

Directions for International Tax Reform

*Stephen E. Shay**

*Testimony before the U.S. Senate Committee on Finance
Hearing on International Tax Reform*

October 3, 2017.

Good morning Chairman Hatch, Ranking Member Wyden, and Members of the Committee. My name is Stephen Shay. Thank you for the opportunity to testify before you today on international tax reform. It is a pleasure and honor to be with the Committee once again. By way of background, I am a Senior Lecturer on Law at Harvard Law School. I have served twice in the Treasury Department, the first time in the Reagan Administration¹ and the second time as Deputy Assistant Secretary for International Tax Affairs in the first term of the Obama Administration, and practiced international tax law for over two decades as a partner at Ropes & Gray LLP in Boston.

My topic today is international tax reform. I set out what I believe should be the objectives for tax reform and their implications for international tax reform in the next section. I next provide data on tax burdens on U.S. multinational corporations (MNCs) and their foreign subsidiaries. Based on conclusions I draw from this data and my decades of experience in international taxation, I set out my recommendations for the direction that the Committee should take to reform U.S. international tax rules. Although I do not favor a territorial system, I offer suggestions on how to improve this approach, if that path is chosen.

Executive Summary

Objectives for Tax Reform

Tax reform should maintain or enhance our tax system's current level of progressivity in distributing tax burdens and benefits. The most significant social welfare fact today is that the income of middle and lower income workers has stagnated in recent decades and a disproportionate share of income growth has accrued to those with highest incomes—the top 1%. While we have recovered from the recession and middle and lower income workers have made some gains, the disparity between high-income and middle- and lower-income has grown substantially and income

* Senior Lecturer on Law, Harvard Law School. I thank Megan McCafferty for assistance with editing and visual aids and Lisa Brem, Kim Clausing, Cliff Fleming and Steven Rosenthal for comments on earlier drafts. The views expressed in this testimony are my own, are in my personal capacity and do not reflect those of any organization for which I render paid or pro bono services nor any client. I disclose certain activities not directly connected with my position at Harvard Law School at <http://hls.harvard.edu/faculty/directory/10794/Shay/>.

¹ I participated as Treasury Deputy International Tax Counsel and then as International Tax Counsel in each step of the process leading to the Tax Reform Act of 1986, starting with the initial 1984 Treasury international proposals that became President Reagan's proposals in 1985, to House passage of the bill in 1985 and Senate passage in 1986, through conference committee to final legislation in November, 1986. I resigned from the Treasury in 1987 after publication of an initial round of regulations interpreting international provisions of the Act.

mobility is more constrained than for prior generations.² The taxation of cross-border income of U.S. MNCs should be analyzed under the same fairness standards that apply to any other income.³ In particular, as I discuss later in this testimony, a reduced “holiday” tax rate on U.S. MNCs’ pre-effective date offshore earnings will overwhelmingly benefit high-income Americans (and foreigners) and is not justified on any policy ground.⁴ Its sole purpose is to provide a one-time source of revenue that disguises the future revenue loss from shifting to a weak territorial system.

Tax reform should be revenue neutral or increase net revenues. The central importance of our tax system to national competitiveness and growth is to fund public goods, such as education, basic research, infrastructure, healthcare and income security transfers, and national defense. These government services and capital expenditures support a high standard of living, income security, and physical security for all Americans. It is the job of the tax system to raise the necessary revenue to fund needed public expenditure and not add trillions to the national debt as proposed in the Senate Budget proposal and the GOP Tax Reform Plan.

Objectives for International Tax Reform

International tax reform should maintain or increase, not reduce, the aggregate tax on U.S. MNCs’ foreign income. There is no policy justification to advantage international business income of multinational corporations (MNCs) beyond allowing a credit for foreign income taxes. Moreover, evidence does not support claims that U.S. MNCs are overtaxed or are non-competitive as a consequence of U.S. tax rules. The U.S. Treasury Department found that the average tax paid by U.S. companies from 2007–2011 on their book earnings plus foreign dividends was 22%.⁵ The most recent publicly available Statistics of Income data for 2012 shows that foreign subsidiaries of U.S. MNCs in the aggregate paid an average foreign tax rate of 12%. Foreign income should be taxed currently or, if that is not politically feasible, under a per country minimum tax regime that is effective in discouraging tax avoidance through transfer pricing and related techniques that shift income to low tax countries and directly and indirectly erode the U.S. tax base.

International tax reform should assure that the tax rules for foreign multinational companies on U.S. business activity does not provide them an advantage in relation to U.S. companies. Tax reform should undertake a fundamental review of U.S. source taxation of cross-border activity

² Professor Lily Batchelder’s September 13, 2017 testimony before this Committee provides an excellent summary of the relevant data and references to literature. Lily L. Batchelder, Professor of Law, New York University, “Opportunities and Risks in Individual Tax Reform,” Testimony before the Senate Committee on Finance, Hearing on Individual Tax Reform (Sept. 13, 2017).

³ See J Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income, 5 Fla. Tax Rev. 299 (2001).

⁴ J Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, Getting From Here to There: The Transition Tax Issue, 154 Tax Notes 69 (2017).

⁵ U.S. Treasury, Office of Tax Analysis, Average Effective Federal Corporate Tax Rates, Table 1 (April 1, 2016).

having a U.S. destination including remote digital sales into the United States. In addition, tax reform should strengthen U.S. corporate residence and earnings stripping rules.

Taxation of international portfolio income should be fundamentally re-examined. Under current rules, there are U.S. tax advantages for portfolio investment by U.S. investors in foreign stock over domestic stock. Similarly, foreign pension funds that benefit principally foreign workers receive exemptions and reliefs from U.S. tax that are not reciprocated by foreign countries on U.S. pension funds benefitting U.S. workers. A fundamental tax reform effort should re-examine from scratch the U.S. rules for taxing cross-border portfolio income, however, the treatment of portfolio income is a subject for development on another occasion.

Background to Tax Reform

I draw on the testimony of Professor Lily Batchelder from last month's hearing for three background facts that are critical to sensible tax reform. First, real median after-tax and after-transfer income for a working-class household of three has only grown 3% from 1997 to 2015—even with the expansion of the earned income tax credit. Second, generational advantages and disadvantages are passed on more here than in peer countries, leading to less intergenerational mobility here. This is not the result of government regulation, but of a failure of government to foster genuinely equal opportunity and assure that we contribute to society according to our ability to pay. Third, we face a shortfall in revenues to pay for the services we demand. The CBO estimates of revenues and expenditures under current law project unprecedented levels of national debt as a share of GDP.

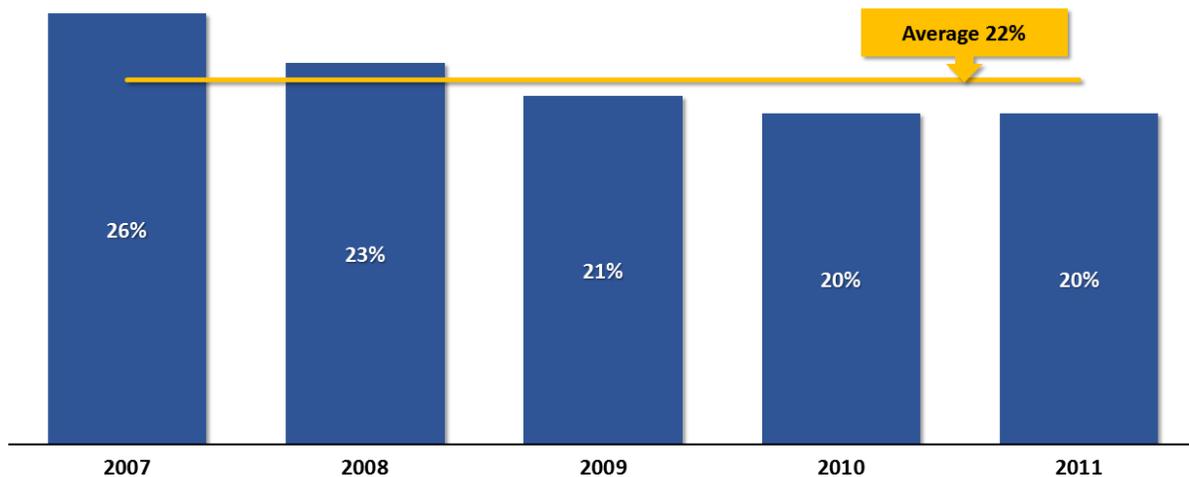
In the face of the pressing needs for public investment in human capital and infrastructure, and demographic trends that cannot be reversed, we will be forced to spend more in the future. It would be foolhardy to adopt a revenue-losing tax reform, particularly one that would benefit those with high incomes, in the unsupported hope, based on tooth fairy economics, that short-term growth will outweigh longer term effects on interest rates and inflation.⁶ When spending exceeds revenues, the debt issued to pay the difference simply represents future taxes. What is needed is to re-build the income tax base so that it can raise revenues necessary to fund expenditures while honoring ability to pay principles. If the income tax base proves over time to be unable to support U.S. needs, then it would be necessary to employ additional revenue instruments.

U.S. companies are not over-taxed, domestically or abroad. The U.S. Treasury estimated the average effective “actual” tax rate on U.S. companies, *excluding foreign subsidiaries*, for 2007 to 2011 to be 22%. The Treasury's measure of the average effective “actual” tax rate is corporate-

⁶ As Milton Friedman was said to explain, “Who do you suppose pays for the...difference? The tooth fairy? Hardly. You do.” Gene Epstein, “Tooth-Fairy Economics Triumphs in GOP Tax-Cut Plan,” *Barron's* (Sept. 25, 2017).

level tax actually remitted (after credits for foreign taxes paid on foreign income earned directly and credits for foreign taxes deemed paid on actual foreign dividends) as shown on tax filings divided by book or financial statement income (rather than taxable income). The average rate of tax is appropriate for measuring cash flows (used in valuations) and distributional burdens.⁷ It also is the most appropriate measure for evaluating whether to make a new direct investment in one country or another country—a discrete choice between two mutually exclusive locations.⁸

**Average Effective “Actual” Federal Corporate Tax Rate (ATR)
U.S. Corporations with Positive Income and > \$10M Assets –
By Year 2007-2011**



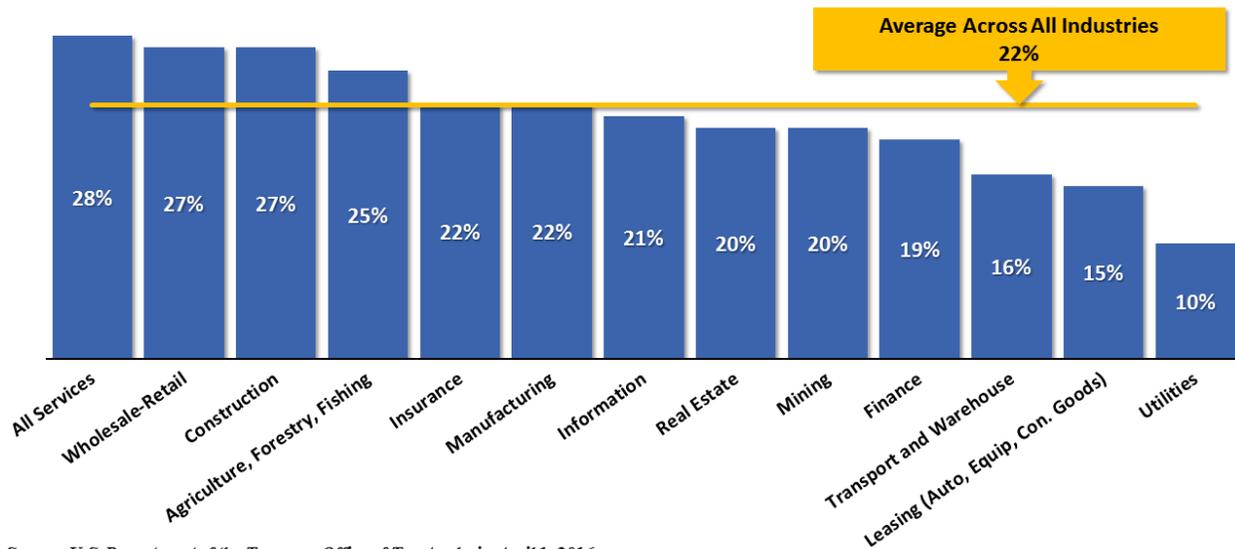
Source: U.S. Department of the Treasury, Office of Tax Analysis, April 1, 2016

When examined on an industry basis, the disparity in effective average actual taxation between different industries becomes clear with rates ranging from 28% for services to 10% for utilities.

⁷ U.S. Dept. of the Treasury, Office of Tax Analysis, “The Case for Responsible Business Tax Reform,” 21 (Jan. 2017) (hereinafter “Treasury, Responsible Business Tax Reform”); Don Fullerton, “Which Effective Tax Rate?” 37 National Tax J. 23, 30 (1984).

⁸ Michael P. Devereux and Rachel Griffith, “Evaluating Tax Policy for Location Decisions,” 10 Int’l Tax and Public Finance 107 (2003). The ATR measure may be contrasted with the effective marginal tax rate (EMTR), a metric used to make a decision whether to make a new investment or not by evaluating the impact of tax on the cost of capital. Treasury, Responsible Business Tax Reform, *supra* note *, at 5-7; Devereux and Griffith, at 107.

Average Effective “Actual” Federal Corporate Tax Rate (ATR) U.S. Corporations with Positive Income and > \$10M Assets – By Industry Average 2007-2011



Source: U.S. Department of the Treasury, Office of Tax Analysis, April 1, 2016

These differences justify reducing tax incentives that treat investments in separate sectors differently and insert the government unnecessarily into economic decision making.⁹ The ATR data, however, do not support a claim that U.S. companies are over-taxed.

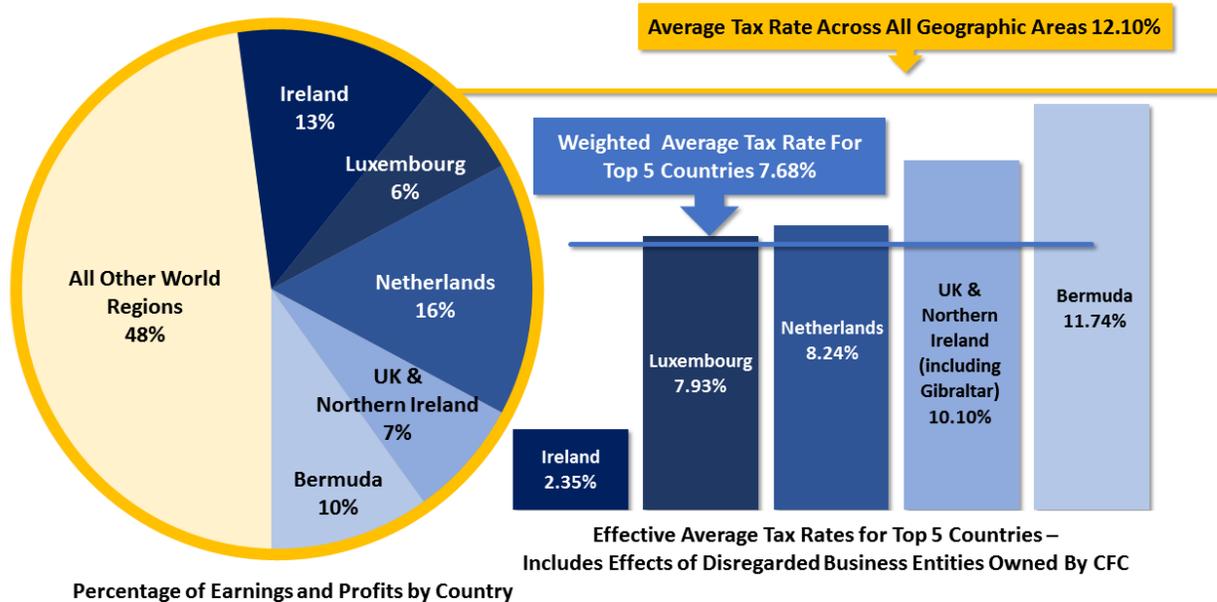
But what about foreign subsidiaries of U.S. companies? Are they unable to compete in the countries in which they operate? The preceding corporate average actual effective tax rates *do not* reflect the *even lower* average effective *foreign* tax rates that controlled foreign corporation (CFC) subsidiaries of U.S. MNCs pay on their foreign income. In 2012, the most recent year for which IRS CFC data is publicly available, 52% of all U.S. CFCs’ earnings and profits before tax was generated by companies in five tax haven or low-tax countries.¹⁰ Moreover, the ratio of these CFCs’ foreign taxes paid (as reflected on IRS tax filings) to earnings and profits before taxes (under U.S. tax principles) was 12.10% in 2012.¹¹

⁹ For differences in EMTRs by asset groupings and form of financing, see Treasury, Responsible Business Tax Reform, *supra* note 7, at 7

¹⁰ IRS, Statistics of Income Division, September 2015, U.S. Corporations and CFCs, Table 2 and author's calculations.

¹¹ IRS, Statistics of Income Division, September 2015, U.S. Corporations and CFCs, Table 2 and author's calculations.

2012 Earnings and Profits Before Tax of CFCs by Country – Country Shares



Source: IRS, Statistics of Income Division, September 2015, U.S. Corporations and CFCs, Table 2 and author's calculations

The CFC data undercut the claim that U.S. MNCs' foreign subsidiaries are over-taxed on their foreign income. The low effective tax rates on the earnings of foreign subsidiaries contradicts the claim that the subsidiaries cannot compete globally because of taxes.

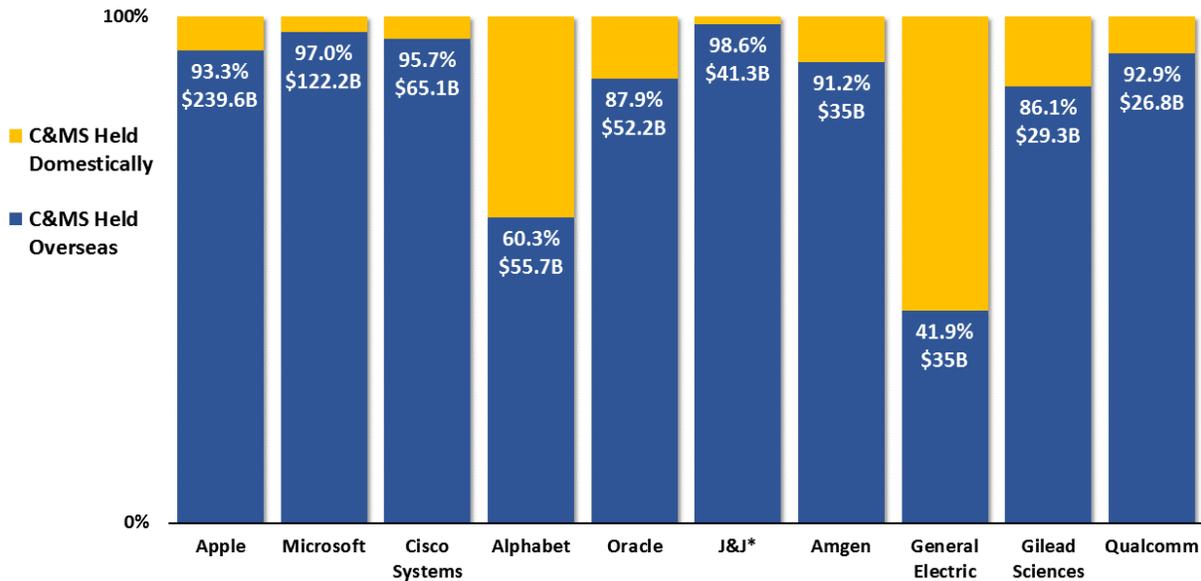
The very low average taxes paid on foreign subsidiary income are a major factor for retaining the low-taxed earnings to maximize after-tax profits reported on financial statements by relying on the claim to auditors that these amounts are "indefinitely reinvested" in investments that do not trigger deemed repatriation under U.S. tax rules.¹² This position is maintained even though large amounts (approximately 40%) of these retained earnings are held offshore in U.S. dollar cash or marketable securities.¹³ Bloomberg assembled these amounts for public companies with the 50 largest reported cash holdings.¹⁴ The amounts and ratios of offshore to total cash for the 10 companies with the highest cash holdings (totaling *US\$702 billion* for these companies alone) are shown in the next chart.

¹² See Letter from Tom Barthold to Kevin Brady and Richard Neal (Aug. 31, 2016) (estimating \$2.6 trillion in post-1986 not previously taxed CFC earnings for 2015). For a description of the relevant investment in U.S. property rules, see Stephen E. Shay, "The Truthiness of 'Lockout': A Review of What We Know," 146 Tax Notes 1393 (2015).

¹³ The Financial Times has run a series of articles examining the investment strategies employed with respect to these cash and securities holdings and implications for financial markets. See e.g., Eric Platt, "Corporate America's patchy disclosure on cash piles raises risks," Financial Times (Sept. 27, 2017) (30 companies studied have a portfolio of more than \$400bn of US corporate bonds, representing nearly 5 per cent of the outstanding market).

¹⁴ Laurie Meisler, The 50 Largest Stashes of Cash Companies Keep Overseas (June 13, 2017).

Largest Holdings of "Overseas" Cash and Marketable Securities



Source: Laurie Meister, *The 50 Largest Stashes of Cash Companies Keep Overseas* (June 13, 2017); Bloomberg, companies' quarterly and annual reports
 *Information was taken from company's 10K. Numbers for other companies come from their 10Qs.

It bears repeating the Treasury Department's assessment from January of this year of the economic effect of the unrepatriated earnings (held in cash or marketable securities):

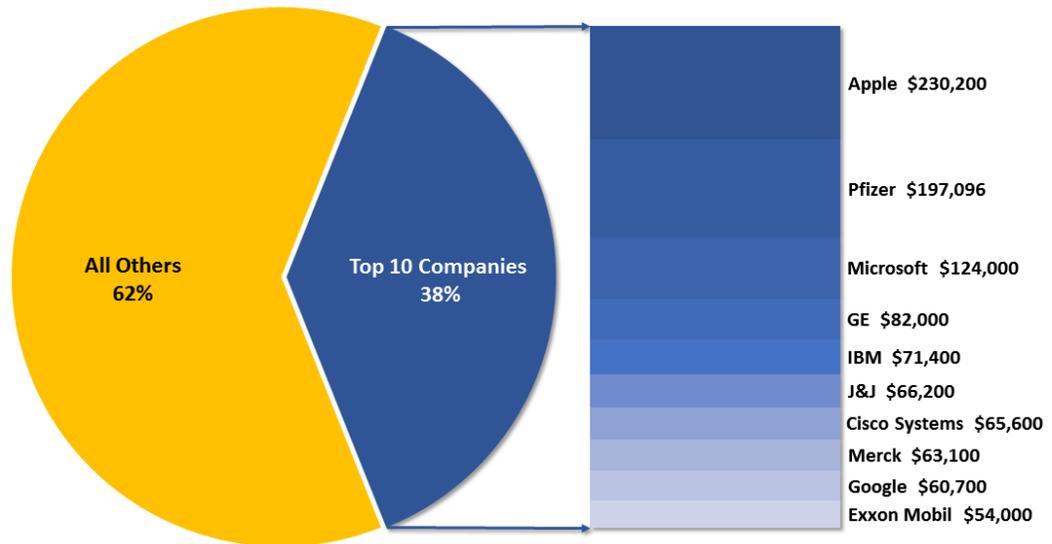
The broader economic effects of the unrepatriated income are likely to be small, however, because that income is generally held in dollar-denominated assets, deposited at U.S. banks, and actively invested in productive uses by the financial system. A common misconception is that income reported as "permanently reinvested abroad" must be physically held or invested outside of the U.S. Instead, that is a tax reporting convention intended to differentiate income that is immediately subject to U.S. tax from that which is deferred from tax; while there are limitations on how those funds may be used by the corporation, in general those assets are held for investment at U.S. financial institutions, and thus contribute to investment and capital formation in the United States, even if the earnings are not "repatriated" by the MNC.¹⁵

Looking at filings for Fortune 500 companies, the Institute on Taxation and Economic Policy found that in 2016 10 companies alone reported over \$1 trillion of the Fortune 500's estimated \$2.6 trillion (or 38%) of "indefinitely reinvested" offshore earnings.

¹⁵ Treasury, Responsible Business Tax Reform, supra note 7, at 38.

Offshore Indefinitely Reinvested Earnings of U.S. Fortune 500 Companies (2016)

38% held by 10 Companies (US \$ Millions)



Source: ITEP, "Fortune 500 Companies Hold a Record \$2.6 Trillion Offshore" (March 28, 2017)

The primary businesses of these 10 companies rest on one or more of: (i) technology patents, copyrights, and trademarks created under the protection of U.S. laws; (ii) U.S. food and drug approvals authorizing access to and assurance to U.S. healthcare consumers; (iii) the internet developed by the U.S. government and transitioned to private hands; or (iv) leases of valuable rights to U.S. oil and gas natural resources. All of these are fruits of U.S. public goods and legal infrastructure developed and maintained with U.S. taxpayer dollars. Yet, these companies have been permitted to routinely use transfer pricing and stateless income planning techniques to pay extraordinarily low rates of tax on vast swathes of their income—and now the plan is to give them an amnesty rate on pre-effective date earnings?

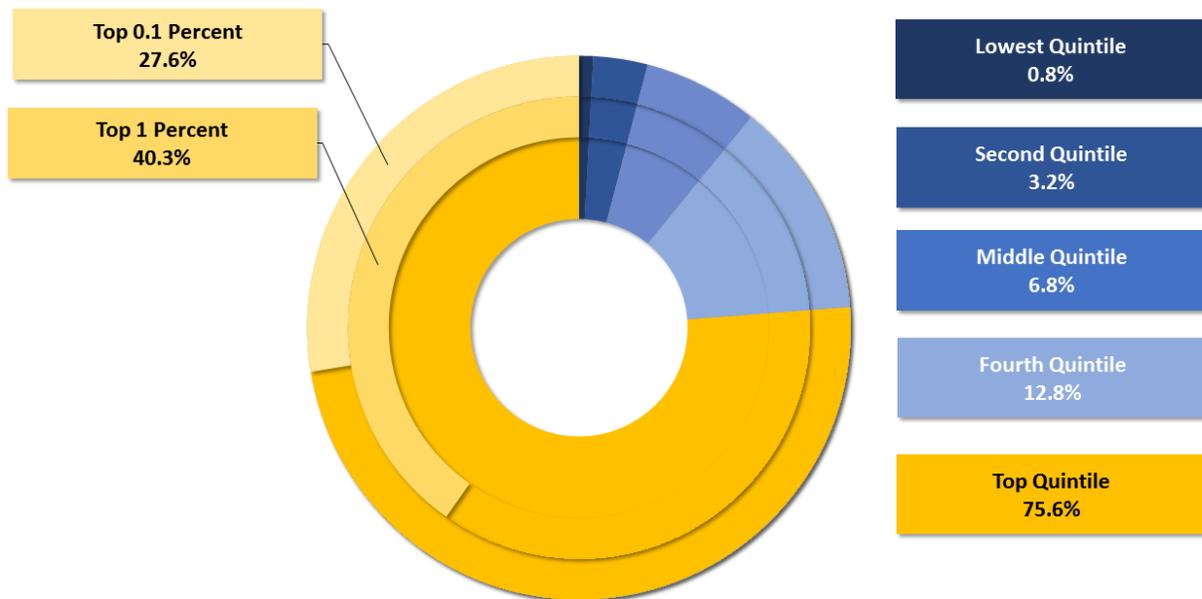
My co-authors Cliff Fleming and Bob Peroni and I have explained why a low rate on pre-effective date earnings is unjustified on policy grounds.¹⁶ In addition to the observations we made in that article, I want to emphasize that the benefit of a low tax rate on pre-effective date earnings will go to the highest income Americans (and foreigners) that are shareholders of these largest MNCs.¹⁷

¹⁶ See J. Clifton Fleming, Jr., Robert J. Peroni, and Stephen E. Shay, "Getting from Here to There: The Transition Tax Issue," *Tax Notes*, Apr. 3, 2017, p. 69 (proposing immediate taxation of accumulated offshore earnings at regular corporate rates with an option to pay the tax in interest-bearing installments). An important practical implication of our analysis is that it would be normatively justifiable to dial up the tax rate on pre-effective date earnings, indeed to the full pre-effective date tax rate of 35%, if necessary to meet the revenue objectives of a tax reform.

¹⁷ See Steven M. Rosenthal, A Tax Break on Repatriated Earnings Will Not Trickle Down to U.S. Workers TaxVox: Individual Taxes (Sept. 25, 2017), available at <http://www.taxpolicycenter.org/taxvox/tax-break-repatriated-earnings-will-not-trickle-down-us-workers> (last viewed Sept. 27, 2017).

On this point, Donald Marron’s testimony before this Committee on September 19 was crystal clear: “Retroactive tax cuts do not help workers; the benefits would go solely to shareholders.”¹⁸ The most recent data show that companies publicly traded on U.S. securities markets are approximately 75% owned by U.S. shareholders, including principally individuals (directly and through mutual funds) and tax-favored retirement accounts.¹⁹ The Tax Policy Center finds that 76% of a retroactive corporate tax change would go to the highest quintile of income earners, 40% goes to the top 1% and 27% of the benefit goes to the top 0.1% of taxpayers.²⁰ The remaining shares are owned by foreign shareholders.

Distribution of Offshore Earnings Amnesty Tax Rate Benefit



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0217-1).

Directions for Tax Reform

The preceding discussion leads me to recommend that the Committee consider the following proposals or areas for reform.

¹⁸ Donald B. Marron, Institute Fellow, Urban Institute and Urban-Brookings Tax Policy Center, Testimony before the Senate Committee on Finance, Hearing on Business Tax Reform 3 (Sept. 19, 2017).

¹⁹ See Leonard E. Burman, Kimberly A. Clausing and Lydia Austin, “Is U.S. Corporate Income Double Taxed?” (May 4, 2017) (Building on work of Rosenthal & Austin); Steven M. Rosenthal and Lydia S. Austin, “The Dwindling Taxable Share of U.S. Corporate Stock,” 151 Tax Notes 923 (2016).

²⁰ Tax Policy Center, Share of Change to Corporate Income Tax Burden by Expanded Cash Income Percentile, T17-0180 Preliminary Results (June 6, 2017), available at <http://www.taxpolicycenter.org/model-estimates/distribution-change-corporate-tax-burden-june-2017/t17-0180-share-change-corporate>, last viewed Sept. 27, 2017.

Improve Taxation of Foreign Business Income

My first recommendation would be to follow the Wyden-Coats and Trump campaign proposals to tax U.S. MNCs' foreign subsidiary earnings currently and allow deductions allocable to foreign subsidiary earnings in full.²¹ This would address U.S. multinational base erosion and profit shifting that is pervasive under current law and would be exacerbated under a final global minimum tax. The claim that U.S. MNCs would not be able to compete if the corporate rate is reduced to 20% (or 24% under the Wyden-Coats proposal) is unsupported and a claim for special treatment for foreign income that should be justified with evidence.

A second best approach would be to adopt an advance minimum tax on foreign business income under the current law deferral regime and to defer U.S. deductions allocable to deferred foreign income until the foreign income is taxed. This is described in my 2015 Senate Finance Committee testimony and is developed in greater detail in a co-authored Florida Tax Review article.²²

A territorial system such as one referred to but not specified in the GOP Tax Reform Plan of September 27 is a least good proposal and indeed can, if not designed properly, leave the tax system materially worse off than under current law. My co-authors and I detailed design features that should characterize a principled territorial system in a 2012 article.²³ In a new Tax Notes article we describe how to incorporate a principled minimum tax in a territorial regime.²⁴ Key

²¹ See S.727 - Bipartisan Tax Fairness and Simplification Act of 2011, 112th Cong., 1st Sess., §204(c) (2011). The GOP Tax Reform Plan of September 27 appears to describe a minimum tax combined with a form of dividend exemption. An important element from a revenue perspective is how deductions are allocable to foreign subsidiary earnings eligible for a reduced rate of tax. The effects of the minimum tax are not easy to discern without a specific proposal, including a specific tax rate.

²² See Stephen E. Shay, J. Clifton Fleming, Jr., and Robert J. Peroni, "Designing a 21st Century Corporate Tax—An Advance U.S. Minimum Tax on Foreign Income and Other Measures to Protect the Base," 17 Fla. Tax Rev. 669 (2015) (proposing a minimum tax that would partially end deferral by effectively serving as an advance withholding tax with respect to the ultimate U.S. levy on repatriated foreign-source active-business income). Under an advance minimum tax, a United States shareholder in a controlled foreign corporation (CFC) would be required to include in income (under the Code's Subpart F rules) the portion of the CFC's earnings that would result in a residual U.S. tax sufficient to achieve the target minimum effective tax rate on the CFC's current year earnings. The target minimum effective tax rate would be based on a percentage of the of the U.S. corporate rate, so that it would adapt to changes in the U.S. corporate tax rate. Deductions incurred by U.S. affiliates allocable to the CFC's earnings only would be allowed to the extent the CFC's earnings were actually or deemed distributed. For example, if the actual and deemed distributions caused 35% of the CFC's earnings to be distributed, then 35% of the deductions allocable to the CFC's income would be allowed and the remaining 65% would be suspended until the remaining earnings were distributed. The earnings deemed distributed would be treated as previously taxed as under current law and would be available for distribution without a further U.S. tax (which would reduce pressure on earnings held abroad).

²³ See J. Clifton Fleming, Jr., Robert J. Peroni, and Stephen E Shay, "Designing a U.S. Exemption System for Foreign Income When the Treasury Is Empty," 13 Fla. Tax Rev. 397 (2012) (hereinafter Fleming, Peroni, and Shay, "Designing Exemption").

²⁴ J. Clifton Fleming, Jr., Robert J. Peroni, and Stephen E Shay, "Incorporating a Minimum Tax in a Territorial System," 156 Tax Notes 54 (Oct. 2, 2017).

design features of such a minimum tax that are critical to protecting the tax base include the following:

1. To avoid gaming, a U.S. territorial system should apply to both foreign branch income and dividends received from foreign subsidiaries.
2. There should be no deferral; the minimum tax should apply to the foreign-source income of U.S. MNCs as the income is earned either directly or by foreign affiliates.
3. The minimum tax should be a relatively high percentage of the regular U.S. tax rate (no less than 60% and preferably 80%).²⁵ The minimum tax should be applied on a *country-by-country* and *not a global* basis as is suggested in the GOP framework. Allowing blending of high and low foreign taxes will in some cases incentivize high-taxed foreign investments and shifting of U.S. income to be low-taxed foreign income in other cases.
4. A foreign tax credit should be allowed against the minimum tax but only in the ratio that the U.S. minimum tax rate bears to the regular U.S. corporate tax rate.²⁶ Only the pro-rated amount of foreign taxes allocable to minimum taxed income on a country-by-country basis should be creditable against the U.S. tax on that income. Cross-crediting should be severely limited or there again will be incentives to mix and match investment by the level of tax on the return from the investment.
5. A U.S. territorial system should exempt only dividends paid out of foreign-source *active* business income that has borne a meaningful tax and only foreign-source branch income that has the same characteristic. No sound policy objective is achieved by going further and exempting other income. An exemption should *not* apply to foreign-source income that was treated as a deductible payment in the foreign country—royalties, rents, and interest should be fully taxed and only withholding taxes on that income allowed as a credit against the U.S. tax on that income. Consistent with practice in other developed countries, current taxation of passive income (under subpart F) should be retained so that the exemption does not encourage tax avoidance on passive income.²⁷
6. Corporate overhead, interest, and research and development deductions should be properly and fully allocated to exempt income and disallowed. Limiting the exemption

²⁵ For example, if the corporate rate were 20% the minimum tax should be at least 12% and preferably 16%.

²⁶ The foreign income taxes eligible for the credit would be limited to the ratio that the minimum tax rate bears to the regular U.S. rate. This is the same approach taken in the section 965 temporary tax holiday provision. *See* IRS Notice 2005-64, § 4.03, 2005-36 IRB 471, 476-478.

²⁷ With respect to private equity and other investment funds, subpart F should be modified so that it applies at the level of the fund (whether the fund is a domestic or a foreign partnership) and U.S. investors can no longer escape current taxation of subpart F income by being less than ten percent owners of the fund.

to 95% (or some other percentage) of otherwise qualifying income as a substitute for properly allocating deductions between exempt income and non-exempt income inappropriately expands the exemption subsidy to domestic income. Foreign losses should be prorated between exempt foreign income and taxable income. The portion allocable to exempt foreign income should be disallowed; only losses allocable to taxable income should be deductible.

If these design principles are followed, it is possible for such a regime to improve current taxation of international operations over current law.

Honor 2004 Congressional Commitment to One-Time-Only Amnesty; If Not, Use the Highest Possible Single Rate

The Committee should resist taxing pre-effective date earnings of the largest U.S. MNCs at a low amnesty rate that will overwhelmingly benefit high income American and foreign shareholders. This is unjustified on policy and distributional grounds. Moreover, the additional revenue will be sorely needed to reduce the massive deficits that would result from the GOP Tax Reform Plan of September 27.

There should not be a higher rate on cash and cash equivalents and certainly not one announced in advance without an immediate effective date. A dual rate structure will require a definition of cash and cash equivalent and a measurement on a set date that, if prospective, will be subject to planning and manipulation. At a minimum, it would create an incentive for pre-effective date investment in “illiquid assets” which could have unintended effects on markets in which U.S. MNCs hold large portions of outstanding securities. If experience with the manufacturing deduction is any guide (where Starbucks coffee roasting can obtain a tax benefit for manufacturing), definitions will be stretched with the well-paid assistance of K Street denizens. If any relief is given, which is poor policy, use a single rate as close to the historic rate as possible (and certainly not below the new regular corporate tax rate).

Strengthen U.S. Corporate Residence Rules

If taxation of foreign income is reformed along the lines described above, or with most plausible anti-base erosion provisions in a further development of the tax reform legislation, there will be continued pressure on U.S. corporations to change corporate residence. The United States should broaden its definition of a resident corporation to provide that a foreign corporation would be a U.S. tax resident if it satisfied either a shareholder residency test or the presently controlling place of incorporation test. Importantly, linking corporate residence to greater than 50% control by U.S. tax residents would align corporate residence with the primary reason the U.S. seeks to impose a corporate tax, which is to tax resident shareholders. There are important details to be worked out in designing a shareholder residence test, but my colleagues and I have explored many of the relevant issues and I strongly encourage the Committee to pursue this avenue.

Strengthen U.S. Source Taxation Rules

The first and most direct way to generally strengthen U.S. source taxation is through improved earnings stripping rules that should not be limited to interest.²⁸ If the Committee does not adopt a general limitation on deductions for net interest expense, which would subsume earnings stripping, then it is important to adopt a limitation on deduction for excess related party interest. There have been robust proposals by Representative Camp and the Obama Administration so I do not address details here except to emphasize that, unless addressed, U.S. MNCs will continue to attempt to shift corporate residence to take advantage of the U.S. tax reduction opportunities from earnings stripping. It would be a significant mistake for the Administration to undo the substance of the recently finalized Section 385 regulations before a replacement of equal strength is firmly in place.²⁹

It is foolish to believe that the U.S. tax base is immune from the same source tax avoidance, base erosion, and profit shifting that has afflicted other developed countries and given rise to the G20/OECD BEPS project. Structural advantages for foreign-controlled domestic companies constitutes an integral part of the current international tax architecture and is found in almost every country's tax system. The sources of advantage include remote sellers using digital commerce and foreign businesses using treaties and information technology advances to avoid direct local activity. In addition to adopting robust anti-earnings stripping rules that extend beyond interest to other deductible payments, it is time to engage in a more fundamental review of U.S. source taxation interests and legal rules. It is striking that a so-called fundamental tax reform effort over many years has disregarded this area that badly needs re-thinking and updated rules.

Conclusion

International business income is but a part of the larger mosaic that comprises the U.S. economy. In no area of business are tax planning skills more acute and heavily deployed to take advantage of exceptions, special deductions, and lower effective rates than in relation to earning cross-border business income.

There is no normative reason to privilege foreign business income beyond allowing a credit for foreign income taxes. My recommendation is to tax foreign business income broadly and allow a credit for foreign income taxes. I encourage you not to gamble with a territorial system with weak protections and not to give away tax benefits to the undeserving rich and foreigners. If any group of taxpayers does not bear its share of tax, others must make up the difference sooner or, if the

²⁸ See J. Clifton Fleming, Jr., Robert J. Peroni, and Stephen E. Shay, "Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytical Framework," 93 *N.C.L. Rev.* 673 (2015).

²⁹ This Committee should discourage any such steps. For various reasons, including inducing inversions in any interim period, it would be especially foolish to encourage repeal of the regulations in hopes of improving a revenue score for a legislative change.

deficit is debt-financed, later. Neither the tooth fairy nor dynamic scoring will alter this fundamental reality.

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