id.*

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corporate income tax and replace it with a subtraction-method, border-adjustable "business consumption tax" of 8.5 percent on goods and services.

##### 5. *Restoring America's Future' Report*

In November 2010 the Bipartisan Policy Center, a nonprofit organization established by former Senate Majority Leaders Howard Baker, Tom Daschle, Bob Dole, and George Mitchell, released a report by its Debt Reduction Tax Force on "a long-term plan to reduce the national debt and place our nation on a sustainable fiscal path."<sup>69</sup> Regarding taxes, the task force recommended (1) lowering marginal rates on individuals and corporations, with 15 percent and 27 percent brackets for individuals and a 27 percent rate for corporations; (2) eliminating itemized deductions and the standard deduction and instead allowing all taxpayers a 15 percent credit for home mortgage interest expenses (up to \$25,000) and a 15 percent credit for charitable contributions; (3) restructuring tax provisions benefitting low-income taxpayers and families with children; (4) ending almost all tax expenditures for both individuals and corporations; (5) creating a new 6.5 percent "debt reduction sales tax" (that is, a credit-invoice VAT with a broad base); and (6) implementing a Social Security payroll tax holiday in 2011.<sup>70</sup>

The Debt Reduction Task Force plan does not specifically address international tax issues and, as a result, assumes the United States would maintain the current system of deferral:

The Task Force plan leaves in place the provision that allows U.S. multinationals to defer taxation of the profits of their foreign subsidiaries until those profits are repatriated to the U.S. parent (deferral). Some view deferral as an incentive for U.S.-based companies to invest overseas, but others believe eliminating deferral would damage the ability of U.S. corporations to compete with foreign-based corporations and note that most of our major trading partners have enacted territorial systems that exempt completely the active foreign income of their corporations. While the Task Force plan does not address our complex system of taxing international income flows of corporations, the substantially lower corporate tax rate that the Task Force proposes will increase the incentive for both U.S. and foreign-based multinationals to invest in the United States.<sup>71</sup>

##### 6. *The Bowles-Simpson Commission*

The Bowles-Simpson commission created by Obama was "charged with identifying policies to improve the

<sup>69</sup>Bipartisan Policy Center, Debt Reduction Task Force, "Restoring America's Future: Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System," 2 (2010), *Doc 2010-24611*, 2010 TNT 222-29.

<sup>70</sup>*Id.* at 31-45.

<sup>71</sup>*Id.* at 130 footnote 89.

fiscal situation in the medium term and to achieve fiscal sustainability over the long run."<sup>72</sup> The commission released its report in December 2010 with the approval of 11 of the commission's 18 members, falling short of the 14 votes necessary to officially approve the report.<sup>73</sup> Regarding tax reform, the commission stated:

America's tax code is broken and must be reformed. . . . The corporate income tax hurts America's ability to compete. On the one hand, statutory rates in the U.S. are significantly higher than the average for industrialized countries (even as revenue collection is low), and our method of taxing foreign income is outside the norm. The U.S. is one of the only industrialized countries with a hybrid system of taxing active foreign-source income. The current system puts U.S. corporations at a competitive disadvantage against their foreign competitors.<sup>74</sup>

The commission's report recommended enacting a single corporate tax rate between 23 and 29 percent, eliminating all tax expenditures for business, and moving to a territorial tax system. The tax expenditures eliminated would include the domestic production deduction, inventory methods, and general business credits. Regarding moving to a territorial tax system, the report argued that the U.S. tax system should be brought "more in line with our international trading partners" by exempting active income earned by foreign subsidiaries and branches.<sup>75</sup> The report recommended that passive foreign-source income continue to be taxed.

##### 7. *Auerbach 'Modern Corporate Tax' Proposal*

Alan Auerbach, a professor of economics at the University of California, Berkeley, in collaboration with the Center for American Progress and the Hamilton Project (an economic policy initiative at the Brookings Institution), released in December 2010 a paper proposing a "modern corporate tax."<sup>76</sup> Auerbach proposed to replace the current corporate income tax with a destination-based cash flow tax. Under the cash flow tax, depreciation deductions would be replaced with immediate expenses for all tangible investments in plants, equipment, inventories, and net financial investment (that is, net lending less net borrowing). All taxes (and tax credits) on foreign-source income and all

<sup>72</sup>"Executive Order — National Commission on Fiscal Responsibility and Reform" (Dec. 18, 2010), available at <http://www.whitehouse.gov/the-press-office/2010/12/18/eo-13526>.

<sup>73</sup>National Commission on Fiscal Responsibility and Reform, "The Moment of Truth" (Dec. 2010), *Doc 2010-25486*, 2010 TNT 231-35.

<sup>74</sup>*Id.* at 24.

<sup>75</sup>*Id.* at 29.

<sup>76</sup>Alan J. Auerbach, "A Modern Corporate Tax" (Dec. 2010), *Doc 2010-25625*, 2010 TNT 233-104.

cross-border transactions, regardless of their nature, would be eliminated from the calculation of a company's tax base. For example, sales abroad would not be included in receipts, and purchases from abroad would not be deductible.

#### D. Where We Are (and Should Be) Going

##### 1. Potential Goals for Reform

When considering fundamental tax reform, policymakers should ask themselves whether today's tax system, which in many cases was designed to reflect the realities of a prior era, can carry out the United States' goals for the 21st century. These goals may include meeting the U.S.'s fiscal challenges; enhancing the U.S. economy by encouraging investment in the United States and enhancing the competitiveness of U.S. multinationals; and minimizing undesirable economic distortions.

##### a. Meeting the U.S.'s fiscal challenges.

i. *Revenue trends.* The United States faces many fiscal challenges. As the report of the Bowles-Simpson commission states:

Spending is rising and revenues are falling short, requiring the government to borrow huge sums each year to make up the difference. We face staggering deficits. . . . Since the last time our budget was balanced in 2001, the federal debt has increased dramatically, rising from 33 percent of GDP to 62 percent of GDP in 2010. The escalation was driven in large part by two wars and a slew of fiscally irresponsible policies, along with a deep economic downturn. We have arrived at the moment of truth.

In its June 2010 report, "The Long-Term Budget Outlook," the Congressional Budget Office projected that even if the 2001 and 2003 tax cuts were to expire as scheduled and the expanded reach of the AMT were not curtailed, federal debt held by the public would continue to grow from an estimated 62 percent of GDP in 2010 to about 80 percent by 2035.<sup>77</sup> Interest payments on the federal debt, which currently amount to more than 1 percent of GDP, would rise to 4 percent of GDP by 2035. If most provisions of the 2001 and 2003 tax cuts were extended, the reach of the AMT was limited, and some healthcare spending restraints were not continued, the fiscal situation would be considerably bleaker: Debt would reach 87 percent of GDP by 2020 and 185 percent in 2035. Interest payments would equal 9 percent of GDP by 2035 and by 2055 would exceed that year's total federal revenues.

ii. *Tax considerations.* I do not believe policymakers should consider raising taxes on U.S. businesses as a leading option to address the U.S.'s economic chal-

lenges. In 2009 the corporate income tax comprised only approximately 7 percent of U.S. revenue, compared with the 45 percent of revenue raised by the individual income tax and 30 percent raised by Social Security taxes.<sup>78</sup> Given that raising the already high corporate income tax rate would likely negatively affect investment in the United States, it appears that raising the corporate income tax is an undesirable strategy for addressing the United States' revenue needs.

Conversely, we should not put ourselves in a strait-jacket by ruling out all tax increases. As described below, we should consider corporate base-broadening measures, which might result in tax increases on some business sectors. I also believe a VAT should be on the table.

But I believe we will be led out of this deficit the way we have been led out of all our deficits — with economic growth. And while it is hard to correlate every tax increase with reduced growth and every tax cut with increased growth, common sense tells us that corporations, which are highly responsive to tax incentives, will help spur economic growth if they are more profitable on an after-tax basis.

We must consider reforming the corporate and international tax system to make the United States a more attractive place for investment. Further, we should consider reforming our tax system to make U.S.-based multinationals, which have a significant impact on the U.S. economy, more competitive globally. A tax system that serves these goals would help create a more robust U.S. economy and generate increased tax revenue and U.S. employment.

##### b. Enhancing the U.S. economy.

i. *Encouraging investment in the United States.* The U.S. tax system should encourage investment in the United States by both U.S. and foreign-owned companies. It is true that many nontax factors, such as a strong legal and regulatory framework, infrastructure, economic stability, and a skilled workforce, are key to investment location decisions. It is also true, however, that taxes are often another important factor in a business's investment decisions.

As a result, the high U.S. corporate tax rate may be a significant impediment for firms to make investments in the United States. Economic literature suggests that tax systems affect firms' foreign direct investment decisions. For example, Ruud de Mooij and Stef Ederveen, analyzing 25 foreign direct investment studies, found that a 1 percentage point reduction in a host country

<sup>77</sup>CBO, "The Long-Term Budget Outlook" (2010), Doc 2010-14510, 2010 TNT 126-19.

<sup>78</sup>See Office of Management and Budget, Historical Tables: Budget of the U.S. Government, Fiscal Year 2011, at 31 (2010), available at <http://www.gpoaccess.gov/usbudget/fy11/pdf/hist.pdf>.

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tax rate raises foreign direct investment by 3.3 percent.<sup>79</sup> Other studies have similar results, and "there is a general consensus that this empirical evidence demonstrates that [foreign direct investment] is in fact sensitive to tax factors, and suggests that this sensitivity may be increasing over time."<sup>80</sup>

It is sometimes argued that many U.S. companies have lower effective rates than the statutory rate and thus the effective rates must be analyzed in assessing the U.S. corporate tax burden. Although I agree that effective rates should be considered as one factor, I note that high statutory tax rates are significant because (1) lower effective rates are often the result of base-narrowing provisions that benefit only a few taxpayers; (2) corporations may engage in a significant amount of tax planning (which may come at high costs) to achieve lower tax rates; (3) statutory rates can be significant as corporations assess where to do business; and (4) the benefits of income-shifting are driven by the statutory rate. In fact:

the benefits of income shifting are determined primarily by the statutory tax rate, as firms face obvious incentives to shift revenues to jurisdictions with relatively low statutory tax rates and deductions to jurisdictions with relatively high statutory tax rates . . . if income shifting is sufficiently important, competition in statutory tax rates may be more important than competition in effective marginal tax rates in attracting mobile capital.<sup>81</sup>

ii. *Enhancing competitiveness of U.S. multinationals.* U.S. multinationals play a significant role in the U.S. economy. A 2010 study by the McKinsey Global Institute found that "relative to their size, U.S. multinational companies contribute disproportionately to private sector real GDP growth (or value added) and labor productivity."<sup>82</sup> The study found that U.S. multinationals operate primarily in the United States — in

2007 U.S. multinationals generated 60 percent of their collective sales, employed two-thirds of their workforce, paid three-quarters of their total wages, and held 60 percent of their assets in the United States. Further, in 2007 U.S. multinationals accounted for more than a third of U.S. private sector sales and nearly 25 percent of U.S. private sector GDP.

In addition to generating a significant amount of economic activity in the United States directly, U.S. multinational companies also have a significant indirect effect on the U.S. economy. According to the McKinsey study, U.S. multinationals purchase approximately 90 percent of their intermediate input from other U.S.-based firms.<sup>83</sup> When the indirect effects of U.S. multinationals are added to their direct contributions to the U.S. economy, U.S. multinationals contribute more than one-third of U.S. private sector GDP and are responsible for 28 percent of U.S. employment.<sup>84</sup>

American households have a significant stake in the success of U.S. multinationals. Although U.S. multinationals constitute less than 1 percent of U.S. businesses, they directly employ nearly 20 percent of the private sector work force and pay a quarter of private sector workforce wages. In 2007 U.S. residents held 86 percent (approximately \$17.5 trillion) of the total market value of all U.S. companies' equity, either directly as individual investors or indirectly through pensions, retirement accounts, and insurance accounts.<sup>85</sup>

As explained above, the success of U.S. multinationals increasingly depends on overseas investment, as does the success of all countries' multinationals. In 2007 the net income of U.S. parent corporations was \$701.3 billion, while the net income of the U.S. corporation's foreign affiliates was \$765.2 billion — the foreign affiliates accounted for more than half of the worldwide net income of U.S. multinationals.<sup>86</sup> When these multinationals establish affiliates overseas, the overseas investments are generally made in furtherance of foreign investments and not as substitutions for U.S. investments. For example, a study by Prof. Matthew J. Slaughter found that nearly 90 percent of sales by foreign affiliates majority-owned by U.S. companies are into the host-country market or other foreign markets — only 10.5 percent of affiliate sales are back to the United States.<sup>87</sup> Studies have also suggested that this

maintains its headquarters in the United States and holds at least a 10 percent equity interest in a foreign affiliate) as the bureau.

<sup>79</sup>*Id.* at 11.

<sup>80</sup>*Id.*

<sup>81</sup>*Id.* at 10.

<sup>82</sup>Matthew J. Slaughter, "How U.S. Multinational Companies Strengthen the U.S. Economy: Data Update," at 8 (Mar. 2010), available at [http://businessroundtable.org/uploads/studies-reports/downloads/BRT\\_USCIB\\_White\\_Paper\\_Revise\\_Synopsis\\_3\\_23\\_10\\_FORMATTED\\_FINAL\\_v2\\_1.pdf](http://businessroundtable.org/uploads/studies-reports/downloads/BRT_USCIB_White_Paper_Revise_Synopsis_3_23_10_FORMATTED_FINAL_v2_1.pdf).

<sup>83</sup>*Id.* at 7.

<sup>79</sup>Ruud A. de Mooij and Stef Ederveen, "Taxation and Foreign Direct Investment, A Synthesis of Empirical Research," 10 *Int'l Tax and Pub. Fin.* 673 (2003); see also de Mooij and Ederveen, "Explaining the Variation in Empirical Estimates of Tax Elasticities of Foreign Investment," Tinbergen Institute Discussion Paper (2005), available at <http://ftp.tinbergen.nl/discussionpapers/05108.pdf>.

<sup>80</sup>George R. Zodrow, "Capital Mobility and Capital Tax Competition," 63 *Nat'l Tax J.* (2010); see also Altschuler, Harry Grubert, and T. Scott Newlen, "Has U.S. Investment Abroad Become More Sensitive to Tax Rates?" in James R. Hines Jr. (ed.), *International Taxation and Multinational Activity*, 9-32 (2001); Roger H. Gordon and Hines, "International Taxation," *Handbook of Public Economics* (1995).

<sup>81</sup>Zodrow, *supra* note 80.

<sup>82</sup>McKinsey Global Institute, *supra* note 36. The McKinsey study's primary source for data on U.S. multinational companies was the U.S. Direct Investment Abroad surveys conducted by the U.S. Bureau of Economic Analysis. The study used the same definition of "U.S. multinational company" (a company that

(Footnote continued in next column.)

overseas activity supports U.S. activities. Profs. Mihir Desai, Fritz Foley, and James Hines have found that a 10 percent increase in U.S. multinationals' foreign direct investment was associated with a 2.6 percent increase in domestic investment, while a 10 percent faster foreign sales growth was associated with a 6.6 percent increase in U.S. exports.<sup>88</sup>

The global economy has changed significantly in the nearly 50 years since subpart F was enacted. As Treasury has recognized:

The U.S. system was developed at a time when the United States was the primary source of capital investment and dominated world markets. The global landscape has shifted considerably over the past several decades, with other countries challenging the U.S. position of economic preeminence. The United States is now a net recipient of foreign investment rather than the largest source.<sup>89</sup>

When subpart F was enacted in 1962, a U.S. company's decision whether to invest abroad or in the United States may well have been a choice. Today, however, U.S. companies must invest abroad because markets and growth are abroad. We must recognize that U.S. companies do not invest abroad at the expense of America; rather, these companies invest abroad to grow and compete, which benefits American workers and the U.S. economy.

*c. Minimizing economic distortions.* In considering reforming our corporate and international tax system, we may wish to determine whether there are significant economic distortions that should be addressed. For example, many believe that the current U.S. international tax system, which generally does not tax active foreign income of U.S. companies' foreign subsidiaries until that income is repatriated to the United States, creates a lockout effect that discourages foreign earnings repatriation. Others would focus on the distortive effect of deferral itself, which allows foreign subsidiaries to accumulate income tax free and benefit from the time value of money. These distortions could be addressed by two different approaches: one that would tax all foreign-source income currently, without regard to whether it is active or passive, or one that would exempt foreign income from U.S. taxation. Economic distortions created by the double tax on corporate profits include the bias against equity investment, the bias against incorporation, and the bias against dividend distributions.

<sup>88</sup>Mihir A. Desai, C. Fritz Foley, and James Hines, "Domestic Effects of the Foreign Affiliates of U.S. Multinationals," 1 *Am. Econ. J. Econ. Pol.* 1 (2009).

<sup>89</sup>Treasury, "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century" (Dec. 2007), *Doc 2007-27866, 2007 TNT 246-31*.

*d. Other objectives: administrability, simplicity, and certainty.* Policymakers should strive to reform the tax system to enhance administrability and lower compliance costs. Both of these goals may be furthered by simplifying current rules when possible, which may reduce errors, improve compliance, reduce taxpayers' planning expenses (and perhaps planning opportunities), and enhance the IRS's ability to administer the rules.

Another goal of tax reform may be certainty: The tax rules should allow taxpayers to determine with relative certainty the tax consequences of their transactions. For example, expiring tax provisions and retroactive tax changes generally should be avoided.

### III. A Proposal for Tax Reform

#### A. Overview

Tax reform should be based on today's realities. We must recognize that the United States, compared with other developed countries, has high corporate tax rates that create too great an incentive for tax planning and a disincentive for U.S. and foreign firms to invest in the United States. We also must recognize that the global economy is becoming more competitive. If the United States does not encourage U.S. investment, that investment will go elsewhere, and if the United States does not encourage U.S. firms to grow their foreign presence, they may not grow at all. Further, we must recognize that our international tax rules may create a disincentive for U.S.-based companies to reinvest foreign earnings in the United States.

The reform proposal described here is designed to encourage investment in the United States, to make U.S.-based companies more competitive across the globe, and to improve the economic efficiency of taxing repatriated income. As detailed below, this proposal recommends (1) exemption for receipt of dividends that are paid out of active income; (2) a limitation on the deductibility of expenses allocated to exempt income; (3) a limitation on transfers of intangibles to offshore locations; and (4) a limitation on "round-tripping" transactions.<sup>90</sup> Further, as discussed in Section III.C, the proposal also recommends lowering the corporate tax rate along with several additional base-broadening measures and other revenue-raising measures.

#### B. International Tax Reform

I propose that the United States enact a dividend exemption regime under which dividend distributions from active income are not subject to U.S. tax. Passive

<sup>90</sup>Although I expect that my proposal could be enacted on either a revenue-neutral or revenue-raising basis (depending on which features were adopted), I have not commissioned a revenue estimate of my proposal.

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income earned by foreign subsidiaries of U.S. corporations would continue to be taxed currently.<sup>91</sup>

A dividend exemption proposal is neither radical nor new. Many of the United States' closest trading partners have similar regimes. Further, similar proposals have been made by a recent presidential tax reform commission and well-respected economists.<sup>92</sup>

#### 1. Reasons for Change

I describe below three major arguments in favor of moving the U.S. international tax regime toward a dividend exemption system.<sup>93</sup> In sum: (1) the current international tax rules collect little tax but appear to distort behavior; (2) corporate residence appears to be a precarious basis for taxation; and (3) all of the United States' major trading partners have or are moving toward territorial regimes.

a. *The current rules distort behavior without raising significant revenue.* The current U.S. international tax rules result in very little tax being collected on the foreign-source income of U.S.-based multinationals. Rosanne Altshuler and Harry Grubert have found an overall effective repatriation tax burden for income earned in low-tax countries of just 3.3 percent of pretax earnings on equity income.<sup>94</sup> In 2009 the Obama administration observed that "in 2004, the most recent year for which data is available, U.S. multinational corporations paid about \$16 billion of U.S. tax on approximately \$700 billion of foreign active earnings — an effective U.S. tax rate of about 2.3 percent."<sup>95</sup>

Although the tax on repatriated foreign income raises little revenue, it appears to encourage U.S. companies to keep income abroad. One example of this apparent incentive is the 2004 enactment of a one-year reduced tax of 5.25 percent on repatriations, which resulted in \$360 billion in repatriations in 2005, compared with an average of about \$60 billion per year from 2000-2004.<sup>96</sup> Executives of U.S. multinational

companies have also said that the tax on repatriated foreign income discourages them from bringing that money back to the United States.<sup>97</sup>

The economic literature supports the proposition that repatriation taxes affect behavior. Analyzing the behavior of U.S.-owned affiliates over the 1982 to 1997 period, Desai, Foley, and Hines have found that "repatriation taxes imposed by current U.S. tax rules reduce the volume and efficiency of financial flows between affiliates and their American parents."<sup>98</sup> They determined that "U.S. repatriation taxes reduce aggregate dividend repatriations by 12.8 percent annually."<sup>99</sup> Hines and Glenn Hubbard have estimated that a 1 percent decrease in the tax on repatriation is associated with a 4 percent increase in dividend payments by foreign subsidiaries.<sup>100</sup>

The tax on repatriation also appears to distort corporate behavior in other ways. In a survey conducted by Profs. John R. Graham, Michelle Hanlon, and Terry Shevlin, firms reported incurring nontax costs to finance U.S. operations in a manner that would result in tax on repatriated earnings.<sup>101</sup> For example, firms reported that they had incurred debt in the United States instead of bringing cash back. Other firms said that they had accepted a lower rate of return by investing foreign cash overseas instead of in the United States.

The lockout effect of current law likely comes at a cost to the U.S. economy.<sup>102</sup> The amount of income kept abroad is significant. Even after the 2005 reduced

<sup>97</sup>See, e.g., John Chambers and Safra Catz, "The Overseas Profits Elephant in the Room," *The Wall Street Journal*, Oct. 20, 2010 (Cisco CEO John Chambers and Oracle President Safra Catz writing: "By permitting companies to repatriate foreign earnings at a low tax rate — say, 5 percent — Congress and the president could create a privately funded stimulus of up to a trillion dollars. They could also raise up to \$50 billion in federal tax revenue. That's money the economy would not otherwise receive."). *But see* editorial, "Fool Me Twice," *The New York Times*, Oct. 23, 2010 ("Large multinationals are not refraining from investing in the United States because their money is locked up abroad. Many have large piles of cash in the United States, too. Interest rates are near historic lows, and banks will trip over themselves to lend to big multinationals sitting on mountains of cash. If they are not investing, it is because of the uncertain economic outlook.").

<sup>98</sup>Desai, Foley, and Hines, "Repatriation Taxes and Dividend Distortions," 54 *Nat'l Tax J.* 829 (2001).

<sup>99</sup>*Id.*

<sup>100</sup>Hines and R. Glenn Hubbard, "Coming Home to America: Dividend Repatriations by U.S. Multinationals," in *Taxation in the Global Economy* 161-208 (1990).

<sup>101</sup>John R. Graham, Michelle Hanlon, and Terry Shevlin, "Barriers to Mobility: The Lockout Effect of U.S. Taxation of Worldwide Corporate Profits," 63 *Nat'l Tax J.* 1111 (2010).

<sup>102</sup>See Foley et al., "Why Do Firms Hold So Much Cash? A Tax-Based Explanation," 60 *J. Fin. Econ.* 187 (2007) (finding that firms that face higher repatriation tax burdens hold higher levels

(Footnote continued on next page.)

<sup>91</sup>Mobile income, which has been the subject of much attention since 1997 (e.g., Notice 98-11, 1998-1 C.B. 433, *Doc 98-2983*, 98 *TNT* 12-8; section 954(c)(6)), should be taxed currently to the extent that policymakers determine that income earned in high-tax jurisdictions is deflected to low-tax jurisdictions and provides too great an incentive for investment outside the United States that would displace U.S. investment and job creation.

<sup>92</sup>President's Advisory Panel on Federal Tax Reform, *supra* note 56; Grubert and John Mutti, *Taxing International Business Income: Dividend Exemption Versus the Current System* (2001).

<sup>93</sup>Some argue that because the current system is so close to an exemption system, the transition costs are not worth the change. I would let that question be sorted out in the political process.

<sup>94</sup>Altshuler and Grubert, "Where Will They Go If We Go Territorial?" 54 *Nat'l Tax J.* 787 (2001).

<sup>95</sup>Treasury, "Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas" (May 4, 2009), *Doc 2009-10037*, 2009 *TNT* 84-44.

<sup>96</sup>PERAB, *supra* note 13, at 82.

rate on repatriations, U.S. companies reported more than \$1 trillion of permanently reinvested earnings on 2008 financial statements.<sup>103</sup> Investment of deferred earnings in the United States, even in the form of a loan, is taxed on a current basis. No other OECD country has a provision like section 956 that operates in this manner.

The current rules also cause taxpayers to incur significant transaction costs in avoiding the repatriation tax. Several recent transactions have been publicized in which U.S. multinationals have tried to bring large amounts back to the United States with little or no tax.<sup>104</sup> Also, rather than directly repatriating funds to the United States, firms may engage in other investment strategies that have “the effect of achieving the equivalent of repatriation without incurring the home country tax on direct repatriations of low-tax income.”<sup>105</sup> Altshuler and Grubert have found that “controlled foreign corporations that face high repatriation taxes make greater investments in related affiliates and send a greater share of their dividends to other foreign affiliates. In addition, they also pay off more local debt as they accumulate retained earnings.”<sup>106</sup>

*b. The significance of corporate residence.* As described above, the United States generally taxes U.S. corporations on their worldwide income (subject to an FTC for foreign income taxes paid on foreign-source income).<sup>107</sup> Foreign corporations, however, are subject to U.S. tax only on their U.S. effectively connected income (on a net basis) and U.S.-source fixed or determinable income (on a gross basis).<sup>108</sup> As a result, whether a corporation is treated as foreign or domestic generally controls the extent to which it is taxed by the United States.

Whether corporate residence is a meaningful concept is debatable. Many large corporations are not predominantly based in only one country — their em-

ployees, business activities, shareholders, and income may be spread across the globe. As a result, it may make little sense to base the entire U.S. international tax regime on the concept of residence.

Further, the U.S. rule for determining corporate residence is essentially based on a legal formality and may not correlate with where a corporation’s economic activity occurs. The United States determines whether a corporation is treated as domestic or foreign by reference to its place of organization.<sup>109</sup> Unlike many other countries, the United States does not consider where the corporation is managed and controlled, although there have been several recent proposals to do so.<sup>110</sup> Nor does it tax economic activity on a formulary basis. The place of organization as a basis for taxation provides taxpayers with a great deal of electivity in determining whether a corporation should be subject to U.S. tax as a domestic corporation (and thus taxed on its worldwide income) or a foreign entity (and thus taxed on only U.S.-source income and income effectively connected with a U.S. trade or business). The electivity of the current regime also provides an impetus for inversions.<sup>111</sup>

Further, the current rules also provide a significant incentive for original incorporations of firms overseas. As Daniel Shaviro writes, “foreign incorporation — often in jurisdictions such as Bermuda and the Cayman Islands that lack significant domestic income tax systems — has become more common, and I have heard U.S. tax lawyers joke that recommending (or even not objecting to) U.S. incorporation of an intended global business verges on being malpractice per se.”<sup>112</sup> Although it is true that a full empirical assessment of the electivity of corporate residence on new incorporations is difficult because it “would require worldwide data on incorporations, and an empirical strategy that credibly identifies the relevant counterfactual — i.e., incorporations that would have occurred in the United States, but occurred in other countries for tax reasons,” recent studies have shown that new incorporations in

of cash, hold cash abroad, and hold cash in affiliates that would trigger high tax costs when repatriating earnings).

<sup>103</sup>PERAB, *supra* note 13, at 82.

<sup>104</sup>*See, e.g.*, Notice 2006-85, 2006-2 C.B. 677, *Doc 2006-19944*, 2006 *TNT* 183-6; Notice 2007-48, 2007-1 C.B. 1428, *Doc 2007-13117*, 2007 *TNT* 106-13 (responding to “Killer B” transactions); Notice 2008-10, 2008-1 C.B. 277, *Doc 2007-28315*, 2007 *TNT* 250-9 (responding to “Deadly D” transactions); *Schering-Plough Corp. v. United States*, 651 F. Supp. 2d 219 (D.N.J. 2009), *Doc 2009-19512*, 2009 *TNT* 167-3; Jesse Drucker, “Dodging Repatriation Tax Lets U.S. Companies Bring Home Cash,” *Bloomberg* (Dec. 29, 2010).

<sup>105</sup>Altshuler and Grubert, “Repatriation Taxes, Repatriation Strategies and Multinational Financial Policy,” 87 *J. Pub. Econ.* 73 (2001) (describing alternatives to repatriation, including subsidiary investment in passive assets against which the parent corporation may borrow, and subsidiary investment in high-tax foreign affiliates).

<sup>106</sup>*Id.*

<sup>107</sup>Sections 1, 11, 61, and 901-904.

<sup>108</sup>Sections 882, 871, and 881.

<sup>109</sup>Section 7701(a)(4) and (5).

<sup>110</sup>Stop Tax Haven Abuse Act, S. 506; JCT, “Options to Improve Tax Compliance and Reform Tax Expenditures,” JCS-02-05 (2005), at 178-181, *Doc 2005-1714*, 2005 *TNT* 18-18; President’s Advisory Panel on Federal Tax Reform, *supra* note 56, at 179.

<sup>111</sup>Although the enactment of the anti-inversion rules of section 7874 in 2004 attempted to curb U.S. corporations reincorporating overseas, the continual cat-and-mouse game that is the recent history of anti-inversion rules seems to illustrate a poorly functioning system.

<sup>112</sup>Daniel Shaviro, “The Rising Tax-Electivity of U.S. Corporate Residence” (Oct. 2010), available at [http://www.law.nyu.edu/ecm\\_dlv1/groups/public/@nyu\\_law\\_website\\_alumni/documents/documents/ecm\\_pro\\_066815.pdf](http://www.law.nyu.edu/ecm_dlv1/groups/public/@nyu_law_website_alumni/documents/documents/ecm_pro_066815.pdf).

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recent years appear to be tax motivated.<sup>113</sup> Desai and Dhammika Dharmapala have found that the ratio of initial public offerings (IPOs) on the New York Stock Exchange and NASDAQ from 2005 through 2009 for firms incorporated in countries that Desai and Dharmapala define as "tax haven jurisdictions" compared with IPOs for firms incorporated in the United States was 1 to 10, with a peak of 1 to 3 in 2008. No firms were incorporated in tax havens early in the period for which data were available (approximately 1988-1990).<sup>114</sup> Desai and Dharmapala found that the same pattern did not exist for IPOs in the stock markets of France and Germany, which both have territorial tax systems.

In sum, "the principal function of corporate residence is to determine whether a corporation will be taxed by the United States on its worldwide income or whether it will be subject to limited source-based taxation."<sup>115</sup> Although some alternatives to the place of residence test might reduce the ease with which corporations may essentially choose the extent to which they are subject to U.S. tax when deciding whether to carry out business through a U.S. or foreign corporation, the fundamental difference in U.S. taxation of domestic and foreign corporations, and the economic distortions resulting from that difference, would remain. The stakes of corporate residence may best be reduced by modifying U.S. tax law to make the treatment of foreign income more neutral and depend less on whether it is earned by a U.S. or foreign corporation.

*c. Aligning our rules with our trading partners.* Another argument supporting a change in the U.S.'s current system of taxing foreign income is that most of the United States' major trading partners, whose multinationals are the major competitors of U.S.-headquartered companies, have territorial (exemption) tax systems.<sup>116</sup> Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Hong Kong, Japan, the Netherlands, Norway, Russia, Singapore, Spain, Sweden, Switzerland, and the United Kingdom all have territorial tax systems.<sup>117</sup>

Two countries with historic worldwide taxation systems, the United Kingdom and Japan, both adopted territorial systems in 2009. Both countries sought to improve the global competitiveness of their corpora-

tions as well as encourage companies to repatriate funds into the local economy.

The new Japanese system exempts 95 percent of foreign dividends from taxation.<sup>118</sup> According to Tadao Yanase, the director of corporate tax policy in Japan's Ministry of Economy, Trade and Industry, the Japanese tax reform was anticipated to "promote domestic investment in such activities as research and development and further strengthen competitiveness of Japanese companies in overseas markets."<sup>119</sup>

The new U.K. territorial regime exempts 100 percent of foreign dividends from taxation. Before the regime was enacted, U.K. Treasury Financial Secretary Stephen Timms said he was confident that the dividend exemption (in combination with a worldwide debt cap) and accompanying modernization of the U.K.'s CFC regime would "enhance UK competitiveness making the UK a more attractive place to do business, and reduce the administrative burden on business, while striking the right balance with mitigating the risk to tax revenues."<sup>120</sup> HM Revenue & Customs echoed this rationale for the movement toward a territorial regime:

As a result of globalisation, businesses are becoming more mobile. In this context it is increasingly important that the UK remains an attractive location for businesses to locate and invest. It is therefore important that the tax system continues to be (and is seen to be) internationally competitive, minimising complexity and administration costs, while providing stability and certainty for taxpayers.<sup>121</sup>

As described above, the United States is now one of only seven OECD countries with a worldwide corporate tax system — only Chile, Ireland, Israel, Mexico, Poland, and South Korea have similar worldwide systems. Each of the other OECD countries that tax corporations on a worldwide basis, however, has significantly lower corporate tax rates.<sup>122</sup>

<sup>118</sup>Charles Gnaedinger, "Japanese, U.K. Exemption Systems Could Inform U.S. Tax Reform Decisions," *Doc 2010-4363, 2010 WTD 40-3* (citing statements made by Jonathan Stuart-Smith, partner at Tohmatsu Tax Co. in Tokyo).

<sup>119</sup>"Japan Tax Reform May Help Repatriate Company Funds," Reuters (May 9, 2008).

<sup>120</sup>Letter from U.K. Treasury Financial Secretary Stephen Timms to Richard Lambert, director general, Confederation of British Industry (Nov. 24, 2008).

<sup>121</sup>HMRC, "Taxation of the Foreign Profits of Companies," Draft Provisions Discussion Paper (Dec. 9, 2008), *Doc 2009-12298, 2009 WTD 104-19*. HMRC also stated: "The policy objective [of the territorial regime] is to enhance the competitiveness of the UK by providing the widest possible exemption. Compared with other developed countries, this dividend exemption is one of the most generous as it is available regardless of the level of shareholding." *Id.*

<sup>122</sup>China, a non-OECD country, also has a worldwide tax system. Like the other OECD countries that tax on a worldwide system. (Footnote continued on next page.)

<sup>113</sup>Desai and Dhammika Dharmapala, "Do Strong Fences Make Strong Neighbors?" 63 *Nat'l Tax J.* 723 (2010).

<sup>114</sup>*Id.*

<sup>115</sup>"Report of the American Bar Association Task Force on International Tax Reform," 59 *Tax Law.* 649, 748 (2006).

<sup>116</sup>Although I generally refer to these countries as having territorial tax systems, some may have special rules for passive or other types of income and thus do not have purely territorial systems.

<sup>117</sup>John M. Samuels, "American Tax Isolationism," *Tax Notes*, June 29, 2009, p. 1593, *Doc 2009-14174*, or 2009 *TNT* 122-11.

The United States' continued taxation of U.S. corporations on a worldwide basis, combined with its high statutory corporate tax rate (the second highest such tax rate in the OECD), puts U.S.-based multinationals at a competitive disadvantage. Aligning our international tax rules with those of our major trading partners (and the homes of U.S.-based multinationals' competitors) would allow U.S.-based companies to compete better in today's global economy.

As a result, the time may have come for the United States to join nearly all the other OECD members in exempting dividends paid out of active income.<sup>123</sup> Subpart F and the FTC would be retained for passive income. Active income, however, would be taxed purely on a source basis.<sup>124</sup>

#### 2. Suggested Features of a Dividend Exemption System

*a. Expense allocations.* There are compelling arguments that, in principle, deductions allocated to exempt income should be limited. For example, some U.S. domestic tax law provisions deny deductions for expenses relating to tax-exempt income.<sup>125</sup>

Most of our trading partners that exempt dividends from the active income of a CFC, however, do not limit deductions. Austria, Canada,<sup>126</sup> Denmark, Finland, the Netherlands, Russia, Spain, Sweden, and the United Kingdom exempt all foreign business income from home country tax and do not deny deductions for domestic expenses allocable to exempt foreign income tax.<sup>127</sup> Belgium, France, Germany, Italy, Japan, and Norway exempt at least 95 percent of foreign business income from home country tax, subjecting a small portion of foreign income to tax as a proxy for expense allocation.<sup>128</sup> Australia, Hong Kong, and Singapore have territorial tax systems but impose some limitation on deductions of domestic expenses based on foreign

investment. Several countries do, however, apply some limitations on deductibility of interest generally, such as the United Kingdom.

Some limitation on the deductibility of expenses relating to tax-exempt income would appear consistent with the treatment of expenses allocated to exempt income under domestic U.S. tax law.<sup>129</sup> A sensible compromise between full deductibility and a cumbersome expense disallowance regime would appear to be to exempt 90 percent of the foreign dividend from U.S. taxation.<sup>130</sup>

Alternatively, policymakers could consider a 95 percent dividend exemption with overall interest disallowance (thin capitalization) rules for U.S. corporations.<sup>131</sup> One approach, which would be similar to the rules adopted by many major U.S. trading partners, would restrict the overall debt-to-equity ratio of U.S. corporations to some acceptable ratio, treating interest in excess of that ratio as nondeductible dividends. This approach is taken by most EU member countries and (as a result of ECJ decisions) applies to interest paid to both domestic and foreign lenders. Expanding our thin capitalization rules to cover U.S. groups could also have the added advantage of discouraging excessive leverage, which some have viewed as particularly problematic in difficult economic conditions.<sup>132</sup>

*b. Transfer pricing and intangibles.* A dividend exemption system could create incentives for multinational corporations to attempt to use transfer pricing to minimize taxable income generated by domestic operations while maximizing income generated by active foreign business operations. These incentives also exist under current law, although some may argue that they could be more significant under a dividend exemption system because the shifting of income could lead to the exemption, rather than the deferral, of U.S. tax.<sup>133</sup> As a result, reform of the transfer pricing rules may be needed.

basis, however, it has a significantly lower corporate tax rate than the United States: 25 percent compared to 39.21 percent.

<sup>123</sup>For the reasons explained below, I recommend a partial exemption to reflect expenses allocable to exempt income.

<sup>124</sup>This proposed system would treat foreign branches and foreign subsidiaries differently, but taxpayers could avoid the full inclusion of branch income by simply incorporating the branch.

<sup>125</sup>Sections 264-265.

<sup>126</sup>Although the issue was addressed in the recent report of an advisory panel on reforming Canada's international tax system, no changes were recommended even though Canada's dividend exemption was broadened. The principal reason given was to maintain the international competitiveness of Canadian companies. Advisory Panel on International Taxation, "Enhancing Canada's International Tax Advantage" (Dec. 2008), *Doc 2008-26028, 2008 WTD 242-18*.

<sup>127</sup>Samuels, *supra* note 117.

<sup>128</sup>*Id.* Switzerland exempts a variable amount of foreign business income from home country tax and does not deny deductions for domestic expenses allocable to exempt foreign income. *Id.*

<sup>129</sup>Sections 264-265.

<sup>130</sup>The rough justice of a 90 percent exclusion should be measured against the proper amount of deductions that should be disallowed after taking into account that deductible expenses incurred for the direct benefit of a foreign affiliate would be properly chargeable to that affiliate under applicable transfer pricing rules and therefore would be effectively nondeductible before consideration of any limitation on the dividend exclusion.

<sup>131</sup>The earnings stripping rule of section 163(j) currently applies only to interest paid to "tax exempt related parties," i.e., foreign parents of U.S. subsidiaries.

<sup>132</sup>*See, e.g.,* Stijn Claessens, Michael Keen, and Ceyla Pazarbasioglu, "Financial Sector Taxation: The IMF's Report to the G-20 and Background Material" (Sept. 2010), available at <http://www.imf.org/external/np/seminars/eng/2010/paris/pdt/090110.pdf> ("Ideally, new measures would address or mitigate existing tax distortions (notably the tax bias in favor of debt), so improving the efficiency of resource allocation and reducing excessive leverage").

<sup>133</sup>Conversely, if a rate reduction is enacted, this incentive may be at least partially counterbalanced.

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Compelling arguments have been made for and against a formulary system.<sup>134</sup> For a variety of reasons, however, I assume that any transfer pricing reform would have to be done within the context of the arm's-length standard. The arm's-length standard is the accepted international norm and has been endorsed by every member of the OECD. Also, the arm's-length standard may be viewed as beneficial for the United States because, as applied, it rewards the owner of intangibles, and U.S. companies tend to have more intangibles than companies in other countries.

Intangibles contribute significant profits to modern multinational corporations. Current law, however, creates opportunities for companies to shift profits related to intangibles out of the United States. This phenomenon should be distinguished from profits related to business opportunities overseas, which would not be subject to U.S. tax under a dividend exemption system. Addressing the potential base erosion from the transfer of intangibles is crucial to advancing dividend exemption against the assertion that it would lead to further erosion of the U.S. tax base.

The key question is: If intangibles are developed in the United States, when should the income related to them be taxed in the United States? That was Congress's concern when it added the second sentence (the super-royalty or commensurate with income rule) to section 482 in 1986.<sup>135</sup>

Under the cost-sharing regulations as they existed until the recent amendments, it was possible for a U.S.-based multinational to locate most of the profit from an intangible in a CFC solely because the CFC participated in the costs of developing the intangible in the United States. The CFC was not required to participate in the research in any way other than by making a monetary contribution (which could be a capital contribution from the U.S. parent). Under these regulations, it was possible to conduct the development of an intangible, the manufacturing, and the sales in the United States, but to have the majority of the profits treated as arising overseas because the intangible was located there. Valuation of intellectual property for purposes of the buy-in became the crucial determinant of tax liability, but, as recent case law has shown, it is a very inexact science.<sup>136</sup>

<sup>134</sup>See, e.g., Reuven Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," 9 *Fla. Tax Rev.* 497 (2009); Alshuler and Grubert, "Formula Apportionment: Is It Better Than the Current System and Are There Better Alternatives?" 63 *Nat'l. Tax J.* 1145 (2010).

<sup>135</sup>Congress considered and rejected more stringent transfer pricing rules that would have applied only to U.S.-based companies. See Treasury, "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity," 387-388 (May 1985).

<sup>136</sup>*Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009), *Doc 2009-27116*, 2009 *TNT* 236-17.

Recent amendments to the cost-sharing regulations have tightened the requirements for a CFC to participate in a qualified cost-sharing arrangement.<sup>137</sup> These regulations are likely to be more successful than the former regulations at limiting the ability of U.S.-based multinational corporations to shift profits from intangibles developed in the United States to their foreign subsidiaries. The recent amendments include new methods for valuing the assets each party contributes to the arrangement, as well as additional guidance on the required scope of the cost-sharing activity and the IRS's ability to make adjustments to ensure that the income with respect to the transfer of intangible assets is commensurate with the income attributable to the intangible.

It may make sense, however, to further amend the regulations so that cost sharing would apply only to intangibles developed with substantial participation by a foreign corporation or to intangibles whose costs are shared with foreign affiliates that have actual experience making and selling the goods or services to which the intellectual property relates. If a U.S.-based multinational corporation develops an intangible jointly with its foreign subsidiaries, cost sharing is an appropriate way to allocate the resulting profit between the related parties. A very credible policy argument exists, however, that cost sharing should not be applied to allocate profits to a foreign subsidiary that did not actually participate in developing the intangible or have experience exploiting it.<sup>138</sup>

When a foreign partner is an active participant in the development of the intangible, the arrangement should not raise the same base-erosion concerns that arise in other cases. When an intangible is developed in the United States and a foreign partner is in a better position to manage the intellectual property, the facts could also justify retention of the intangible profit offshore. When, however, an intangible is developed and exploited in the United States with minimal participation by the foreign affiliate, amended cost-sharing rules could allocate the profit back to the United States.

Preexisting cost-sharing agreements could be grandfathered and therefore would not need to meet the new, more restrictive requirements for qualification. However, the tax benefits from preexisting agreements

<sup>137</sup>Reg. section 1.482-7T.

<sup>138</sup>Indeed, final cost-sharing regulations released in 1995 required that a cost-sharing participant use covered intangibles in the "active conduct of a trade or business." T.D. 8632, *Doc 95-11248*, 95 *TNI* 245-8 ("A controlled participant must use or reasonably expect to use covered intangibles in the active conduct of a trade or business. Thus, an entity that chiefly provides services (e.g., as a contract researcher) may not be a controlled participant."). This rule was eliminated in 1996. T.D. 8670, *Doc 96-13943*, 96 *TNI* 93-19.

could be cut back, to an extent to be decided by Congress, through the application of special subpart F rules that could be drafted for those grandfathered agreements.

This may, however, not be viewed as a sufficient disincentive to exploit the transfer pricing rules in a dividend exemption environment. If not, consideration could be given to adopting some form of the administration's excess returns proposal. Under that proposal, "if a U.S. person transferred an intangible from the United States to a related [CFC] that is subject to a low foreign effective tax rate in circumstances that evidence excessive income-shifting, then an amount equal to the excessive return would be treated as subpart F income."<sup>139</sup> For purposes of revenue estimating, Treasury economists assumed that subsidiaries with an effective foreign tax rate of less than 10 percent and with intangibles earning a return in excess of 30 percent were subject to the provision.<sup>140</sup> If the proposal is viewed as too blunt an instrument, it could be modified to apply only when triggered by some further metric designed to measure more precisely whether foreign profits are sufficiently tax motivated (such as whether substantial business activities are conducted in the low- or zero-tax jurisdiction).

*c. Round-tripping transactions.* Another concern with adopting a dividend exemption is that it could encourage U.S.-based companies to close plants in the United States, open plants overseas, and import the goods that were formerly produced domestically. A significant body of economic literature suggests that this is not typically the way U.S. multinational corporations operate.<sup>141</sup> Further, if the dividend exemption were combined with a corporate rate cut, as suggested below, companies would have less of an incentive to incur the significant costs required to close and reopen a plant overseas. However, because this remains a concern,<sup>142</sup>

income from these runaway plants could be subject to subpart F under some circumstances if the products are sold into the United States.<sup>143</sup>

Recent proposed legislation, however, illustrates some of the difficulty in drafting that legislation. For example, the American Jobs and Ending Offshoring Act proposed to disallow deductions for some items incurred in moving American jobs offshore, and it would have created a new category of subpart F income for income directly or indirectly derived from the operation of a trade or business that was started or expanded outside the United States as part of an American jobs offshoring transaction.<sup>144</sup> The proposed legislation would have defined an "American jobs offshoring transaction" as "any transaction (or series of transactions) in which the taxpayer reduces or eliminates the operation of a trade or business (or line of business) within the United States in connection with the start up or expansion of such trade or business (or such line of business) by the taxpayer outside of the United States."

Determining whether the reduction or elimination of a U.S. business is "in connection with" the commencement of that business outside the United States may be difficult as a factual matter. Further, even if the ending of U.S. business and commencement of a foreign business are clearly related, there may be valid nontax business reasons for the change in operation, and it is unclear why those business-motivated transactions should be subject to current taxation. In a statement opposing the Creating American Jobs and Ending Offshoring Act, then-Finance Committee ranking minority member Charles E. Grassley, R-Iowa, provided several examples of nontax reasons, including when there is only a small demand for the product in the United States compared with its overseas markets, when some items are not found in appreciable quantities in the United States, or when a U.S. company acquires a foreign company that imports into the United States.<sup>145</sup> Grassley also argued that the bill could decrease employment in the United States by encouraging American companies to sell their foreign subsidiaries or further expatriating manufacturing jobs.

<sup>139</sup>Treasury, "General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals," 43 (Feb. 2010), *Doc 2010-2363*, 2010 WTD 22-26 (Treasury green book).

<sup>140</sup>See Kristen A. Parillo, "Intangible Proposal Won't Displace Transfer Pricing Rules," *Tax Notes Int'l*, Mar. 1, 2010, p. 765, *Doc 2010-4055*, or 2010 WTD 37-4. Treasury estimated a revenue gain of \$15.5 billion over 10 years. Treasury green book, *supra* note 139, at 43. The JCT estimated a revenue gain of \$10.2 billion over 10 years. See JCT, "Estimated Budget Effects of the Revenue Provisions Contained in The President's Fiscal Year 2011 Budget Proposal," JCX-7-10R (Mar. 15, 2010), *Doc 2010-5625*, 2010 TNT 50-13.

<sup>141</sup>The research is summarized in Desai, "Securing Jobs or the New Protectionism?" *Tax Notes Int'l*, July 6, 2009, p. 61, *Doc 2009-6392*, or 2009 WTD 126-12. The supply chain of U.S.-based companies is typically greater than 75 percent in the United States, while more than 50 percent of their sales are overseas. These findings also support the conclusion that foreign growth spurs U.S. economic activity.

<sup>142</sup>See, e.g., S. 3816; S. 260; Export Products Not Jobs Act, S. 96.

<sup>143</sup>The trigger for inclusion could be if a Worker Adjustment and Retraining Notification Act notification is given to the employees of a plant that is about to be closed. 29 U.S.C. sections 2101 to 2109. Also, the U.S.-based multinational could be permitted to enter into a 10-year gain recognition agreement in which it commits not to sell goods produced by the foreign plant into the United States. Cf. section 367(a) regulations. In those circumstances, the shift would be viewed as not primarily tax motivated and thus not subject to a subpart F inclusion.

<sup>144</sup>S. 3816.

<sup>145</sup>Grassley Floor Speech, "Creating American Jobs and Ending Offshoring Act" (Sept. 27, 2010).

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As opposed to the general "in connection" language used in several recent legislative proposals, a rule taxing income from runaway plants if the products of the plant are sold into the United States could require a specific nexus between the plant closure and the product sale into the United States. In other words, the subpart F inclusion would be limited to round-tripped goods rather than generally to all goods sold into the United States after a combination of a U.S. closure and foreign expansion.

*d. Transition issues.* Although I do not fully consider these issues here, transition rules would need to be considered if the United States enacted a dividend exemption system.<sup>146</sup> Without transition rules, U.S. corporations with foreign subsidiaries, and their shareholders, would gain a transition benefit because corporate earnings that previously would be available only at the cost of U.S. tax would now be accessible with no tax cost. As commentators have recognized, however, "perfection is unlikely to be attainable" when designing a transition system, and there will be a need to balance many considerations. These include the taxes U.S. multinationals would have paid if the current system had remained in place, the tax planning costs they would have incurred in minimizing that tax, administrative and compliance complexity, and the creation of undesirable incentives.<sup>147</sup> Potential transition regimes include a one-time transition tax imposed on foreign subsidiaries' accumulated earnings and profits (even if not repatriated) or imposing a reduced tax on actual and deemed distributions to U.S. parents until an amount equal to pre-enactment foreign E&P had been paid out.

*e. Revenue impact.* Revenue estimates for dividend exemption tax systems have varied significantly. A 2007 Treasury study estimated that switching to a dividend exemption system would raise \$40 billion over 10 years. According to Treasury, "this revenue gain arises primarily from the elimination of foreign tax credits that, in effect, shield a considerable portion of low-taxed non-dividend foreign source income, such as certain royalties, from U.S. tax."<sup>148</sup> The recent PERAB report said that a territorial system without full expense allocation rules would lose approximately \$130 billion over 10 years, but also said that "a territorial system with full application of expense allocation rules could

<sup>146</sup>It should be noted, however, that Japan and the United Kingdom did not enact transition rules when they each recently switched to dividend exemption systems.

<sup>147</sup>See Shaviro, "The Rising Tax-Electivity of U.S. Corporate Residence," *supra* note 112.

<sup>148</sup>Treasury, *supra* note 89, at 58; see also Grubert and Mutti, "Taxing International Business Income: Dividend Exemption Versus the Current System" (2001), available at [http://www.aei.org/docLib/20021130\\_71546.pdf](http://www.aei.org/docLib/20021130_71546.pdf) (using 1994 data, estimating that an exemption system would generate \$7.7 billion annually in additional revenue).

be revenue neutral or could raise revenue depending on the behavioral responses of corporations and the ability of the IRS to police transfer pricing and expense allocations."<sup>149</sup>

### C. Corporate Tax Reform

#### 1. Lowering the Rate

After TRA 1986, the U.S. corporate tax rate was among the lowest in the OECD. However, while other OECD countries have gradually lowered their rates, the United States has actually increased the top marginal corporate rate by one percentage point. As a result, the United States will soon have the second-highest corporate tax rate in the OECD.

Having a corporate tax rate that exceeds those of our trading partners may have significant implications for the location of investment. As described above, economic literature has shown that the nominal corporate tax rate is correlated with the location of multinational investment. Also, a high tax rate exacerbates the incentives to shift profits out of the United States via transfer pricing, thin capitalization, and other plans to avoid U.S. tax.

#### 2. Broadening the Base

To make the tax reform suggested herein revenue neutral or revenue positive, it may be possible to broaden the corporate tax base by eliminating or revising various corporate tax expenditures. Also, given the significant growth of flow-through businesses in recent years, Congress may want to consider some measures to equalize the treatment of large businesses, whether flow-through or not.

Further, a VAT should be on the table as a revenue raiser in the coming years. However, policymakers must be willing to put a VAT on a menu of revenue-raising provisions to be considered in any upcoming fundamental tax reform.

*a. Reconsidering corporate tax expenditures.* As the Bowles-Simpson commission wrote in its December 2010 report:

In the quarter century since the last comprehensive tax reform, Washington has riddled the system with countless tax expenditures, which are simply spending by another name. These tax earmarks — amounting to \$1.1 trillion a year of spending in the tax code — not only increase the deficit, but cause tax rates to be too high. Instead of promoting economic growth and competitiveness, our current code drives up health care costs and provides special treatment to special interests.

<sup>149</sup>PERAB, *supra* note 13, at 90.

The code presents individuals and businesses with perverse economic incentives instead of a level playing field.<sup>150</sup>

It is debatable whether the corporate tax expenditures are an effective and efficient means of carrying out their intended objectives (for example, encouraging specific types of investments) or, further, whether those intended objectives come at too high a cost (for example, distorting investment decisions). As Donald Lubick and Ward Hussey state:

It is usually less efficient to use the tax system than to pay a direct subsidiary to the activity involved. Use of the tax system imparts a degree of permanence that preserves the subsidy long past the period of its need, complicates and undermines efficient enforcement of the revenue laws generally, introduces government intervention through revenue officials who are not equipped to police the qualifications of those subsidized, and, most important perhaps, is inefficient because of the inflexibility inherent in defining the proper objects of the subsidy in tax law terms. Such tax preferences inevitably direct government resources in large measure to unintended beneficiaries. They distort market influence on efficient allocation of resources.<sup>151</sup>

In its recent report, "Tax Policy Reform and Economic Growth," the OECD recognized that "in many cases, base-broadening is a growth-oriented tax reform strategy."<sup>152</sup> The OECD highlighted four main efficiency and cost-related arguments in favor of a broad base: (1) increased efficiency (minimization of distortions and deadweight losses arising from different rules applying to similar types of taxpayers or activities); (2) reduction in administrative, enforcement, and compliance costs; (3) increased tax compliance (with opportunities for tax arbitrage reduced); and (4) the potential to lower rates, which can lead to efficiency gains and reductions in tax avoidance and evasion incentives.<sup>153</sup>

There are more than 75 corporate tax expenditures and 30 general business tax credits in the code.<sup>154</sup> Although I recognize that decisions regarding tax ex-

penditures are highly political, policymakers and businesses must be willing to sacrifice a few sacred cows to broaden the corporate tax base to lower the corporate tax rates. Congress ultimately may decide to keep some tax expenditures, but businesses should recognize that the continuation of specific corporate tax expenditures, which tend to benefit only certain types of businesses, comes at the expense of a lower corporate rate, which tends to benefit all corporations.

Although I do not make specific recommendations here on which specific tax expenditures should be preserved or eliminated, Table 2 lists some of the largest business tax expenditures that policymakers may wish to examine.

*b. Thinking beyond corporate taxation.* I recognize that any proposal to change the boundaries between corporate and noncorporate taxation of business entities is likely to encounter significant debate. Given the increased growth of flow-through entities and thus the continued narrowing of the corporate tax base, however, these boundaries should be subject to reconsideration in any tax reform debate.

Flow-through entities now earn nearly half of all U.S. business income. Further, there is a compelling policy argument that businesses of similar sizes and engaged in similar activities should face similar tax regimes and rates. Policymakers may wish to consider measures to promote neutrality of business entity taxation, many of which could raise revenue. These measures could be targeted, such as subjecting profits earned by shareholders in businesses (other than those currently taxed as corporations under the section 7701 regulations) to payroll taxes, or broad, such as requiring firms with specified corporate characteristics (for example, publicly traded businesses or businesses with certain income or assets thresholds) to pay the corporate income tax.<sup>155</sup>

*c. Considering a VAT.* It appears that opposition to a VAT is one of the few things lawmakers of all political persuasions can agree on these days. Rep. Barney Frank, D-Mass., has said a VAT is "dead as a doornail,"<sup>156</sup> while House Majority Leader Eric Cantor, R-Va., has said, "I don't think any of us want to go the direction of the social welfare states around the world."<sup>157</sup> In April 2010 the Senate voted 85-13 to pass a (nonbinding) resolution declaring a VAT a "massive tax increase that will cripple families on fixed income and only further push back America's economic recovery."<sup>158</sup>

<sup>150</sup>National Commission on Fiscal Responsibility and Reform, *supra* note 73, at 24.

<sup>151</sup>Ward M. Hussey and Donald C. Lubick, *Basic World Tax Code and Commentary 7-8* (1996).

<sup>152</sup>OECD, *supra* note 2, at 86. The OECD report observes that the retention of tax expenditures might be justified when the costs of broadening the base exceed the corresponding efficiency gains; when the expenditure is intended to serve as a social benefit and the tax system is an efficient mechanism for delivering that benefit; and when expenditures operate as tax incentives that correct for market failures or provide incentives to internalize positive external effects. *Id.* at 85-86.

<sup>153</sup>*Id.* at 84.

<sup>154</sup>*Id.* at 29.

<sup>155</sup>PERAB, *supra* note 13, at 75.

<sup>156</sup>See Michael O'Brien, "Barney Frank: 'Zero chance' of Congress Approving a Value-Added tax," *thehill.com* (July 29, 2010) (quoting Frank).

<sup>157</sup>See Damian Paletta, "Another Deficit Plan Targets Taxes," *The Wall Street Journal*, Nov. 17, 2010 (quoting Cantor).

<sup>158</sup>S. Amdt. 3724 to S. Amdt. 3721 to H.R. 3851.

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Table 2. Corporate Tax Expenditures

Major Special Business Tax Provisions	Revenue, 2008-2017 (Fiscal Year, \$ in billions)		
	Corporate	Non-Corporate	Total
Accelerated depreciation/expensing provisions	356	306	662
Deduction for U.S. production/manufacturing activities	210	48	258
Research and experimentation (research credit)	132	1	133
Low-income housing tax credit	55	6	61
Exclusion of interest on life insurance savings	30	0	30
Inventory property sales source rules	29	0	29
Deductibility of charitable contributions	28	0	28
Special employee stock ownership plan rules	23	4	27
Exemption of credit union income	19	0	19
New technology credit	8	1	9
Blue Cross/Blue Shield deduction	8	0	8
Expense of percentage over cost depletion, fuels	7	0	7
Other business preferences	27	28	66
<b>Total</b>	<b>\$932</b>	<b>\$394</b>	<b>\$1,326</b>

Source: PERAB report, Table 9, at 77 (citing Department of the Treasury, Office of Tax Analysis data).

A VAT should be on the table as our nation considers the best ways to tackle its deficit. The advantages and disadvantages of a VAT have been addressed extensively elsewhere, and I will not repeat them at length here.<sup>159</sup> Rather, I submit that policymakers must be willing to consider whether the nation's interests can be served by enacting a VAT.<sup>160</sup>

<sup>159</sup>Proponents of a VAT argue that it could serve as an efficient revenue-raising mechanism in a time of increasing revenue needs. See, e.g., Gale and Harris, *supra* note 43. Opponents of a VAT argue that the federal government will grow as federal lawmakers continually increase the VAT rate to pay for spending. See Curtis S. Dubay, "The Value-Added Tax Is Wrong for the United States" (Dec. 21, 2010), *Doc 2010-27158*, 2010 *TNT* 245-29. Opponents also argue that a VAT will slow economic growth. *Id.* Some have also made the point that there should be a high burden of persuasion before adopting an entirely new tax, requiring an entirely new (or at least significantly adapted) administrative infrastructure.

<sup>160</sup>In general, a VAT is a tax on sales to consumers that is collected at the different stages of the production process. There are two general types of VATs: credit invoice and subtraction method. Under a credit-invoice VAT, which is used in Australia, Canada, Europe, and New Zealand, all business sales are taxable but sellers pass on invoices to registered business taxpayers who purchase goods and services from them. These purchasers then claim a credit for the taxes paid on their purchases. The result is that there are no net taxes on sales between registered VAT businesses. Rather, the end consumer bears the full tax. Under a

subtraction-method VAT, all businesses pay VAT on the difference between the value of their sales and the value of their purchases from other businesses. The sum of all amounts subject to the VAT (assuming no exemptions) equals the value of sales to end consumers. For interesting discussions of how a U.S. add-on VAT might be structured and analysis of the international experience in implementing VATs, see Symposium (Part I), "Designing a Federal VAT," 63 *Tax. L. Rev.* 285 (2010), and Symposium (Part II), "Designing a Federal VAT," 63 *Tax. L. Rev.* 517 (2010).

<sup>161</sup>Altshuler, et al., "Desperately Seeking Revenue," *supra* note 12. The paper also considers the options necessary to reduce the debt to 3 percent of GDP, which is a target that former OMB Director Peter Orszag deemed sustainable.

(Footnote continued in next column.)

are assumed to have been permanently extended, revenues would need to rise an average of \$775 billion annually over the 2015-2019 period to meet the same goal.

Altshuler, Lim, and Williams examined five options for meeting the 2 percent deficit target: (1) raising all individual income tax rates proportionally; (2) raising the top three tax rates proportionally; (3) raising tax rates proportionately on single taxpayers with income exceeding \$200,000 and married couples filing jointly with income greater than \$250,000 (that is, the taxpayers targeted for tax increases by President Obama during the 2008 presidential election); (4) eliminating itemized deductions; and (5) limiting the value of itemized deductions to 15 percent.

Under option 1, Altshuler, Lim, and Williams found that all tax rates would need to rise significantly to meet the 2 percent of GDP deficit target. Assuming the 2001 and 2003 tax cuts continue beyond their sunset date, the bottom 10 percent rate would become almost 15 percent and the top rate would increase from 35 percent to 52 percent. If those tax cuts did not continue, the bottom 15 percent rate would rise to 17 percent and the top rate would rise from 39.6 percent to 45.5 percent. Under option 2, in which rates for taxpayers in the lowest tax brackets would remain the same, the top three tax rates would rise from 28 percent to 60.8 percent, from 33 percent to 71.7 percent, and 35 percent to 76.1 percent, assuming the 2001 and 2003 tax cuts had been extended. If the 2001 and 2003 tax cuts had not been extended, the top three tax rates would rise from 31 percent to 41.1 percent, from 36 percent to 47.7 percent, and 39.6 percent to 52.5 percent. Under option 3, the top rate would need to rise to nearly 91 percent assuming the 2001 and 2003 tax cuts were extended and 56.4 percent if the 2001 and 2003 tax cuts were not extended. Altshuler, Lim, and Williams found that options 4 and 5, which would limit itemized deductions, would not raise enough revenue to meet the 2 percent of GDP target if the 2001 and 2003 tax cuts were continued.

Altshuler, Lim, and Williams concluded:

None of the options we have examined would provide a realistic approach to reducing the deficit over the coming decade. . . . We do not rule out corporate tax increases (through either statutory rate increases or base broadening), but we feel that raising significant revenues through the corporate tax is not a viable strategy. We need a different approach. . . . Reducing the federal budget deficit to a level that is sustainable over the long run will likely require either more comprehensive tax reform or tapping a new source of revenue, such as a value-added tax.

A VAT could raise significant revenue. Eric Toder and Joseph Rosenberg have estimated that imposing a 5 percent VAT on a broad base in 2012 would raise about \$355 billion and, when partially offset by accompanying reductions in individual, corporate, and pay-

roll tax liabilities, would result in net revenue increase of \$258.6 billion (for one year).<sup>162</sup> The broad-base VAT would include all domestic consumption, except education, government-financed healthcare, services by charitable organizations, and services performed by subnational governments. Sales and local sales taxes, the imputed value of financial services, and interest on consumer debt would also be exempt. A narrow-base VAT (that is, one that has the same exemptions as the broad base but also exempts housing consumption, food consumed at home, and private medical expenses such as out-of-pocket expenses and insurance premiums) would raise about \$221 billion and, when offset by reduced individual, corporate, and payroll tax liabilities, would raise approximately \$161 billion.<sup>163</sup>

Further, although many charge that a VAT would be a regressive tax that would raise tax burdens proportionately more on low-income taxpayers, a VAT itself is not necessarily regressive<sup>164</sup> and may be structured to promote progressivity while still raising significant revenue.<sup>165</sup> For example, revenue from the VAT could be used to reduce payroll taxes. Toder and Rosenberg have found that using revenues from a broad-based VAT to replace part of the payroll tax would actually raise after-tax income for the bottom 95 percent of the population (while lowering after-tax income for the top 5 percent).<sup>166</sup> A VAT combined with a refundable credit of \$436.88 per adult and \$218.44 per dependent child could be "very progressive," especially if coupled with a payroll tax deduction.<sup>167</sup>

Some have suggested enacting a VAT in combination with fundamental individual income tax reform, which, although I do not specifically discuss IT herein, may be of interest to policymakers. For example, Michael J. Graetz has proposed a tax plan that would,

<sup>162</sup>Toder and Rosenberg, "Effects of Imposing a Value-Added Tax to Replace Payroll Taxes or Corporate Taxes," *supra* note 12. Toder and Rosenberg's revenue estimate follows the estimating convention used by Treasury and the JCT, which uses a fixed GDP. According to Toder and Rosenberg:

with nominal GDP (and prices) fixed, a consumption tax must lower factor incomes. Effectively, the sales tax paid by the business is deductible from profits that the business reports and reduces the taxable wages it pays. Treasury and JCT thus apply an offset in reduced individual income, corporate income, and payroll tax revenues when sales taxes are imposed or increased.

*Id.*

<sup>163</sup>*Id.* at 13.

<sup>164</sup>*Id.* at 23 (finding that "the burden of a broad-based VAT is roughly proportional throughout the income distribution, except at the very top"). Toder and Rosenberg observed that a narrow-based VAT would likely be more progressive than the broad-based VAT.

<sup>165</sup>See generally *id.*

<sup>166</sup>*Id.* at 24.

<sup>167</sup>*Id.* at 26.

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in sum, enact a VAT with a broad base and a rate between 10 and 14 percent, exempt all income less than \$100,000 for married couples and \$50,000 for single persons (indexed for inflation), impose a low rate of tax (20 to 25 percent) on the taxable income of high-income individuals, and lower the corporate tax rate to 15 or 20 percent.<sup>168</sup>

**IV. Conclusion**

The current U.S. corporate and international tax rules put U.S. multinationals in a disadvantageous position while raising relatively little revenue compared to the total U.S. tax revenue and less revenue than would be expected when compared to the revenue collected by other countries with lower corporate tax rates. U.S.-based companies often do not repatriate profits in the

absence of complex and contentious tax planning transactions. Foreign businesses often find the United States inhospitable from a tax perspective.

The time has come for a pragmatic and centrist reform of the U.S. corporate and international tax rules. Such a reform could involve reducing the corporate rate to the OECD average and exempting active foreign dividends from income. At the same time, it could involve limiting indirectly the deductibility of expenses allocated to exempt dividends by partially taxing the dividends, further restricting the ability of U.S.-based companies to artificially shift profits out of the United States or to engage in round-tripping transactions, re-considering a variety of corporate tax expenditures, and introducing a VAT.

There may be other pragmatic, centrist, and revenue neutral reform ideas that could be integrated into this proposal or that are better alternatives. The question is whether a serious discussion is possible. The answer is yes, and the time is now. ♦

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<sup>168</sup>Graetz, *100 Million Unnecessary Returns*, *supra* note 28.

## COMMUNICATIONS

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### United States Senate Committee on Finance

#### Hearing on Tax Reform Options: International Issues

Thursday, September 8, 2011, 9:30 AM  
215 Dirksen Senate Office Building

By Michael Bindner  
Center for Fiscal Equity  
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Chairman Baucus and Ranking Member Hatch, thank you for the opportunity to address this topic, which is all the more crucial as rating agencies question and downgrade our debt, which could conceivably have major international implications.

The Center's Tax Reform plan has four major parts.

Part One is a Value Added Tax (VAT), which is suggested because of its difficulty to evade, because it can be as visible to the ultimate consumer as a retail sales tax and **because it can be zero rated at the border for exports and collected fully for imports**. As this feature has been well explained by others, I will not go into detail on this point. What is more important is to exercise care in delineating what is funded by such a tax.

We believe that VAT funding should be confined to funding domestic discretionary military and civilian spending. Zero rating a tax supporting such spending is totally appropriate, as foreign consumers gain no benefit from these expenditures. Likewise, making imports fully taxable for this spending correctly burdens the consumers who fully benefit from these services. As importantly, making such a tax visible provides an incentive to taxpayers to demand less of such spending.

In order to fully fund current domestic obligations, the Center calculates that the tax rate should be 13.3%. In order for this to be affordable, during the transition, income tax withholding tables should be adjusted to increase net income by the same percentage, with Social Security beneficiaries receiving a similar bump in payments. This is a "balanced budget" rate. It could be set lower if the spending categories funded receive a supplement from income taxes.

Part Two is a VAT-like Net Business Receipts Tax (NBRT). Its base is similar to a VAT, but not identical. **Unlike a VAT, an NBRT would not be visible on receipts and should not be zero rated at the border – nor should it be applied to imports**. While both collect from consumers, the unit of analysis for the NBRT should be the business rather than the transaction. As such, its application should be universal – covering both public companies who currently file business income taxes and private companies who currently file their business expenses on individual returns.

The key difference between the two taxes is that the NBRT should be the vehicle for distributing tax benefits for families, particularly the Child Tax Credit, the Dependent Care Credit and the Health Insurance Exclusion, as well as any recently enacted credits or subsidies under the Patient Protection and Affordable Care Act (ACA). In the event the ACA is reformed, any additional subsidies or taxes should be taken against this tax (to pay for a public option or provide for catastrophic care and Health Savings Accounts and/or Flexible Spending Accounts).

The Child Tax Credit should be made fully refundable and should be expanded to include revenue now collected under the dependent exemption, the home mortgage interest deduction and the property tax deduction. Transitioning these deductions will allow a \$500 per month per child distribution with payroll. It will likely increase incentives to expand affordable housing and may not decrease housing for the wealthy, who are less likely to forgo vacation housing or purchase of luxury housing for want of a tax cut, as the richest families likely pay the alternative minimum tax anyway, so that they do not fully use this tax benefit now.

This tax should fund services to families, including education at all levels, mental health care, disability benefits, Temporary Aid to Needy Families, Supplemental Nutrition Assistance, Medicare and Medicaid. If society acts compassionately to prisoners and shifts from punishment to treatment for mentally ill and addicted offenders, funding for these services would be from the NBRT rather than the VAT.

This tax could also be used to shift governmental spending from public agencies to private providers without any involvement by the government – especially if the several states adopted an identical tax structure. Either employers as donors or workers as recipients could designate that revenues that would otherwise be collected for public schools would instead fund the public or private school of their choice. Private mental health providers could be preferred on the same basis over public mental health institutions.

Employers receive a tax credit if their retirees opt out of Medicare and Medicaid for seniors by fully employer funding of retiree health care, either by hiring doctors or purchasing comparable coverage, including catastrophic coverage in return for some kind of tax credit. This proposal is probably the most promising way to decrease health care costs from their current upward spiral – as employers who would be financially responsible for this care through taxes would have a real incentive to limit spending in a way that individual taxpayers simply do not have the means or incentive to exercise. While not all employers would participate, those who do would dramatically alter the market. In addition, a kind of beneficiary exchange could be established so that participating employers might trade credits for the funding of former employees who retired elsewhere, so that no one must pay unduly for the medical costs of workers who spent the majority of their careers in the service of other employers.

Conceivably, NBRT offsets could exceed revenue. In this case, employers would receive a VAT credit.

**It is not appropriate for this tax to be zero rated, as doing so would decrease the incentive to pass these tax benefits to employees. As importantly, the tax benefits and government services provided under this tax go to workers and their families. As such, overseas purchasers accrue benefits from these services and should therefore participate in their funding.**

If the NBRT is enacted in this way, the United States should seek modification to our trade agreements to require that similar expenditures not be funded with taxes that are zero rated at the border. As foreign consumers benefit from subsidies for American families, American consumers benefit from services provided to overseas workers and their families. This benefit should be recognized in international tax and trade policy and American workers should not be penalized when other nations refuse to distribute the cost of benefits to foreign workers to the American consumers who receive the benefit of these services. If our trading partners do not match this initiative, some items of spending could be shifted from NBRT funding to VAT funding, so that we are not making unilateral concessions in this area.

The VAT would replace income taxes collected at the lowest rate, while the NBRT would replace disability insurance, hospital insurance, the corporate income tax, business income taxation through the personal income tax and the mid range of personal income tax collection, effectively lowering personal income taxes by 25% in most brackets. Note that collection of this tax would lead to a reduction of gross wages, but not necessarily net wages – although larger families would receive a large wage bump, while wealthier families and childless families would likely receive a somewhat lower net wage due to loss of some tax subsidies and because reductions in income to make up for an increased tax benefit for families will likely be skewed to higher incomes. For this reason, a higher minimum wage is necessary so that lower wage workers are compensated with more than just their child tax benefits.

The NBRT rate is projected to be 27% before offsets for the Child Tax Credit and Health Insurance Exclusion, or 33% after the exclusions are included. This is a “balanced budget” rate. It could be set lower if the spending categories funded receive a supplement from income taxes.

Part Three is the continuation of a payroll tax for Old Age and Survivors Insurance (although insurance for survivors under age 60 may be shifted to the NBRT). Given the across the board decrease in gross income, the tax rate would have to be increased to 6.5% for employees and employers (provided younger survivors are excluded). To improve program progressivity, the employer contribution could be credited on an equal basis, moving redistributive effects from benefit distribution to revenue collection. Additionally, the amount subject to tax should be increased or the income cap eliminated, which would help both program income and support for lower income retirees.

Separation of this tax from the NBRT is necessary unless the employee contribution is to be totally eliminated with a uniform benefit or uniform. A separate payroll contribution is required as long as benefit levels are set according to income. If a uniform benefit is desired, then payroll taxes can be discontinued and the NBRT expanded. Employee contributions could not be zero rated at the border. If employer contributions are equalized and contributed to a public system, however, they could be incorporated into a VAT rather than an NBRT. This allows the Social Security system to benefit from foreign labor where outsourcing has occurred. Indeed, it would be an essential expansion of the tax base if globalization is to continue unabated.

The prospect of Personal Retirement Accounts can also be considered, although doing so is like holding a lightning rod in a thunderstorm. I do agree with President Obama that such accounts should not be used for speculative investments or even for unaccountable index fund investments where fund managers ignore the interests of workers. Investing such accounts in insured employee-ownership of the workplace would have an entirely different outcome, especially if voting shares occurred on an occupational basis with union representation. **The impact at the international level of such employee-ownership if extended to subsidiaries and the supply chain is also potentially profound, especially in regard to transfer pricing and the international growth of the union movement.** Those interested in my thoughts on this issue can contact me for more information.

Part Four is surtax on high income earners and heirs. It would replace the Inheritance or Death Tax by instead taxing only cash or in-kind distributions from inheritances but not asset transfers, with distributions remaining tax free they are the result of a sale to a qualified Employee Stock Ownership Plan.

In testimony before the Senate Budget Committee, Lawrence B. Lindsey explored the possibility of including high income taxation as a component of a Net Business Receipts Tax. The tax form could have a line on it to report income to highly paid employees and investors and pay a surtax on that income. We considered and rejected a similar option in a plan submitted to President Bush's Tax Reform Task Force, largely because you could not guarantee that the right people pay taxes. If only large dividend payments are reported, then diversified investment income might be under-taxed, as would employment income from individuals with high investment income. Under collection could, of course, be overcome by forcing high income individuals to disclose their income to their employers and investment sources – however this may make some inheritors unemployable if the employer is in charge of paying a higher tax rate. For the sake of privacy, it is preferable to leave filing responsibilities with high income individuals.

This surtax could have few rates or many rates, although I suspect as rates go up, taxpayers of more modest means would prefer a more graduated rate structure. The need for some form of surtax at all is necessary both to preserve the progressivity of the system overall, especially if permanent tax law enacted before 2001 is considered the baseline (which it should be) and to take into account the fact that at the higher levels, income is less likely to be spent so that higher tax rates are necessary to ensure progressivity.

This tax would fund net interest on the debt, repayment of the Social Security Trust fund, any other debt reduction and overseas civilian, military, naval and marine activities, most especially international conflicts, which would otherwise require borrowing to fund. It would also fund transfers to discretionary and entitlement spending funds when tax revenue loss is due to economic recession or depression, as is currently the case. Unlike the other parts of the system, this fund would allow the running of deficits.

**Explicitly identifying this tax with net interest payments highlights the need to raise these taxes as a means of dealing with our long term indebtedness, especially in regard to debt held by other nations.** While consumers have benefited from the outsourcing of American jobs, it is ultimately high income investors which have reaped the lion's share of rewards. The loss of American jobs has led to the need for foreign borrowing to offset our trade deficit. Without the tax cuts for the wealthiest Americans, such outsourcing would not have been possible. Indeed, there would have been any incentive to break unions and bargain down wages if income taxes were still at pre-1981 or pre-1964 levels. The middle class would have shared more fully in the gains from technical productivity and the artificial productivity of exploiting foreign labor would not have occurred at all. Increasing taxes will ultimately provide less of an incentive to outsource American jobs and will lead to lower interest costs overall. Additionally, as foreign labor markets mature, foreign workers will demand more of their own productive product as consumers, so depending on globalization for funding the deficit is not wise in the long term.

Identifying deficit reduction with this tax recognizes that attempting to reduce the debt through either higher taxes on or lower benefits to lower income individuals will have a contracting effect on consumer spending, but no such effect when progressive income taxes are used. Indeed, if progressive income taxes lead to debt reduction and lower interest costs, economic growth will occur as a consequence.

Using this tax to fund deficit reduction explicitly shows which economic strata owe the national debt. Only income taxes have the ability to back the national debt with any efficiency. Payroll taxes are designed to create obligation rather than being useful for discharging them. Other taxes are transaction based or obligations to fictitious individuals. Only the personal income tax burden is potentially allocable and only taxes on dividends, capital gains and inheritance are unavoidable in the long run because the income is unavoidable, unlike income from wages.

Even without progressive rate structures, using an income tax to pay the national debt firmly shows that attempts to cut income taxes on the wealthiest taxpayers do not burden the next generation at large. Instead, they burden only those children who will have the ability to pay high income taxes. In an increasingly stratified society, this means that those who demand tax cuts for the wealthy are burdening the children of the top 20% of earners, as well as their children, with the obligation to repay these cuts. That realization should have a healthy impact on the debate on raising income taxes.

Resolution of this debate will have a salutary effect on the credit of the United States and its status as the world's reserve currency, so we urge you to give serious consideration to the proposals laid out here.

Thank you for the opportunity to address these issues.

**STATEMENT FOR INCLUSION IN THE HEARING RECORD OF:  
HEARING ON TAX REFORM OPTIONS: INTERNATIONAL ISSUES  
HELD SEPTEMBER 8, 2011  
BEFORE U.S. SENATE FINANCE COMMITTEE**

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September 15, 2011**

**CONGRESS SHOULD REPLACE THE CURRENT DEFERRAL REGIME FOR  
FOREIGN INCOME WITH AN IMPUTATION SYSTEM AND REJECT PROPOSALS  
FOR ENACTMENT OF A TERRITORIAL SYSTEM**

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## § I Introduction

Thank you for giving me the opportunity to share my views with the Senate Finance Committee. The views I express are my own, are not supported by any organization or client, and are motivated only by my interest in the U.S. tax system. This submission focuses on the importance of ending deferral for foreign source income of controlled foreign corporations, and is based on several articles I have written on this subject, including an article that appeared earlier this year in both *Tax Notes* and *Tax Notes International* entitled *An Imputation System for Taxing Foreign Source Income*.<sup>1</sup> It is also based on testimony I gave on May 9, 2006 at Hearing on Corporate Tax Reform before the U.S. House of Representatives, Committee on Ways And Means, Subcommittee on Select Revenue Measures.

## § II Introduction to a Territorial Regime and the Current Deferral System

Many groups have proposed that the U.S. adopt a territorial system for taxing foreign source income. Under a territorial system, U.S. corporations would be exempt from paying Federal income taxes on business income they earned in foreign countries. For example, assume that a Pennsylvania corporation headquartered in State College, Pennsylvania, let's call it State Oil Corp, sets up a subsidiary corporation in China, let's call it China Oil Sub. State Oil Corp would not be taxed on the income earned by China Oil Sub either at the time the income was earned or at the time the income was brought back (that is, repatriated) to the U.S. in the form of dividends paid by China Oil Sub to State Oil Corp.

Under our current deferral system and controlled foreign corporation (CFC) regime, State Oil Corp's active business income is not taxed at the time China Oil Sub earns the income but is taxed at the time China Oil Sub pays dividends to State Oil Corp. Upon receipt of dividends, State Oil Corp receives, within limits, a foreign tax credit against its U.S. tax liability for Chinese taxes paid by China Oil Sub. Certain tax haven income of State Oil Corp (*i.e.*, subpart F income) is subject to immediate taxation in the U.S.

To summarize, under our current deferral system, the business income of China Oil Sub gets taxed when the income comes home, with a credit for taxes paid to China; under the proposed territorial system, the business income of China Oil Sub is completely free of U.S. tax even when it comes home.

## § III Analysis of the Competitiveness Reason for Moving to a Territorial Regime

### A. The Foreign or "Horizontal" Competitiveness Claim

In 2005, the Advisory Panel on Federal Tax Reform, appointed by President George W. Bush, suggested that the U.S. move to a territorial regime. Many other groups and individuals,

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<sup>1</sup> Samuel C. Thompson, Jr., *An Imputation System for Taxing Foreign Source Income*, 130 *Tax Notes* 567 (Jan. 31, 2011) and 61 *Tax Notes International* 691 (Feb. 28, 2011).

including Senator Grassley,<sup>2</sup> formerly the Chairman of the Senate Finance Committee, have made similar suggestions. The principal reason the Panel gave for this move was “competitiveness,” and this was also the reason given by Senator Grassley in his August 2011 letter to President Obama, where he suggested that we move to a “territorial tax system to ensure that the United States remains competitive in the global marketplace.”<sup>3</sup> In other words, the Panel and Senator Grassley argue that a territorial system will make U.S. firms competitive with other firms doing business in, for example, China by subjecting the U.S. firm’s Chinese operations to the same tax rate that applies to other companies doing business in China that are either Chinese owned firms or subsidiaries of firms located in countries with territorial systems. I refer to this argument as the “horizontal” competitiveness claim, in that it supports similar tax treatment for firms investing in a particular country.

This competitiveness claim is, at a minimum, overstated. For example, in his testimony before this Senate Finance Committee at the September 8, 2011 hearing on International Tax Issues, Professor Reuven Avi-Yonah made it clear that the facts do not support this competitiveness claim:

**There is no good data indicating that the effective tax rate faced by US-based MNEs is significantly higher than that faced by MNEs based in other OECD countries** [Many of these countries have territorial regimes]. Moreover, there is reason to believe that the effective tax rate faced by US-based MNEs is **lower** than that faced by MNEs based in our trading partners.<sup>4</sup> [emphasis in the original]

Also, Professor Avi-Yonah explained that even though a competitor country may have a territorial regime, in many cases those regimes have “much stricter CFC rules than the United States, so that their multinationals do not enjoy a competitive edge because of the limited territoriality that is allowed.”<sup>5</sup> For example, territorial treatment may be available for only certain types of business income that is subject to tax at a rate that approximates the rate in the home country.<sup>6</sup> Thus, while it is theoretically possible that a U.S. firm operating under our current system or an imputation system could face a higher tax rate than a firm based in a country with a territorial regime, as a practical matter, this type of competitive disadvantage is not a significant factor in shaping the competitive landscape faced by U.S. multinationals.

### ***B. The Ignored U.S. or “Vertical” Competitiveness Problem***

Adoption by the U.S. of a territorial regime would create a clear competitiveness issue for businesses conducted in the U.S. because it would create an unlevel playing field between

<sup>2</sup> Sen. Grassley, Letter to President Obama on Tax Reform (August 11, 2011) (suggesting that we move to a “territorial tax system to ensure that the United States remains competitive in the global marketplace”) [Senator Grassley Letter].

<sup>3</sup> *Id.*

<sup>4</sup> Testimony of Prof. Reuven Avi-Yonah, Hearing on International Tax Issues, Senate Finance Committee 3 (September 8, 2011) [Prof. Avi-Yonah Statement].

<sup>5</sup> *Id.*

<sup>6</sup> For example, in discussing the French CFC provisions, a Deloitte presentation entitled *Controlled Foreign Company Regimes Essentials* (2011), explains that imputation generally applies to income earned by a controlled foreign sub if the sub “benefits from a privileged tax regime, i.e. it is subject to an effective tax rate that is at least 50% lower than the rate in France.” *Id.* at 14.

business conducted in the U.S., for example in State College, and business conducted in China. I refer to this problem as the “vertical” competitiveness problem, because it is a competitiveness problem between the U.S. and foreign investment destinations. President Bush’s Tax Reform Panel, and other proponents of territoriality do not address this competitiveness problem.

To illustrate the “vertical” competitiveness problem, assume that the corporate tax rate in China is 15%, which is 20 percentage points lower than the 35% U.S. corporate tax rate. Assume that State Oil Corp is faced with the following investment decision: (1) invest \$50 million in oil exploration and refining in State College, which is expected to produce \$10 million in annual taxable income, or (2) invest \$50 million in oil exploration and refining in China, which is also expected to produce \$10 million in annual taxable income. Thus, the pre-tax return of both investments is \$10 million. Other things being equal, with a territorial system, what investment decision would State Oil Corp make?

The answer is clear: State Oil Corp will invest in China because although the pre-tax returns of the two investments are the same, the after-tax return with the China investment is \$8.5 million, that is, \$10 million less the \$1.5 million China tax, while the after tax return for the State College investment is only \$6.5 million, that is \$10 million minus the \$3.5 million U.S. tax.

Thus, in purporting to solve an overstated “horizontal” competitiveness problem for U.S. companies doing business in foreign countries, a territorial system would create a very real “vertical” competitiveness problem for the people of State College in that it would give U.S. corporations an incentive to invest capital in foreign markets with lower tax rates, rather than investing that capital here at home. Also, such an incentive would only exacerbate the problem of job outsourcing.

#### **§ IV Congress Should Adopt an Imputation System**

My bottom line is that Congress should not adopt a territorial regime. In thinking about this issue for many years, I have come to the conclusion that Congress should adopt an imputation system that taxes on a current basis all the income of foreign corporations controlled by U.S. taxpayers. Thus, under this system, State Oil Corp would be taxed currently on the income earned by China Oil Sub; in other words, the income of China Oil Sub would be imputed to State Oil Corp as the income is earned. With an imputation system, a foreign subsidiary is treated similarly to a partnership or subchapter S corporation, which are flow-through entities; the entity is not subject to tax, but the entity’s income is imputed up to the owners who pay tax on the income. Also, State Oil Corp would, within limits, receive a foreign tax credit for the Chinese tax paid by China Oil Sub.

Therefore, under the above example, State Oil Corp would be taxed in the U.S. on the \$10 million of income earned by China Oil Sub, which would produce a tentative U.S. tax of \$3.5 million. However, State Oil Corp would receive a credit of \$1.5 million against this tax for the Chinese taxes paid by China Oil Sub, producing a final U.S. tax liability of \$2.0 million. Thus, the total of the U.S. and Chinese taxes would be \$3.5 million. Under this system, the after tax return from investing in the U.S. and China is the same; in other words, the investment playing field is level.

President Kennedy proposed the adoption of a full imputation system in 1962, but the proposal was rejected. Instead, Congress continued the deferral system for active income and enacted the CFC provisions, which provide for imputation of tax haven type income. An imputation system has been recently proposed by, among others, Stephen E. Shay, who served as Treasury International Tax Counsel in the administration of the first President Bush and the Deputy Assistant Treasury Secretary (International Tax Affairs) in the administration of President Obama.<sup>7</sup>

Let me emphasize that I am not suggesting that we penalize investments by China Oil Sub. I am only proposing that the China profits of China Oil Sub be taxed at the same rate as U.S. profits.

## **§ V Pros and Cons of the Imputation System**

### **A. The Benefits of the Imputation System**

#### **1. Economic Efficiency**

The main benefit of the imputation system is that it promotes economic efficiency.<sup>8</sup> An imputation system achieves economic efficiency because it does not distort investment decisions; it does not permit home country income taxes to be a consideration in where investment is located. Therefore, an imputation system would lessen the impact of tax havens or financial privacy jurisdictions. An imputation system will allow companies to make decisions based on economics and business principles rather than possible tax implications.

#### **2. Elimination of the “Lockout” Problem**

Under the current deferral system, U.S. parents are reluctant to repatriate earnings of foreign subs because of the U.S. tax that would be imposed on the repatriated earnings. This has been referred to as the “lockout” problem. This problem would be eliminated with an imputation system because the earnings of a foreign sub would be taxed when earned and not when distributed. Thus, it could be expected that foreign earnings would be deployed in the U.S. or a foreign country without regard to the Federal income tax treatment of the investment, because foreign earnings would not be “locked out” of the U.S.

Although some argue that a territorial regime would also address the “lockout” problem, as indicated above, a territorial regime creates a tax incentive for foreign over domestic investment, and this incentive will work against any repatriation. Further, there are other significant problems with such a system.

<sup>7</sup> See, e.g., Clifton J. Fleming, Jr., Robert J. Peroni, and Stephen E. Shay, *Perspectives on the Worldwide vs. Territorial Taxation Debate*, 125 Tax Notes 1079 (Dec. 7, 2009); Clifton Fleming, and Stephen Shay, "Getting Serious About Curtailing Deferral of U.S. Tax on Foreign-Source Income," 52 SMU L. Rev. 55 (1999). See also Fleming and Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, Tax Notes, Dec. 19, 2005, p. 1557, Doc 2005-24240, 2005 TNT 243-29 (analyzing the territorial proposal of the tax reform panel report and a similar proposal by the JCT; concluding that the United States should move to an imputation system).

<sup>8</sup> Joint Committee on Taxation, *JCT Reports on U.S. International Tax Rules*; 2003 TNT 135-10 (July 15, 2003).

### 3. Preserving the Tax Base

Preserving the U.S. tax base is another benefit that can be achieved by adopting the imputation system. Under the territorial system, income earned abroad is lost forever from the U.S. tax base, while under the imputation system, all income earned abroad is reflected in the tax base.

### 4. Horizontal and Vertical Equity

Adopting an imputation system will also promote horizontal and vertical equity.<sup>9</sup> Horizontal equity is achieved when taxpayers who are similarly situated, or are earning similar levels of income, are taxed at the same effective rate. Horizontal equity would be achieved by taxing corporations at the same effective corporate tax rate no matter where the income is earned.<sup>10</sup> An imputation system would give no benefit to a foreign subsidiary located in the Cayman Islands over a domestic subsidiary located in Pennsylvania.

Vertical equity is the belief that taxpayers who are earning higher levels of income should shoulder more of the overall tax burden in the resident country because taxpayers earning higher levels of income have a greater ability to pay tax. Vertical equity will be promoted under an imputation system because foreign-source income will be subjected to the progressive rates.<sup>11</sup> There would be little, if any, tax incentive under an imputation system for the wealthy taxpayers to earn income abroad.

### 5. Requiring G.E. and Other Similar Companies to Pay Some Federal Income Tax

A March 2011 article in the New York Times reports:

General Electric, the nation's largest corporation, had a very good year in 2010. The company reported worldwide profits of \$14.2 billion, and said \$5.1 billion of the total came from its operations in the United States. Its American tax bill? None. In fact, G.E. claimed a tax benefit of \$3.2 billion.<sup>12</sup>

The article goes on to explain that the "most lucrative" tax benefits received by GE allow it to "operate a vast leasing and lending business abroad with profits that face little foreign taxes and no American taxes as long as the money remains overseas."<sup>13</sup>

The imputation system proposed here provides a simple antidote to the GE "no tax" problem: the U.S. tax would be based on worldwide earnings.

### 6. Fewer Transfer Pricing and Deflection of Expense Abuses

An imputation system would also allow the IRS to expend fewer resources in monitoring foreign-source income, thereby improving economic efficiency as well. In looking at the problems associated with transfer pricing, an imputation system would resolve the problem as it

<sup>9</sup> See the discussion of "Fairness Considerations" and the "Ability to Pay" in Fleming, Peroni and Shay, *Perspectives*, *supra* note 7.

<sup>10</sup> *JCT Reports on U.S. International Tax Rules*, *supra* note 8.

<sup>11</sup> *Id.*

<sup>12</sup> David Kocieniewski, *G.E.'s Strategies Let It Avoid Taxes Altogether*, New York Times (March 24, 2011).

<sup>13</sup> *Id.*

exists with outbound and inbound sales and services transactions between a U.S. parent corporation and a foreign subsidiary. An imputation system achieves this result because income earned in foreign countries would be subject to tax at the U.S. rate. Therefore, no matter where the profits are earned, they will be taxed at the same rate. Transfer pricing issues would still arise with respect to transactions between a foreign parent corporation and its U.S. subsidiary.

An imputation system would also largely eliminate any incentive for deflection of income and expense abuse between U.S. parent corporations and their foreign subs, which is present in the current system and would be exaggerated with a territorial system. For example, with a territorial system there is an enhanced incentive for companies to deflect what would otherwise be high taxed U.S. income into low taxed foreign subs through the use of related party transfer pricing that is not arm's length pricing, as Section 482 of the Code requires. In addition, notwithstanding Section 482, there would be a great incentive to deflect foreign expense of low taxed foreign subs to U.S. parents. Policing of these income and expense deflection schemes under a territorial regime would put a heavy load on the IRS's administration of the territorial regime.

#### **7. No Need to Distinguish between Active and Passive Income**

In both the U.S. deferral system and generally in territorial systems, foreign passive income is taxed on a current or imputation basis. This means that passive income is imputed to the parent corporation at the time the income is earned, thereby imposing an immediate home country tax on the passive income. However, the home country tax may be reduced by a foreign tax credit for foreign taxes paid on the passive income. This is an accepted norm, and no policy commentator that I am aware of has argued for deferral or exemption of foreign passive income.

The general distinction between active income and passive income is that active income is income earned by a company's primary business activities while passive income is income earned by a company by means other than its primary business activities, such as the collection of interest and dividends.<sup>14</sup> Many challenges are presented when attempting to tax active foreign-source income. According to a GAO report, "[t]hese challenges include ensuring tax law compliance, minimizing tax induced distortions of business decisions about where to locate business investment, avoiding the double taxation of income earned in one country by companies located in another country, and minimizing unnecessary taxpayer compliance burden, such as recordkeeping."<sup>15</sup>

Although these challenges are inherent in the current deferral system and would become even more difficult with a territorial system, they would essentially be eliminated with an imputation system.

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<sup>14</sup> See GOV'T ACCOUNTABILITY OFFICE, REPORT TO THE COMMITTEE ON FINANCE, U.S. SENATE, GAO-09-934, INTERNATIONAL TAXATION, STUDY COUNTRIES THAT EXEMPT FOREIGN-SOURCE INCOME FACE COMPLIANCE RISKS AND BURDENS SIMILAR TO THOSE IN THE UNITED STATES (Sept. 2009). For a good illustration of different types of foreign-source income see Table 1 of this GAO's report.

<sup>15</sup> *Id.* at 1.

### 8. Revenue Generated from Move to an Imputation System

Another benefit of an imputation system is the additional revenue it would generate. The Joint Committee on Taxation's October 2008 Tax Expenditure Report<sup>16</sup> shows that only the allowance for accelerated depreciation for equipment produces a larger corporate tax expenditure (*i.e.*, reduction in tax liability) than the deferral provision. Thus, of the nearly 150 corporate tax expenditures covered in the Report, only one produces a greater revenue loss than the deferral provision. As a practical matter, this means that any meaningful amendment to the corporate tax would have to take a hard look at the deferral tax expenditure, which the Joint Committee estimates will result in the loss of \$ 62.9 billion in tax revenues over the period 2008-2012. It is not clear if this estimate takes into account all of the detriments associated with transfer pricing and income/expense deflection abuse under the current deferral system. If such abuses are not included in this revenue estimate, then the tax revenue gain from moving to an imputation system would be even greater.

### 9. Potential Reduction in the Corporate Tax Rate for All Corporations

There is no doubt that the repeal of the deferral system could, on a revenue neutral basis, provide the revenue needed to significantly reduce the maximum corporate tax rate from the current 35%. Professor Clemons has reported that the revenue gained from the "repeal of the deferral provision [could be used on such a revenue neutral basis to] decrease the top corporate tax rate for all U.S. corporations from 35 percent to 28 percent."<sup>17</sup> Thus, the trade-off with this type of revenue neutral policy would be (1) increasing the tax rate on companies investing abroad, and (2) reducing the maximum tax rate on all companies, both those investing abroad and those investing domestically, from 35% to 28%. This is essentially the policy choice made in the Option 1 Base Case proposed by the Co-Chairs of President Obama's Deficit Reduction Commission<sup>18</sup> and in the Bipartisan Tax Act proposed by Senators Wyden and Gregg.

Under this approach, investment in the U.S. would be more attractive for both U.S. companies and for foreign companies because the 28% rate would also apply to foreign companies operating in the U.S.<sup>19</sup> Also, although there would be immediate imputation of foreign income, the imputed income would be taxed at a lower rate than the current 35% rate applicable to companies that earn foreign income and immediately repatriate it to the U.S. Thus, those U.S. companies that currently repatriate low-taxed foreign income on a current basis would receive a tax reduction.

<sup>16</sup> Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012*, Table 4 (Oct. 31, 2008).

<sup>17</sup> Roy Clemons, *U.S. International Tax Policy: Is Significant Reform on the Way?*, 55 *Tax Notes Int'* 1965 (Sept. 14, 2009).

<sup>18</sup> Co-Chairs Proposal, November 2010, 11.10.10 Draft Document. The Deficit Reduction Commission was established by President Obama pursuant to Executive Order 13531 of February 18, 2010 entitled "National Commission on Fiscal Responsibility and Reform."

<sup>19</sup> This is because foreign companies operating businesses in the U.S. pay the same corporate rate as U.S. companies operating U.S. businesses.

## ***B. The Problems with the Imputation System***

### **1. Decrease in Foreign Competitiveness**

By implementing an imputation system, U.S. multinational corporations may be deterred from investing in foreign countries because the tax incentives are no longer present. However, for the reasons discussed above, the “horizontal” competitive issue advanced by President Bush’s Tax Reform Panel and Senator Grassley are greatly overstated. Also, the other side of this coin is that with an imputation system, there would be greater “vertical” competitiveness, that is, investment in the U.S. would not be less desirable than foreign investment, and as a result of the lower corporate tax rate that would come with an imputation system, there would be more investment in the U.S. by both U.S. and foreign businesses.

Further, I have long thought that if the U.S. moves to an imputation system, other countries will likely follow our lead. Professor Avi-Yonah makes the same point: “[I]f we repealed deferral, our major trading partners may follow us, just like they followed us in adopting CFC legislation.”<sup>20</sup>

### **2. Continued Complexity with the Foreign Tax Credit System**

One of the problems with the imputation system is that companies would still have the complexity embedded in the foreign tax credit rules. In using foreign tax credits, multinational corporations would still be able to cross-credit. Therefore, the benefit of easing the economic efficiency could be eroded by efforts that both multinational corporations and the IRS will have to expend in complying with the foreign tax credit provisions. On the other hand, the foreign tax credit rules would be much less complex than such rules under a deferral or territorial system, because, for example, it would not be necessary to have separate baskets for active and passive foreign income.

### **3. Potential Expatriation of U.S. Firms**

Some will argue that adoption of an imputation system will encourage U.S. firms to relocate abroad. There is no doubt that the incentive for such action would be increased under an imputation system. For that reason, with the adoption of an imputation system, Congress should consider tightening Section 7874, the anti-inversion provision, which was enacted in 2004 to prevent such activity.

### **4. Switching Costs**

Another problem with adopting an imputation system is the administrative costs associated with switching from the current U.S. deferral system. For example, if an imputation system were adopted, a decision would have to be made on the treatment of income that has been previously deferred. Would that income become subject to immediate U.S. taxation? It would be reasonable to require that the deferred income held in foreign subsidiaries be included in the income of the U.S. parents (thereby becoming subject to U.S. tax) on a ratable basis over a three or four year period. This would be similar to the rules that applied in the late 1980s when tax exempt Keogh plans were forced onto a calendar year basis, thus eliminating the benefit of deferral for the owners of such plans.

<sup>20</sup> Prof. Avi-Yonah Statement, *supra* note 4 at 3.

## **§ VI Congress Should Understand the Incentives of Those to Whom It Listens on this Issue**

In his August 2011 letter to President Obama on Tax Reform, Senator Grassley cited the following as support for his argument that we should move to a territorial regime: “In the Senate Finance Committee, we recently heard testimony from Chief Executive Officers (CEOs) of four of the largest American companies competing overseas. The message from these CEOs was clear—they need a lower rate and certainty to compete overseas.”<sup>21</sup> It is important for the Senate Finance Committee to understand that these executives have a vested interest in having a low tax rate on their foreign income, and indeed they have a fiduciary duty to their shareholders not to advocate policies that would increase the taxes their firms would pay. Congress needs to seek advice on this issue from those who do not have a financial or other stake in the outcome.

## **§ VII Conclusion and Call for Hearings Specifically on the Pros and Cons of an Imputation System**

While there are no easy solutions in international taxation, an imputation system offers many benefits over the current deferral system or a territorial system. One of the major benefits of an imputation system is that it will eliminate the bias in favor of foreign investment in low tax jurisdictions over U.S. investment and will eliminate the “lockout” effect. Another benefit is that an imputation system would preserve the U.S. tax base. As indicated above, under the current deferral system, the U.S. loses billions of dollars in tax revenue, and this would also be true with a territorial system. With more tax revenue coming in every year under an imputation system, the U.S. would be able to significantly lower the corporate tax rate for all corporations as is the case with both the Option 1 Base Case, proposed by the Co-Chairs of the President’s Deficit Reduction Commission, and the Bipartisan Tax Act, proposed by Wyden-Gregg. A reduction in the corporate tax rate would lead to an increase in investment in the U.S. by both domestic-controlled and foreign-controlled businesses.

By enacting an imputation system, U.S. multinational corporations would no longer have an incentive to abuse the transfer pricing rules by deflecting (1) U.S. income to foreign subsidiaries, and (2) foreign expense to U.S. parents. Such abuses are significant in the current deferral system, would be even greater with a territorial system, and would be eliminated with an imputation system.

I believe that the case for the adoption of an imputation system in conjunction with a lowering of the corporate rate is so strong that the Senate Finance Committee and the House Ways and Means Committee should hold hearings specifically focused on the pros and cons of adopting an imputation system. Among others, Congress should seek comments from all types of businesses, including, large, small, internationally based, and domestically based. Congress should make every effort to understand the motives behind those who address the issue. The basic question Congress should ask is: Would we be better off with a territorial regime and the current 35% corporate rate or an imputation system with a 28% corporate rate?

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<sup>21</sup> Senator Grassley Letter, *supra* note 2.



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**Statement of the Investment Company Institute  
Hearing on “Tax Reform Options: International Issues”  
Committee on Finance  
United States Senate**

**September 8, 2011**

The Investment Company Institute (“ICI”)<sup>1</sup> appreciates the opportunity to present the Committee with its comments regarding options for tax reform on international issues. The ICI applauds the Committee for its efforts to improve and simplify the tax code in a manner that spurs economic growth and job creation, and enhances the competitiveness of U.S. businesses in the global market.

As the Committee is aware, an important component of any comprehensive tax reform initiative should be rules that encourage foreign investment in the United States.

The ICI thus proposes two changes to the Internal Revenue Code (“Code”) that would increase foreign investment in U.S. regulated investment companies (“RICs”), more commonly known as mutual funds. First, we recommend that the Congress make permanent a provision that exempts foreign investors in a RIC from U.S. withholding tax on certain amounts that would be exempt if received directly by those investors. Second, we propose a new investment vehicle that would encourage foreign investment in RICs. Both of these proposals, if adopted, would eliminate disparate treatment between U.S. and foreign funds and thereby allow RICs to compete more effectively with foreign funds for foreign investors.

**Make Permanent Flow Through of Interest and Short-Term Capital Gains to Foreign Investors**

Background

Code section 871(k) was added by the American Jobs Creation Act of 2004 to exempt foreign investors in an electing RIC from U.S. withholding tax on “interest-related dividends” and “short-term capital gain dividends.” Interest-related dividends are amounts attributable to an electing RIC’s U.S.-

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.9 trillion and serve over 90 million shareholders.

source interest income; short-term capital gain dividends are amounts attributable to an electing RIC's short-term capital gains. Section 871(k) permits electing RICs to "flow through" to their foreign shareholders the character of this income.

Prior to section 871(k)'s enactment, foreign investors in RICs were subject to U.S. withholding tax on amounts attributable to RICs' interest income and short-term capital gains because these amounts were treated under the Code as ordinary dividends.<sup>2</sup> Conversely, foreign investors are not subject to U.S. withholding tax on interest and short-term capital gains if the investments instead are made directly in the underlying securities or through foreign funds. Because of this disparate treatment, the Congress enacted section 871(k) to level the playing field and encourage foreign investment in RICs.

As originally enacted, however, section 871(k) was effective for only three years, beginning with a RIC's first taxable year beginning on or after January 1, 2005. This section was extended twice, for two years each time, in 2008 and 2010. Thus, section 871(k) currently is set to expire for dividends with respect to tax years of RICs beginning after December 31, 2011.

#### Reason for Change

Section 871(k) is important for RICs seeking to compete with foreign funds for foreign investors. The temporary nature of section 871(k), however, has limited its utilization. First, many RICs have been sufficiently unsure of the provision's long-term viability to incur the significant programming costs for the possibility of only temporary benefits. Second, foreigners have been unsure whether to make long-term investments in RICs without a long-term assurance that the flow-through benefits would be available. RICs will be more likely to make the necessary programming changes, and foreign investors will be more likely to invest in RICs, if the provisions are made permanent.

#### Proposal

The Internal Revenue Code should be amended to make the flow-through treatment of section 871(k) permanent. Specifically, sections 871(k)(1)(C)(v) and 871(k)(2)(C)(v), which contain the "termination" date for the flow-through of interest-related dividends and short-term capital gain dividends, should be stricken from the Code. This change will enhance the international competitiveness of the U.S. fund industry, thus encouraging foreign investment in RICs and in the U.S. markets.

### **New Investment Vehicle to Encourage Foreign Investment in RICs**

#### Background

Under current law, a RIC must distribute substantially all of its income and capital gain each year. Shareholders thus are taxed currently on their RIC investments.

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<sup>2</sup> The regular withholding rules continue to apply if a RIC does not elect flow-through treatment under section 871(k).

U.S. law imposes a 30 percent withholding tax on certain types of investment income paid by U.S. issuers to foreign portfolio investors. Income tax treaties entered into by the U.S. generally reduce this withholding tax rate to 15 percent for residents of our treaty partners. Dividends, including ordinary income dividends paid by a RIC, are subject to this withholding tax. Capital gains and portfolio interest generally are exempt from this withholding tax.

A foreign investor who receives annual distributions from a RIC also is subject to current taxation in his or her home (residence) country. Although a capital gain distribution from a RIC to a foreign investor is not subject to U.S. withholding tax, such distribution typically will be treated as an ordinary corporate dividend, rather than as a capital gain, by the foreign shareholder's home country. This loss of the distribution's favorable capital gains tax character causes these amounts to be taxed, in the foreign investor's home country, at the higher rate imposed on ordinary income.

Many foreign tax regimes, in contrast to the U.S. regime, do not require their mutual funds to distribute income or gains to their shareholders. These "roll-up" funds are common, for example, in many European countries. The income and gains realized by such a fund are retained and increase the fund's net asset value (and an investor's potential capital gain). These foreign countries likewise typically do not tax the gains realized by investors who are not resident in the country in which the fund is organized (*i.e.*, "foreign" shareholders). Thus, a "foreign" shareholder in a "foreign" fund typically will incur no tax in the country in which the fund is organized.

Thus, a foreign shareholder in a foreign roll-up fund typically incurs tax only in his or her home country – typically at favorable capital gains rates – and only when the fund shares are sold (absent an anti-deferral regime similar to the U.S.'s passive foreign investment company, or PFIC, rules).

#### Reason for Change

Given the disparate tax treatment between U.S. and foreign funds, RICs cannot compete effectively with foreign funds to attract foreign investors. The absence of current distributions by foreign roll-up funds creates two powerful incentives – tax deferral and favorable capital gains treatment for the entire investment return – for foreign investors to invest in such funds. Unless RICs can provide similar roll-up opportunities (and give foreign investors, resident in countries that choose not to impose current inclusion rules, the ability to defer tax until shares are sold), foreign investors will continue to be discouraged by U.S. tax laws from investing in RICs.

#### Proposal

Subchapter M of the Internal Revenue Code should be amended to permit the creation of a new fund entity that would facilitate investment by foreign shareholders in RICs. This "international regulated investment company" or "IRIC" would issue shares only to foreign shareholders and would invest only in RIC shares. U.S. residents would not be permitted to purchase shares in the IRIC.

The IRIC would not be required to distribute its income or capital gain annually. It would be required, however, to pay U.S. tax annually in an amount equal to the tax that would apply to the IRIC's

shareholders had they invested directly in the RIC shares held by the IRIC. An IRIC open only to foreign investors who are resident in countries that have tax treaties with the U.S. – that provide a 15 percent tax rate on dividends subject to withholding – would pay tax at a 15 percent rate on this income. An IRIC open only to foreign investors resident in countries with which the U.S. does not have a tax treaty, in contrast, would pay tax at a 30 percent rate on income subject to withholding tax.

Thus, a foreign investor would incur the same U.S. tax as if he or she had invested in a RIC directly, but would not be subject to tax in his or her home country until the IRIC shares were sold (absent a current inclusion tax regime comparable to the PFIC regime in the U.S.). The RIC in which the IRIC invests would remain subject to the Internal Revenue Code's distribution requirements, as under present law. The creation of this new vehicle would allow RICs to compete with foreign funds.

#### **Conclusion**

The ICI commends the Committee for its goal of improving and simplifying the international provisions of the tax code in a manner that will improve U.S. competitiveness abroad and thereby enhance foreign investment in the U.S. The proposals that we advance today are consistent with these initiatives and, if adopted, will increase foreign investment in RICs. We look forward to working with you to develop further these objectives.

Statement of Todd McCracken

on behalf of

The National Small Business Association

regarding

International Issues relating to Tax Reform

September 8, 2011

My name is Todd McCracken and I am the president of the National Small Business Association (NSBA), America's oldest small-business advocacy organization.<sup>1</sup> The NSBA is pleased to provide its perspective on international issues relating to tax reform.

The NSBA strongly believes that the present tax system is irretrievably broken and constitutes a major impediment to the economic health and international competitiveness of American businesses of all sizes. To promote economic growth, job creation, capital formation, and international competitiveness, fundamental tax reform is required.

To promote the international competitiveness of U.S. businesses, we believe that tax reform, whether fundamental or incremental, should:

- reduce compliance costs and simply the tax system;
- place foreign and domestic manufacturers on an even footing and remove impediments to exporting;
- reduce marginal tax rates;
- provide for a neutral tax treatment of savings and investment;
- eliminate provisions in the tax law that provide artificial incentives to undertake particular kinds of economic activity; and
- remove tax impediments to the free flow of capital and to repatriating profits earned abroad to the U.S.

This statement also examines proposals to move to a territorial tax system, consumption taxes generally and the FairTax in particular.

#### **Reduce Compliance Costs and Simply the Tax System**

Compliance costs are the costs that businesses incur complying with the tax system. In the case of small businesses these costs include the time of small business owners and their accounting staff devoted to collecting necessary information and filling out IRS forms and the costs incurred hiring outside accountants and lawyers for advice about how to comply with the

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tax law. In general, small business compliance costs relative to income or revenues are disproportionately high.

There will always be some compliance costs in any tax system. But today these costs are very high. And if there is one thing the NSBA membership is almost universally agreed on, it is that the current compliance costs are too high and that the tax system needs to be simplified.

Estimates by economists vary as to the magnitude of compliance costs. In general, compliance costs seem to be in the neighborhood of 9 to 14 percent of the revenues raised. These high costs do nothing to further a societal interest. We should aim to raise the revenue needed by the federal government in the least costly way. The costs of the current system represent a huge waste of resources that could be better spent growing businesses, creating new products, conducting research and development, or purchasing productivity enhancing equipment.

These costs also represent a significant drag on the international competitiveness of U.S. businesses. Compliance costs must be recovered by businesses in the sales price of their goods or services. Otherwise, the businesses will fail. Reducing these costs is within our control and it should be a priority of Congress. Furthermore, there is strong reason to believe that U.S. costs are substantially higher than those of most other developed nations.

**Place Foreign and Domestic Manufacturers on an Even Footing and Remove Impediments to Exporting**

An origin principle tax system taxes goods and services based on where they were produced or originated rather than where they were purchased or consumed. In an origin principle tax system, the production of goods and services in the taxing country is taxed no matter where the goods and services are sold, used or consumed. In a destination principle consumption tax, goods consumed in the taxing country are taxed whether the goods or services were produced domestically or abroad. Exported goods are not taxed.

The individual and corporate income tax and payroll tax raise well over 90 percent of the revenue collected by the federal government. These taxes are origin principle taxes. Most consumption taxes (including sales taxes<sup>2</sup>, European style credit-invoice type value added taxes, Canadian and Australian goods and services taxes<sup>3</sup> and proposed business transfer taxes<sup>4</sup>) are destination principle taxes. The Flat Tax and various proposed consumed income taxes<sup>5</sup> are, however, origin principle systems.

<sup>2</sup> Including U.S. state sales taxes and proposed national sales tax such as the FairTax.

<sup>3</sup> GST is essentially just another name for credit-invoice type VAT.

<sup>4</sup> These are subtraction method value added taxes.

<sup>5</sup> A consumed income tax is sometimes called an expenditure tax (Kaldor), cash flow tax (Aaron-Galper) or inflow-outflow tax (Ture) depending on the author or analyst. The only significant difference among the various proposals is the inclusion (or not) of the proceeds from debt in the tax base and the deduction from the tax base of principal payments.

It is a common fallacy that having a destination principle tax like a VAT or a GST helps domestic exporters and hurts foreigners importing goods into the taxing country. This is not the case because both domestic and foreign goods are subject to the same tax when consumed domestically. This is why VATs and GSTs are legal under World Trade Organization rules.

What **will** help U.S. producers and impose a greater effective tax burden on foreigners importing goods into the U.S. would be to **replace** the current origin principle taxes with a destination principle consumption tax. There are two reasons for this. First, exports will no longer bear a U.S. tax burden and imports, for the first time, will bear the same tax burden as U.S. goods. Second, as discussed below, a consumption tax reduces the U.S. user cost of capital and will increase the U.S. capital stock and hence the productivity of U.S. businesses.

The current tax system taxes U.S. producers whether they are selling in U.S. or foreign markets and imposes no appreciable tax on foreign producers selling goods into the U.S. It, therefore, places U.S. producers at a considerable disadvantage.<sup>6</sup> Were the U.S. to replace the current tax system with a destination principle consumption tax (such as the FairTax) then, for the first time in nearly a century, the U.S. government through its tax system would no longer be according a major advantage to those who produce goods abroad over those that produce goods in the U.S.

#### **Reduce Marginal Tax Rates**

The tax base should be broadened and marginal tax rates on business reduced. However, the tax base should only be broadened to the extent that can be accomplished without imposing multiple levels of taxation on savings and investment. High marginal tax rates discourage work, savings and investment. Conversely, reducing marginal tax rates encourages work, savings and investment. Reducing marginal tax rates also increases entrepreneurial risk-taking because less of the potential reward from the risk-taking will be taken by government. Furthermore, lower marginal tax rates reduce the cost of capital and increase productivity increasing investment.

The economic loss associated with the tax system increases with the square of the tax rate increase.<sup>7</sup> Thus, doubling the tax rate will result in a four-fold increase in the adverse economic effect of the tax system. This effect is equally true in reverse. Lowering marginal tax rates has a disproportionately positive impact on the economy.

The U.S. currently has one of the highest statutory corporate tax rates in the developed world. This is mitigated to some degree by U.S. capital cost recovery allowances that are somewhat more rapid than in many countries.

<sup>6</sup> There is an argument sometimes made that exchange rates will adjust to compensate for this effect. It is beyond the scope of this short statement to address that subject. Suffice it to say that the tax system alters costs, relative prices and rates of return and therefore alters behavior, in this case, just like other better understood cases.

<sup>7</sup> Alan Auerbach, "The Theory of Excess Burden and Optimal Taxation," in the Handbook of Public Economics, Alan Auerbach and Martin Feldstein, Editors, 1985; Harry Watson, "Excess Burden," Encyclopedia of Taxation and Tax Policy, Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle, Editors, 2005; John Creedy, "The Excess Burden of Taxation and Why It (Approximately) Quadruples When the Tax Rate Doubles," New Zealand Treasury Working Paper 3/29, December 2003.

Small businesses are, however, overwhelmingly pass-through entities and pay at the individual tax rates which are also higher than business tax rates in most countries. Small businesses also create most of the new jobs created in the U.S. economy. Raising the top tax rates on small businesses by increasing individual tax rates will have an adverse impact on small businesses, job creation and the economy.

#### **Provide for a Neutral Tax Treatment of Savings and Investment**

The current tax system is quite biased against savings and investment. Corporate income and corporate capital gains are taxed. Dividends paid from after-tax income are taxed again.<sup>8</sup> Individual capital gains are taxed but capital gains are simply increases in the present value of future income stream that will be taxed. What is left over and not spent is also taxed by the unified estate and gift tax. Moreover, there are numerous places in the code that force businesses to delay deducting costs incurred now. This raises their costs and reduces their cash flow. Examples include the amortization of start-up expenses and the inventory capitalization requirements of section 263A. But the most important example is the requirement that purchases of equipment and structures be deducted over a period of many years rather than be expensed.

Adequate capital cost recovery allowances, preferably expensing, are critical to maintaining a reasonable cost of capital and to firms of all sizes being able to afford the capital investment necessary to compete in the international marketplace.<sup>9</sup> It is hard to overstate this point. Capital formation is critical to maintaining long-term competitiveness and preserving relatively high U.S. wage rates. Unless U.S. firms invest in productivity-enhancing or innovative cutting-edge equipment that provides new capabilities, U.S. firms will only be able to compete by accepting lower returns and by paying workers less. If, of course, they fall far enough behind, the firms will simply fail.

Section 179 expensing is of vital importance for smaller firms, particularly those in more capital intensive industries. It should be retained or expanded. For now, section 179 eliminates the tax bias against savings and investment for firms that can take advantage of it. It reduces the user cost of capital considerably for small firms. For 2011, up to \$500,000 of investment purchases may be deducted. In 2012, the figure falls to \$125,000. Thereafter, unless Congress acts, the amount deductible will fall to \$25,000. This latter limitation dramatically limits the number of firms that can appreciably benefit and dramatically reduces the economic effect of the provision. Retaining the current \$500,000 threshold should be high on the Congressional agenda.

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<sup>8</sup> Even Henry Simons, one of the fathers of the modern income tax thought double taxing corporations was wrong. In his 1938 book *Personal Income Taxation: the Definition of Income as a Problem of Fiscal Policy* he proposed integrating the personal and corporate income tax to prevent double taxation.

<sup>9</sup> Expensing is always the correct answer in a consumption tax where either (i) interest is neither taxable nor deductible or (ii) debt proceeds are includible in the taxable base and principle and interest are deductible. In a hybrid system, such as the current U.S. system, some limits on debt financed investment in expensed property may be appropriate. As a practical matter, this will only be important in the case of large enterprises with large borrowing capacity.

**Eliminate Provisions in the Tax Law that Provide Artificial Incentives to Undertake Particular Kinds of Economic Activity**

The economy will grow most rapidly and society's scarce resources be used most effectively if the tax code's many provision rewarding or punishing particular types of investment or other economic behavior are eliminated. Business decisions should be made for business reasons not because of the tax treatment or tax subsidy accorded certain activities.

The FairTax and other consumption taxes eliminate the large differential returns caused by the income tax and would channel business investment to the most economically efficient investments. This, along with the reduce user costs of capital and lower marginal tax rates, will have a pronounced positive impact on the economy.

**Remove Tax Impediments to the Free Flow of Capital and to Repatriating Profits Earned Abroad to the U.S.**

Having adequate capital in the U.S. is important to U.S. businesses. Small businesses, in particular, have difficulty obtaining adequate capital for their businesses. Eliminating barriers to the repatriation of capital to the U.S. will help small businesses in two ways. First, by increasing the amount of capital on deposit with U.S. financial institutions, it will improve the likelihood of U.S. small businesses obtaining capital and reduce the cost of obtaining capital.<sup>10</sup> Second, money invested in the U.S. instead of abroad will have positive effects because employment and investment are occurring here. That, in turn, will increase small businesses opportunities.

There is reportedly at least \$1.5 trillion "trapped" or "locked-in" off shore because repatriating those funds will trigger a large tax whereas keeping those funds invested abroad will not. It is time to bring these funds home.

There are three ways to eliminate this "lock-in" effect while retaining the income tax. One approach is to move to a territorial system where foreign source income is not subject to U.S. tax. There would presumably, therefore, be a zero percent tax on repatriated income. This approach has received a great deal of attention lately and is discussed below. A second approach, tried in 2004, is to apply a substantially lower tax rate on repatriations made during a specified window of time. A significant disadvantage of this approach is that it is a temporary solution.<sup>11</sup> A third approach is to eliminate the deferral allowed by the law relating to Controlled Foreign Corporations (CFCs) and in general tax income earned by U.S. businesses currently.<sup>12</sup> Any of these approaches would eliminate the lock-in effect and increase repatriations. It is possible that the latter approach may harm U.S. businesses in other ways. For example, it is thought that U.S. owned subsidiaries are disproportionately likely to buy from the U.S. By

<sup>10</sup> Financial intermediation will direct this capital far beyond just banks.

<sup>11</sup> A permanently reduced rate on repatriations would reduce the lock-in effect to the extent the rate was reduced but would not accelerate the tax revenue gain as much as a short-term reduction to the extent firms believed the change was permanent.

<sup>12</sup> Subchapter N, Part III, Subpart F of the Internal Revenue Code. In principle, the Passive Foreign Investment Company rules would need amended as well. These are much less important than the CFC rules.

making U.S. owned foreign manufacturing subsidiaries less attractive, it may be that U.S. exports are harmed. This third approach would also (at least in the short run) raise taxes on multinational business.

An entirely different means of solving the problem is to move to a destination principle consumption tax such as the FairTax. Under the FairTax, repatriation of foreign source income would not be a taxable event. Neither foreign source nor U.S. source income would be taxed. Instead, domestic consumption would be taxed.

#### **Proposals to Move to a Territorial Tax System**

A number of advocates have advocated that the U.S. move from its current world-wide taxing system to a territorial system income tax system. The Joint Committee on Taxation has estimated that with the appropriate rules regarding intangibles, such a move could actually increase tax revenues. It is remarkable that imposing a zero tax on foreign source income could raise tax revenue. It is also a reminder of how broken the current system is.

A territorial **income tax** system will put tremendous, probably fatal, pressure on the section 482 inter-company pricing rules. Pushing those rules hard is one of the central reasons that the current tax system raises so little revenue from taxing the overseas operations of U.S. multinationals. There is a small industry of lawyers, accountants and economists devoted to helping large corporations defend aggressive intercompany pricing. Those rules will only be pushed that much harder if the U.S. adopts a territorial income tax system. Since there is no single “correct” transfer price, there will be a huge incentive to manipulate intercompany prices to transfer income outside of the U.S. if the tax rate on U.S. source income is 35 percent and the tax rate on foreign source income is zero.

U.S. parents will tend to sell domestic goods cheaply to their foreign subsidiaries so their foreign subsidiaries will show the profits.<sup>13</sup> U.S. corporations will tend to transfer ownership of their intellectual property<sup>14</sup> (a form of intangible property) to their foreign subsidiaries so the income from licensing that IP will be “foreign source.” Of course, if the Treasury gets too aggressive in policing such transfers, the multinationals will simply start conducting the research overseas or purchasing it from trusted foreign strategic partners subject to appropriate licensing and disclosure agreements. This would be economically counterproductive. Thus, a lot of U.S. source income will end up be scored as foreign source income not subject to tax.

As supporters of the FairTax, the NSBA has no problem with eliminating the corporate income tax. We do not believe, however, that the right way to go about that is to make the corporate income tax largely optional for multinationals while corporations operating solely in the U.S. must pay significant corporate income taxes.

It is true that the current U.S. tax system makes headquartering a company in the U.S. unattractive compared to most developed countries. Most developed countries have some form

<sup>13</sup> Since, contrary to popular belief, profits are a small percentage of gross revenues, it does not take much of a change in the price to shift all or most of the profits.

<sup>14</sup> Including patents, trademarks, copyrights and, to a lesser extent, unpatented trade secrets.

of territorial tax system. Thus, a company headquartered there can take advantage of tax rates lower than those in the home country. A U.S. company cannot since the U.S. world-wide system taxes companies on their income throughout the world, allowing a foreign tax credit for foreign taxes paid.<sup>15</sup> For example, taxes are the primary reason that when Mercedes merged with Chrysler, the parent was in Germany not in the U.S. It is in the interest of small businesses and workers to have large corporations headquartered in the U.S. due to business and employment they generate.

There is among many analysts a concern, not entirely unfounded, that a territorial income tax system will provide an incentive for U.S. firms to locate their manufacturing operations in low tax foreign jurisdictions rather than the U.S. The counter argument is that if U.S. owned firms do not do so, then European and Asian firms will and, once again, U.S. firms are rendered less competitive by the current tax system.

There is a solution to these problems. Do not move to a territorial **income tax** system. Instead, move to a territorial **consumption tax** system. In a consumption tax, like the FairTax, intercompany pricing is irrelevant to the tax result and there is no tax incentive to place manufacturing operations abroad. This is because such a tax does not tax production anywhere. Both U.S. and foreign operations of U.S. firms would be free of tax. Headquartering a company in the U.S. would make perfect tax sense. Goods consumed in the U.S. would be taxed, whether they were made here or abroad and goods shipped abroad would not be subject to any tax. Therefore, the tax bias against U.S. producers would be eliminated.

### Consumption Taxes

Most real world consumption taxes in the world today are sales taxes or credit invoice method value added taxes (aka goods and services taxes). They are border adjusted either because exports are excluded from the tax base and imports are subject to tax upon entry (a VAT) or because of their nature (a retail sales tax). They are territorial. No tax is imposed on foreign operations, income or consumption. They are neutral toward savings (all savings is effectively accord Roth IRA tax treatment due to the nature of the tax) and investment (all investment is either expensed (VAT) or not subject to tax (national sales tax)).<sup>16</sup>

### The FairTax

Obviously there are a lot of ways to improve the tax system. To be better than the current system doesn't take a lot. But NSBA regards the FairTax as the best fundamental tax reform proposal. In an international context, it would have a dramatic positive impact on the competitiveness of U.S. businesses. A summary of why:

<sup>15</sup> Subject, in general, to a limit equal the U.S. tax rate times foreign source income. In reality, the foreign tax credit system is much more complex because of the separate baskets that income is separated into.

<sup>16</sup> The FairTax and the Schaefer-Tauzin national retail sales tax excluded all business to business transactions from to prevent cascading. Unfortunately, U.S. state sales taxes collect a substantial portion of their revenue from taxing business inputs.

1. It would be simple and dramatically reduce compliance costs that place U.S. firms at a substantial disadvantage.
2. For the first time, the tax system would impose the same tax burden on foreign produced goods and U.S. produced goods and eliminate the current origin principle system that places U.S. based firms at such a large disadvantage. This is because the FairTax is a destination principle tax (i.e. it is, in effect, border adjusted).
3. It would be neutral toward savings and investment and reduce the user cost of capital substantially. The capital stock would therefore grow. Productivity and innovation would increase.
4. Entrepreneurial risk-taking and innovation would increase because more investment capital would be available and the tax on capital gains would be zero.
5. The U.S. would attract capital from throughout the planet. Investment in the U.S. whether by Americans or foreigners would not be taxed. The U.S. would, in effect, become the largest tax haven in the world. The "giant sucking sound" you would hear, to paraphrase Ross Perot's memorable metaphor, would be the U.S. attracting capital from throughout the world. Having adequate capital is important for all businesses but particularly important for small and start-up businesses.
6. The FairTax has much lower marginal tax rates than the current tax system and has virtually the lowest possible marginal tax rate consistent with a neutral tax treatment of savings and investment.<sup>17</sup>

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<sup>17</sup> The only reason it does not have the lowest possible rate theoretically possible is the rebate that prevents the poor from paying any federal income or payroll tax and reduces middle class effective tax rates substantially.

AppendixThe Equivalence of Consumption Tax Bases (Domestic Analysis)

C = Consumption

O = Output

I = Investment

W = Wages

Y = Income

S = Savings

Retail Sales Tax

Sales Tax Base = C (goods &amp; services)

Business Transfer Tax (Subtraction Method Valued Added Tax)BTT Tax Base = Output less Investment =  $O - I = C$ Flat Tax (bifurcated Subtraction Method Valued Added Tax)

[Hall-Rabushka-Army-Forbes type flat tax]

Business Tax BaseBusiness Flat Tax Base = Output less Investment less wages =  $O - I - W = C - W$ Individual Tax Base

Individual Flat Tax Base = wages = W

Overall Tax Base

Flat Tax Base = Output less Investment less wages plus wages

 $O - I - W + W = O - I = C$ Expenditure Tax or Consumed Income Tax or Inflow-outflow Tax or Cash Flow TaxExpenditure Tax Base = Income less savings =  $Y - S = C$ 

Note: For an expenditure tax to properly measure consumption debt incurred must be included in the taxable base and debt principal payments must be deductible.

All of the above assumes away international transactions. Or, stated differently they fail to distinguish between consumption ( $C_\alpha$ ) of U.S. produced goods **consumed** anywhere in the world and consumption ( $C_\beta$ ) in the U.S. of goods **produced** anywhere in the world. The category into which each proposed system falls is shown below.

Taxation of consumption ( $C_\alpha$ ) of U.S. produced goods consumed anywhere in the world<sup>18</sup>

1. Flat Tax<sup>19</sup>
2. X Tax<sup>20</sup>
3. Consumed Income, Expenditure, Cash Flow or Inflow-Outflow Tax<sup>21</sup>

Taxation of consumption ( $C_\beta$ ) in the U.S. of goods produced anywhere in the world<sup>22</sup>

1. Retail Sales Tax
2. Value Added Tax or Goods and Services Tax (Credit-Invoice Method)
3. Business Transfer Tax (Subtraction Method VAT)

It is the contention of NSBA that the difference between destination and origin principle tax systems matters a great deal and that the taxation of U.S. consumed goods produced anywhere in the world is much better for American businesses and the American people than the taxation of U.S. produced goods consumed anywhere in the world. Border adjusted tax systems that treat U.S. produced goods and foreign produced goods alike are superior.

Given the large merchandise trade deficit that the U.S. is running and has run for many years, the tax base  $C_\beta$  (the taxation of consumption in the U.S. of goods produced anywhere in the world) will be substantially larger than the tax base  $C_\alpha$  (the taxation of consumption of U.S. produced goods anywhere in the world). Thus, the  $C_\beta$  systems (border adjusted systems) will be able to have a lower marginal tax rate while raising the same revenue.

<sup>18</sup> These are origin principle consumption taxes.

<sup>19</sup> It is unclear whether it is WTO legal, but the President's Advisory Panel on Federal Tax Reform (report issued November 2005) proposed a flat tax that was border adjusted. In principle, such a proposal should be WTO legal since a flat tax is a VAT. But it looks a great deal like an income tax and most of its supporters do not understand that it is a special type of VAT rather than an income tax. So it is not clear whether the WTO would regard it as a direct or indirect tax.

<sup>20</sup> The X Tax is a proposal by David Bradford that would apply graduated tax rates to the Hall-Rabushka flat tax base. In other words, it is a graduated rate bifurcated subtraction method value added tax.

<sup>21</sup> It is virtually impossible to make these tax systems destination principle taxes.

<sup>22</sup> These are destination principle consumption taxes.

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**STATEMENT FOR THE RECORD**

**OF**

**ERIC F. SMITH  
VICE PRESIDENT & HEAD OF GOVERNMENT AFFAIRS  
OVERSEAS SHIPHOLDING GROUP, INC.**

**FOR THE HEARING ON**

**“TAX REFORM OPTIONS: INTERNATIONAL ISSUES”**

**BEFORE**

**THE U.S. SENATE  
COMMITTEE ON FINANCE**

**SEPTEMBER 8, 2011**

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Chairman Baucus, Ranking Member Hatch, and members of the Senate Finance Committee, thank you for the opportunity to submit this statement for the record on behalf of the Overseas Shipping Group, Inc. (“OSG”). We applaud the Committee for its work on the critical issue of tax reform.

The international tax system is an important aspect of tax reform. Our statement focuses on S. 626, the “American Shipping Reinvestment Act of 2011” (“ASRA”), which implicates international tax issues. S. 626 addresses the unintended consequences of a 1970s tax provision that effectively requires U.S. shipping companies to maintain investments in qualified foreign shipping assets from revenue earned between 1975 and 1986. The bill would address this issue, providing U.S. shipping companies an opportunity to reinvest that stranded capital in the domestic shipping industry. We applaud the leadership of Senators Cantwell, Vitter, Carper, Cochran, Inouye, Landrieu, and Murray in introducing S. 626. Companion legislation, H.R. 1031, has been introduced in the House. We strongly urge enactment of this important bipartisan legislation, which would provide for an immediate investment in our nation’s maritime industry and stimulate U.S. economic activity and job growth during this fragile time in the country’s economic recovery.

#### **THE U.S. MARITIME INDUSTRY**

The U.S. maritime industry plays a crucial role in the U.S. economy, serving as the backbone of modern transportation and making possible the transport of raw materials, petroleum products, affordable food, and manufactured goods. The maritime industry is an important contributor to the U.S. economy, sustaining thousands of American jobs in the shipbuilding, seagoing, and related trades. A recent PricewaterhouseCoopers analysis estimated that, in 2009, U.S. flag ships that carry goods between U.S. ports – which must be U.S.-owned, built, and crewed – accounted for approximately 74,000 jobs in the U.S. economy, resulting in \$36.4 billion in U.S. economic output and \$6.5 billion in U.S. labor compensation. Another approximately 426,000 jobs arose from indirect and induced effects, accounting for \$35.5 billion in U.S. economic output and \$22.6 billion in U.S. labor compensation.

The U.S. maritime industry is also an essential component of our national security. The U.S. flag fleet supports a shipbuilding defense industrial base and pool of qualified seafarers and shipping assets needed for military sealift in times of war or national emergency. For example, U.S. flag commercial vessels and their American crews transported the majority of cargoes – more than 25 million measurement tons – in support of Operations Enduring Freedom and Iraqi Freedom during the period of 2002-2008.

Additionally, American-owned companies’ international ships are part of what is called the Effective U.S. Controlled Fleet (“EUSC fleet”), or the fleet of merchant vessels, registered in certain foreign nations, that are available for requisition, use, or charter by the U.S. government in the event of war or national emergency. However, a 2002 study commissioned by the Department of Defense (“DOD”) and performed by professors at the Massachusetts Institute of Technology found that the EUSC fleet dropped by 38 percent in terms of numbers of ships and nearly 55 percent in terms of deadweight tonnage between 1986 and 2000.

This finding is reflective of the decline in American-owned international shipping. American-owned shipping companies used to be a major transportation sector on the world's oceans. However, progress has been made in recent years to address international tax inequities affecting the shipping industry and to help rebuild the U.S.-flag shipping industry. Through the enactment of a tonnage tax regime and restoration of deferral in 2004, significant progress has been made, but more needs to be done.

#### **THE OVERSEAS SHIPHOLDING GROUP, INC.**

OSG is a market leader in global energy transportation services. OSG owns and operates an International Flag and U.S. flag fleet of 117 vessels made up of 111 operating vessels and six under construction aggregating 12.1 million deadweight tons. The fleet transports crude oil, petroleum products and gas in the U.S. and throughout the world.

Founded in 1948, OSG has been successful through multiple shipping cycles. This success is the result of OSG's vision, breadth and experience, emphasis on quality and the safety of the environment, the size and diversity of its fleet, and the skills and commitment of its professional staff and crews.

OSG is based in New York and has offices in Athens, Houston, London, Manila, Montreal, Newark, Newcastle, Singapore and Tampa. It has 3,500 employees, of which 3,050 are seafarers.

#### **THE AMERICAN SHIPPING REINVESTMENT ACT**

ASRA addresses the unintended consequence of an antiquated tax provision enacted in 1975. Under the 1970s tax provision, U.S. shipping companies must maintain investments in qualified foreign shipping assets made between 1975 and 1986.

More specifically, between 1975 and 1986, "foreign base company shipping income" was included as a category of subpart F income. Under this provision, subpart F income generally did not include foreign base company shipping income to the extent it was reinvested during the taxable year in certain qualified shipping investments. If, however, in a subsequent year a net decrease in qualified shipping investments occurred, the amount of previously excluded subpart F income equal to such decrease was treated as subpart F income. In other words, any net decrease in these investments resulted in an immediate tax penalty.

Although the deferral for shipping income provision was completely repealed in 1986, the pre-1987 net investment in qualified shipping assets under section 955 of the tax code was retained. As a result, decreases in investments in qualified shipping operations from pre-1987 level continue to trigger subpart F income. These rules apply even after section 415 of the American Jobs Creation Act of 2004 ("2004 Jobs Act") repealed the subpart F rules applicable to foreign base company shipping income.

This quirk in the tax law has created a perverse system that distorts the investment decisions and increases the transaction costs of U.S. companies, particularly with respect to structuring a financing strategy or deciding whether to acquire or divest qualified shipping assets.

For example, because of the method for calculating amounts invested in qualified shipping assets, a company's investment may decrease due to the depreciation of its assets, rather than due to any affirmative action that it takes to withdraw from shipping. In such circumstances, a company may be forced to invest its resources in a way that is not economically optimal in order to avoid triggering subpart F income, regardless of market conditions or business need. Additionally, Subpart F inclusion may be triggered if a company issues debt to invest in non-shipping operations, thereby deterring a company from financing the expansion and diversification of their enterprises. At end, even though these companies have a strong desire to reinvest their foreign earnings in the U.S. and inject money into the economy, they are effectively unable to do so. Instead, the practical consequence is that these earnings are permanently invested abroad.

The bipartisan ASRA legislation would repeal the outdated 1970s tax provision. Additionally, ASRA would provide U.S. shipping companies with a one-time opportunity to receive foreign source earnings at a reduced tax rate. This is appropriate because such companies generally could not previously avail themselves to a 2004 provision to encourage investment of foreign earnings in the U.S.

ASRA also contains a strong jobs provision. In order to preserve the tax benefits provided under ASRA, companies must maintain their current employment levels. If they fail to do so, they will be subject to a significant tax penalty. Specifically, there would be a \$25,000 additional income inclusion for each employee by which the taxpayer's average employment during the two-year period from and including the calendar month of the first shipping income repatriation is less than the average employment during the two-year period prior to that same month of first repatriation.

#### **ASRA'S IMPACT: INVESTMENT, ECONOMIC ACTIVITY, JOBS, AND SECURITY**

As Congress considers legislation to address unemployment and stimulate the American economy, it should consider the merits of ASRA. Enacting ASRA would allow, and incentivize, these companies to bring funds that are currently invested abroad home and reinvest them in the U.S. shipping industry. ASRA would spur job growth in the U.S. by creating a broad and diverse range of well-paying employment opportunities for American workers, both in the short- and long-term. As a result, ASRA is broadly supported by American maritime labor, U.S. shipyards, and U.S. shipping companies.

Enactment of ASRA would stimulate investment in the U.S. shipping industry, leading to the creation of well-paying jobs as construction and repair activity in U.S. shipyards increased. The magnitude of the stimulative economic effect of building ships in the U.S. is significant - a 2002 study performed for the Shipbuilders Council of America found that 3.7 jobs were created elsewhere in the economy for every direct shipyard job. Moreover, as a result of tax provisions in the 2004 Jobs Act, OSG commissioned the construction of 10 new tankers at a U.S. shipyard, the largest commercial shipbuilding project in a U.S. shipyard since World War II. A study performed on this project found that the new shipbuilding activity for these 10 tankers would increase average annual employment in the region where the shipyard was located by 1,217 jobs and nationally by 2,902 jobs during the period of construction. OSG later increased its

commitment with orders for 2 additional tankers and 2 additional tank barge vessels, resulting in even more employment growth and economic activity.

Once in operation, these ships will generate American employment throughout the life of the vessel, which is estimated to be at least 25 years. Ships operating in the domestic Jones Act trades must be manned by Americans, built in a U.S. shipyard, and owned by U.S.-citizen companies. As such, by encouraging American companies to expand their Jones Act operations, ASRA would create and sustain thousands of jobs for Americans during the operating life of the new vessels. These include well-paying jobs in the seagoing and shore side trades, as well as in the shipyards that will maintain the vessels during their economic life. In fact, it is estimated that the 10 new tankers constructed because of the 2004 Jobs Act will increase average annual shore side and seagoing employment directly related to the vessel's operations by 1,313 and increase average labor compensation by \$1.2 billion over the period of 2007 to 2020.

Investment in the U.S. shipping industry would have an economic "multiplier" effect, spurring job growth in affiliated businesses. In addition to the direct employment effect of ship construction and operations, studies indicate that investment in the U.S. shipping industry would have the indirect effect of increasing demand placed on suppliers through the supply chain and the induced effect of additional spending on goods and services resulting from increased Household incomes.

Additionally, ASRA would enhance U.S. national security interests by supporting shipyards that are vital to our defense industrial base by developing new U.S.-flag tanker capacity to transport our nation's energy products, and by providing the DOD with critical assets – manpower and ships – necessary to help sustain military sealift.

#### **CONCLUSION**

OSG greatly appreciates the opportunity to submit this statement. As Congress considers international tax issues, ASRA presents an opening to create thousands of American seagoing and shore side jobs and stimulate critical investments into American shipping companies that help sustain our economic and national security. We are happy to be a resource to Congress and the Committee and we look forward to our continued work together on these issues.

**WORKING GROUP ON INTANGIBLES**

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**STATEMENT OF THE WORKING GROUP ON INTANGIBLES**  
**ON**  
***INCOME FROM INTANGIBLE PROPERTY THAT IS ESSENTIAL TO THE ACTIVITIES OF A GLOBAL***  
***U.S. BUSINESS***  
**SUBMITTED FOR THE RECORD OF THE HEARING**  
**ON**  
**"TAX REFORM OPTIONS: INTERNATIONAL ISSUES"**  
**BEFORE**  
**THE U.S. SENATE COMMITTEE ON FINANCE**  
**ON**  
**SEPTEMBER 8, 2011**

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**Introduction**

The Working Group on Intangibles (the "Intangibles Working Group") welcomes the opportunity to provide comments for the record of the September 8, 2011 Committee on Finance ("Committee") hearing to examine international issues presented by various tax reform options. The Intangibles Working Group is composed of U.S.-based worldwide companies representing a cross-section of industries, including medical device manufacturers, food product companies, consumer nondurable goods companies, pharmaceutical companies, software companies, and information technology companies.

Although the make-up of the Intangibles Working Group is diverse, the member companies generally share several major characteristics – they spend billions of dollars annually on research and development ("R&D") in the United States, and they deploy cutting edge technologies that are integral to products sold to consumers around the globe. In almost every case, they derive foreign-related income from patents, trademarks, or other intellectual property that has substantial value independent of underlying goods or services ("intangibles"). Moreover, members of the Intangibles Working Group compete throughout the world with foreign-headquartered companies that have limited exposure to the U.S. tax regime and may also benefit from special rules in other countries. Thus, the U.S. tax treatment of foreign source intangibles income is of critical importance to companies in the Intangibles Working Group.

The current U.S. tax rules relating to R&D and the use of intangibles, combined with the U.S. deferral rules, contribute to the creation of high-paying U.S. jobs that result from our

companies' successful worldwide operations. Thus, legislative proposals negatively affecting the taxation of intangibles income could have a dramatic impact on both the number and location of R&D jobs currently in the United States as well as the ability of our companies to compete effectively in the global marketplace. Moreover, in view of the question raised at the hearing by Senator Enzi about whether the United States would be well served by implementing a patent or innovation box regime, we would like to share our preliminary views regarding the implications of four regimes that were designed to provide more competitive rules for intangibles income, namely those in Belgium, Netherlands, Luxembourg, and (most recently) the United Kingdom ("UK"). The treatment of intangibles under these European regimes – all of which have come into effect or been developed in or after 2007 – may provide useful "benchmarks" for U.S. policy makers who seek to reform the U.S. international corporate tax regime in a manner that is consistent with international norms. To summarize our findings, the European countries we surveyed –

- (1) Provide robust incentives to conduct R&D within their borders; and
- (2) Provide a "carrot" of incentives to retain ownership and exploitation of intangibles in their countries, rather than utilizing a "stick" in the form of punitive taxes to address concerns about the "mobility" of intangibles income.

### Discussion

Members of the Intangibles Working Group employ intangibles in *routine* ways as an integral part of their business activities, including manufacturing, R&D, distribution, and the provision of services. The Intangibles Working Group was originally formed in response to revenue-raising proposals to increase the tax burden on certain income from intangibles.<sup>1</sup> Part I of this statement explains why such proposals would threaten U.S. competitiveness and innovation. Consistent with the Committee's current focus on laying the groundwork for the consideration of comprehensive tax reform, part II of this statement sets forth a conceptual basis for "design elements" that should be a part of any tax reform plan (territorial or otherwise), if the goal is to encourage companies to locate high-value jobs and activity associated with the development, manufacture, and exploitation of intangibles in the United States.

#### **I. Concerns Presented by Proposals to Increase the US Tax Burden on Income from Intangibles**

Under the general U.S. rule of "deferral," the active foreign earnings of a U.S.-owned controlled foreign corporation ("CFC") are subject to tax on a current basis only under the laws of the foreign jurisdictions in which the CFC conducts business, with the United States deferring income taxation on such foreign earnings until those earnings are repatriated to the United States. Deferral helps protect the international competitiveness of U.S. companies by providing tax

<sup>1</sup>President Obama's FY2011 and FY2012 budgets include novel proposals to end deferral for income from intangibles under circumstances that have yet to be fully defined. As described, the current proposal would impose immediate U.S. tax on the "excess intangible income" from "transactions connected with or benefitting from" intangibles that a "U.S. person transfers...from the United States to a related CFC...if the income is subject to a low foreign effective tax rate." Very generally, "excess" income" would be defined as the excess of gross income from transactions over costs (excluding interest and taxes) plus a percentage mark-up. See General Explanation of the Administration's FY2012 Revenue Proposals, Department of the Treasury (February 2011) 43-44.

results that, on a current basis, are closer to those achieved under the territorial tax systems employed by most major trading partners of the United States, although on a permanent basis the U.S. rules continue to be significantly more burdensome than these systems of our trading partners. The anti-deferral rules of Subpart F, however, can apply to trigger a current U.S. tax as the result of transactions involving related CFCs. In this regard, proposals such as that in President Obama's FY2012 budget would extend the anti-deferral rules of Subpart F to certain royalty payments made by a CFC to a related CFC, even where the royalties are generated by an active business.

It is important to note that the current law "transfer pricing" rules require the payment of adequate compensation for any grant of a right to use intangibles. Very generally, under the "arm's-length" principle that has been in use for over 75 years in the United States, the adequacy of the compensation paid to a related corporation is determined by reference to comparable transactions among *unrelated* parties. The transfer pricing rules were not invented by multinational corporations to minimize their tax liability; rather, these guidelines reflect a consensus among the U.S. government and its major trading partners about the need to properly divide income among transaction participants located in multiple jurisdictions. Indeed, the arm's-length standard is the subject of a worldwide body of law, evidenced by copious and longstanding IRS regulations, U.S. court cases, bilateral tax treaties, and OECD guidelines. Proposals of the type described above effectively abandon the "arm's length" transfer-pricing principle by subjecting income that is properly assigned to another jurisdiction under that standard to immediate U.S. tax. This expansion of the Subpart F rules – and corresponding curtailment of deferral – would be a dramatic departure from international norms, to the detriment of the competitiveness of U.S.-based worldwide companies. Enactment, of an incremental tax in cases in which intangibles transferred at arm's-length are ultimately successful – under the President's proposal – with no correlative adjustment where such intangibles are not successful, would create a clear incentive for U.S. companies to move the development of intangibles to jurisdictions that provide equitable treatment.

## **II. Components of Tax Reform to Provide More Competitive Rules for Intangibles Income**

Based on our comparative survey of the selected European regimes, we have developed a general framework for examining tax incentives and tax penalties designed to reward technical innovation, retain or create high-value jobs, and enhance the competitiveness of U.S. companies. Of course, a particular country's treatment of intangibles income should be evaluated in the context of other features of the underlying corporate tax system (such as the maximum statutory tax rate and the existence of a dividend exemption system for foreign earnings) or applicable treaties (*e.g.*, because the countries we surveyed are members of the European Union, they were limited in their ability to link incentives to in-country jobs; this would likely not be the case in the United States). Nevertheless, it is possible to discern broad similarities among the four countries that could be used to inform the legislative process in the United States.

- The Prevalence of R&D Incentives. As noted above, in addition to a special regime for intangibles income, all four countries provide a variety of R&D incentives such as credits or exemptions to wage withholding for research activity. For example

Belgium provides an investment deduction or R&D credit, as well as wage withholding tax exemptions for researchers. In contrast, the temporary nature of the U.S. R&D tax credit detracts from its effectiveness due to the resulting lack of predictability. *To remain competitive internationally, the Intangibles Working Group supports an attractive and permanent R&D credit in the United States.*

- Use of Tax Regimes to Help Companies Compete Globally. Precisely because of concerns about the mobility of intangibles, the selected countries embraced incentives designed to encourage their companies to exploit intangibles in the home country. *A preferential regime for intangibles income would move the United States in a similar direction of encouraging companies to retain ownership of intangibles in the United States.*
- No “Claw Back” of the Tax Benefits of the Preferential Regime. None of the four countries have adopted or proposes to adopt overly broad anti-abuse rules that would have the effect of negating the promised benefits. As one example, the UK government considered expanding its CFC regime to tax intangibles income currently in the case of “excessive profits,”<sup>2</sup> similar to President Obama’s FY2012 budget proposals to end deferral for “excess intangible income.” We are informed, however, that the March 23, 2011 UK Budget Update reflects a reconsideration of this approach, consistent with the statement that the “aim is to make the CFC regime more competitive while providing adequate protection of the UK corporation tax base. The new regime will... operate in a targeted and more territorial way by bringing within a CFC charge *only* the proportion of overseas profits that have been artificially diverted from the UK” (emphasis added).<sup>3</sup> *Because the current treatment of intangibles is part and parcel of the deferral rules that have helped U.S. global corporations to remain competitive and preserve high-paying U.S. jobs, an “excess returns” proposal (in present law or a territorial-type system) would have the sort of anti-competitive effect that the UK has sought to avoid.*

Members of the Intangibles Working Group have granted rights in or to intangibles to their related foreign subsidiaries in order to function in global markets and compete against foreign-based multinational corporations. Rights to use intangibles are not granted casually, and the granting of such rights is usually required to facilitate multi-source manufacturing, and to obtain protection under trademark, patent, or other applicable law, quite apart from tax considerations. Furthermore, such grants or transfers must be done in compliance with all applicable laws and regulations, not just U.S. transfer pricing rules. In the case of a global business, rights to intangibles must be granted across the worldwide affiliated group of corporations – with arm’s length compensation provided for the functions performed, risks borne, and investments made by each such corporation. As Mr. Scott Naatjes (Vice President and General Tax Counsel of

<sup>2</sup> *Corporate Tax Reform: delivering a more competitive system*, page 26, 29 November 2010 ([http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_part2a\\_cfc\\_reform.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_part2a_cfc_reform.pdf); accessed 20 May 2011)

<sup>3</sup> *Overview of Tax Legislation and Rate*, page 22, 23 March 2011 (<http://www.hmrc.gov.uk/budget2011/overview.htm>; accessed 20 May 2011).

Cargill, Incorporated) testified at the September 8 hearing, transfer pricing rules based on the arm's length standard tend to follow where the economics lie. These business realities must be given consideration in applying the framework outlined above.

#### **Conclusions**

It is vitally important that policy makers seriously consider reforming the U.S. international corporate tax regime in a manner that is consistent with international norms, including the treatment of intangibles income. The transfer and collaborative use of intellectual property are necessary components of modern business practices. These transfers relate both to U.S. developed intellectual property used by foreign affiliates as well as foreign developed intellectual property used by U.S. affiliates. The Intangibles Working Group looks forward to assisting members of the Committee and their staffs to gain a more detailed understanding of the business practices that are necessary for our companies to compete globally, and the tax consequences of these practices. We are hopeful that the Committee will continue its thorough examination of much needed comprehensive reform of the U.S. international tax regime, rather than the development of piecemeal proposals that would produce unintended negative results for U.S. companies, U.S.-based R&D jobs, and ultimately U.S. competitiveness.

