TESTIMONY OF PROFESSOR BRET WELLS
before the
US SENATE COMMITTEE ON FINANCE
at the
HEARING ON INTERNATIONAL TAX REFORM
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My name is Bret Wells, and I am the George R. Butler Professor of Law at the University of Houston Law Center. I would like to thank Chairman Hatch, Ranking Member Wyden, and the other members of the committee for inviting me to testify. I am testifying in my individual capacity, and so my testimony does not necessarily represent the views of the University of Houston Law Center or the University of Houston. I request that my full written testimony be included in the record.

Before addressing international taxation, I want to make a preliminary statement about the related topic of business tax reform. As to business tax reform, Chairman Hatch is to be commended for his work on corporate integration as part of tax reform—specifically, his partial dividends paid deduction proposal. A partial dividends paid deduction regime provides a corporate tax deduction that can approximate the stock ownership held by US taxable investors.[1] The existing scholarship makes a compelling case that significant efficiencies can be achieved through corporate integration.[2] By limiting the dividend deductibility to the amount of equity held by US taxable shareholders, the partial dividends paid deduction regime preserves corporate level taxation for earnings in an amount broadly equal to the equity ownership of nontaxable

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[1] For a more detailed analysis of my views on an earlier iteration of a dividends paid deduction proposal, see Bret Wells, *International Tax Reform By Means of Corporate Integration*, 19 FLA. TAX REV. 71 (2016); see also Testimony of Bret Wells at the *Hearing on Integrating the Corporate and Individual Tax Systems: The Dividends Paid Deduction Considered* before the Senate Finance Committee (May 17, 2016).

[2] See e.g., MICHAEL J. GRAETZ & ALVIN C. WARREN, INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND THE AMERICAN LAW INSTITUTE REPORTS (1998); see also Staff of the Joint Comm. on Tax'n, *Overview of Approaches to Corporate Integration*, JCX-44-66 (May 13, 2016); REPUBLICAN STAFF OF THE SENATE FINANCE COMMITTEE, COMPREHENSIVE TAX REFORM FOR 2015 AND BEYOND at 122-237, 113th Cong., S. Prt. No. 113-31 (Dec. 2014).

shareholders. A partial dividends paid deduction regime narrows the distinction between the tax treatment of debt and equity. A partial dividends paid deduction regime, in combination with a dividends and capital gains preference, in tandem can result in a combined tax rate on corporate business profits that approximates the individual tax rate, thus eliminating the disparity in tax rates between C corporations and pass-through entities. Thus, a partial dividends paid deduction regime is a critical step in the right direction and should be part of the final business tax reform legislation.

Now, I want to address outbound international taxation. This committee is well aware that our major trading partners have all opted for some variant of a territorial tax regime and that the divergent approach taken by the United States poses competitiveness concerns.[3] This reality creates an urgent need for this Congress to consider how to structure a territorial tax regime that provides parity with the tax systems of our major trading partners but at the same time protects the US tax base from inappropriate profit shifting strategies. Under current law, the US subpart F regime provides a fairly narrow set of exceptions to the deferral privilege, and these anti-deferral provisions serve as an important backstop to prevent tax avoidance of US origin profits by US-based multinational enterprises. Another means to address the tax avoidance concerns that underlie the US subpart F regime would be to adopt greater source taxation measures to protect the US tax base. Relying on a source taxation solution to address the profit shifting problem is consistent with a territorial tax regime and has the favorable benefit of

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[3] See REPUBLICAN STAFF OF THE SENATE FINANCE COMMITTEE, COMPREHENSIVE TAX REFORM FOR 2015 AND BEYOND at 249-293, 113th Cong., S. Prt. No. 113-31 (Dec. 2014); see also Staff of the Joint Comm. on Tax'n, *Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income*, JCX-33-11 (2011) (analyzing nine major trading partners of the United States that provide for an exemption system); Staff of the Joint Comm. on Tax'n, *Present Law and Issues in U.S. Cross-Border Income*, JCX-42-11 (2011) (reviewing policy considerations between a territorial and worldwide tax system).

implementing base protection measures that apply across-the-board to both US-based multinational enterprises and foreign-based multinational enterprises. In contrast, solutions that rely on residency taxation principles (such as the US subpart F regime) only protects against the profit shifting strategies of US-based multinational enterprises. Thus, I favor source taxation measures over an expanded Subpart F regime exactly because Subpart F measures create divergent and discriminatory tax results for US-based multinational enterprises and leaves in place the inbound earning stripping advantages for foreign-based multinational enterprises. Thus, for competitiveness reasons, this Congress must consider a territorial tax regime, and as part of that consideration Congress must utilize tax base protection measures that are even-handed.[4] Expanding residency-based solutions via an expansion of the US Subpart F regime creates artificial winners and losers based on the ultimate place of residence of the global parent company. The United States needs an international tax system that protects US taxation over US origin profits and is consistent with the tax regimes of our major trading partners.

For the balance of my time, I want to highlight three key issues with respect to inbound international tax reform.

1. Earning stripping is multifaceted and requires a comprehensive solution.

For corporate tax reform to be sustainable in a global environment, the United States tax system must be designed to ensure that business profits earned within the United States are subject to US taxation regardless of where a multinational corporation is incorporated. Today's tax system does not achieve this objective, and its failure to do

[4] For a more detailed analysis of my views on a territorial tax regime and the earning stripping issues inherent in such a regime, see Bret Wells, *Territorial Taxation: Homeless Income is the Achilles Heel,* 12 HOUS. BUS. & TAX L.J. 1 (2012).

so creates earning stripping opportunities for foreign-based multinational enterprises that allow them to achieve a lower tax burden with respect to their US operations than can be achieved by US-based multinational enterprises conducting those same operations.[5] Thus, US-based multinational enterprises are competitively disadvantaged by our own tax system.

How does this inbound earning stripping problem arise? When a US subsidiary makes a cross-border tax deductible payment to a low-taxed offshore affiliate, the overall income of the multinational enterprise has not changed. The multinational enterprise has simply moved assets from one affiliate entity's pocket to another affiliate's pocket. But, from a US tax perspective, this related party (intercompany) transaction is quite lucrative. This intercompany transaction affords the US affiliate with a US tax deduction that reduces the US corporate tax liability of the US affiliate. The intercompany payment creates income in the hands of the low-taxed offshore affiliate that often escapes US taxation and often avoids any meaningful taxation in the offshore jurisdiction. There are five intercompany techniques that can be utilized to strip out this US origin "homeless income"[6] from the hands of the US affiliate: (1) related party Interest Stripping

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[5] Earning stripping has been identified as a systemic challenge that requires a further legislative policy response. See e.g., Staff of the Joint Comm. on Tax'n, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing,* JCX-37-10 (2010). For a more detailed analysis of my views on how US-based multinational enterprises are competitively disadvantaged because of the extra earning stripping opportunities that exist for foreign-based multinational enterprises that do not exist for US-based multinational enterprises, see Bret Wells, *Territorial Taxation: Homeless Income is the Achilles Heel,* 12 HOUS. BUS. & TAX L.J. 1 (2012).

[6] By Homeless Income, I mean to refer to that category of a multinational corporation's consolidated income that has been removed from the tax base of the country of origin via a related-party tax deductible payment and relocated to an offshore affiliate's country of residence that chooses not to tax this extra-territorial income or provides concessionary taxation to this category of income. Thus, the income is "homeless" in the sense that it lost its tax home in the country of source. The origins of the homeless income mistake is dealt with extensively in my earlier writings in Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX L. REV. 535 (2012); Bret Wells & Cym Lowell, *Income Tax Treaty Policy in the 21st Century: Residence vs. Source*, 5 COLUM. TAX J. 1 (2013).

Transactions; (2) related party Royalty Stripping Transactions;[7] (3) related party Lease Stripping Transactions; (4) Supply Chain restructuring exercises; and (5) related party Service Stripping Transactions.

Multinational enterprises come to every jurisdiction, including the United States, with a toolbox of tax planning techniques that utilize all five of the above earning stripping categories. So, to have a sustainable system of business taxation, the United States simply must address earnings stripping by addressing each of the categories of earning stripping transactions. Foreclosing one, but not all, of the earning stripping categories simply motivates a foreign-based multinational enterprise to use other tax planning tools.

2. **Corporate inversions are not a stand-alone problem but merely the alter ego of the inbound earning stripping problem.**

Corporate inversions are a telltale symptom of the larger inbound earning stripping cancer. Thus, corporate inversions cannot be handled as a stand-alone problem. Again, my first key point bears repeating: the current tax system provides significant earning stripping advantages that afford a better tax result for the US activities of foreign-based multinational enterprises than exist for US-based multinational enterprises that conduct similar US activities.[8] This reality causes US-based multinational enterprises to

[7] The outbound migration of foreign-use intangibles is another systemic challenge to the current US international taxation regime that does not involve an inbound Royalty Stripping Transaction and thus would not be prevented by a Base Protecting Surtax. But, the Treasury Department can and should amend its existing cost sharing regulations to disregard a funding party's tax ownership of an intangible above its actual functional contribution toward the intangible's creation apart from funding. For a further detailed analysis of this issue, see Bret Wells, *Revisiting §367(d): How Treasury Took the Bite Out of Section 367(d) and What Should Be Done About It,* 16 FLA. TAX REV. 519 (2014).

[8] The US subpart F rules serve as a backstop to prevent a US-based multinational enterprise from stripping US source profits via inbound Interest Stripping, Royalty Stripping, and Lease Stripping transactions. For a more detailed analysis of my views on how the US subpart F regime serves as a backstop to prevent US-based multinational enterprises from benefitting from these earnings stripping techniques and how this subpart F backstop regime does not apply to foreign-based multinational enterprises, see Bret Wells & Cym

want to become foreign-based multinational enterprises, or in other words to enter into a corporate inversion transaction so that the post-inversion company can avail itself of the same earning stripping opportunities as its foreign-based competitors without the impediment of the US subpart F regime.

This is the point to be learned from the corporate inversion phenomenon:[9] corporate inversions are an effort by US-based multinational enterprises to become foreign-based enterprises exactly because the inbound earning stripping advantages available to foreign-based multinational enterprises are coveted by US-based companies.[10] Thus, instead of attacking the corporate inversion messenger in isolation, Congress should focus its attention on the inversion message, namely that the earning stripping techniques available to foreign-based multinational enterprises, if left unchecked, create an unlevel playing field that motivates US-based multinational corporations to find pathways to successfully engage in corporate inversions. Said differently, corporate inversions tell Congress that it must solve the inbound earning stripping problem on a holistic basis if it wants to eliminate the tax incentives for these transactions. Corporate inversions are simply the alter ego of the inbound earning stripping problem and should not be viewed as a separate policy problem.

Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX L. REV. 535 (2012); see also Bret Wells, *Territorial Taxation: Homeless Income is the Achilles Heel,* 12 HOUS. BUS. & TAX L.J. 1 (2012).

[9] Corporate inversions cause significant revenue losses and ongoing policy concerns. See Congressional Budget Office, An Analysis of Corporate Inversions (September 2017), available at https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53093-inversions.pdf. In the past, Congress has attacked the corporate inversion phenomenon as a stand-alone problem. In my view, Congress will not eliminate the corporate inversion phenomenon until Congress eliminates the inbound earning stripping advantages that motivate these transactions.

[10] For a more in depth discussion of my views on why the corporate inversion phenomenon is best understood as a commentary on the broader inbound earning stripping problem and should not be viewed as a stand-alone problem, see Bret Wells, *Corporate Inversions and Whack-a-Mole Tax Policy,* 143 TAX NOTES 1429 (June 23, 2014); Bret Wells, *Cant and the Inconvenient Truth About Corporate Inversions,* 136 TAX NOTES 429 (July 23, 2012); Bret Wells, *What Corporate Inversions Teach Us About International Tax Reform,* 127 TAX NOTES 1345 (June 21, 2010).

3. A Base Protecting Surtax should be part of inbound international tax reform.

Congress needs a new approach to address the earning stripping problem, and it should address this problem in a comprehensive manner. I believe that a base protecting surtax is a solution that comprehensively addresses the inbound earnings stripping problem, and so I urge this committee to seriously consider it as part of international tax reform.[11] By imposing a base protecting surtax on all five categories of earning stripping transactions, a surtax would be collected upfront in an amount equal to the amount of tax that would have been collected had the intercompany payment instead been paid as an intercompany dividend distribution. A base protecting surtax is essential even if Congress were to enact a partial dividends paid deduction regime because a foreign-based multinational enterprise can strip "homeless income" out of the US tax base in a manner that achieves a better result than can be achieved via a partial dividends paid deduction. Thus, Congress needs to level the playing field with a base protecting surtax.

If appropriately designed, a base protecting surtax would be applied on the payer in each of the five types of earning stripping transactions. As such, it is not a withholding tax on the payee. The base protecting surtax collects a surtax upfront on the payer's share (not the payee's share) of the residual profits that are earned by the multinational enterprises from within the United States and remitted as a tax deductible payment to a jurisdiction outside of the US tax base. Thus, the surtax protects the US tax base from

[11] Although adoption of a Base Protecting Surtax is my preferred policy response, the committee should consider this proposal alongside other thoughtful reform proposals that have been offered by other scholars. See e.g., J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytical Framework,* 93 N.C. L. REV. 673 (2015) (provides a comprehensive expense disallowance approach to earning stripping transactions); Michael C. Durst, *Statutory Protection for Developing Countries*, 69 TAX NOTES INT'L 465 (Feb. 4, 2013) (endorses disallowance of related party payments made to tax haven affiliates); Reuven S. Avi-Yonah, *A Coordinated Withholding Tax on Deductible Payments*, 119 TAX NOTES 993, 995–96 (June 2, 2008) (endorses a withholding tax on earning stripping payments that is refundable if subjected to meaningful taxation in the offshore jurisdiction).

being reduced by reason of earning stripping transactions and as such would provide tax revenue for tax reform. Moreover, by eliminating the tax benefits associated with earning stripping transactions, Congress will eliminate the fuel that drives the corporate inversion phenomenon. And finally, a comprehensively applied base protecting surtax levels the playing field between US-based multinational enterprises and foreign-based multinational enterprises.

Conclusion

Let me conclude my testimony by stating that this committee is to be commended for considering fundamental business tax reform. Business tax reform requires a careful consideration of international tax reform, and in my view any resulting legislation must be structured to withstand the systemic inbound earning stripping challenges that face the United States. Thank you for allowing me to speak at today's hearing. I would be happy to answer any of your questions.

APPENDIX A
to the
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The base protecting surtax that I and a co-author originally proposed[12] in 2012 is updated in this testimony to mesh with a corporate integration proposal that would utilize a partial dividends paid deduction with the following elements:

1. *Base Protecting Surtax on Base Erosion Payments.* A related-party U.S. payer of a base erosion payment would be subjected to a Base Protecting Surtax on the earnings that are transferred to a foreign affiliate in an amount equal to the amount that would have been collected had those earnings instead been distributed as a partially deductible dividend. The purpose of the Base Protecting Surtax is to collect, as a surtax, a tax calculated on the gross amount of the earning stripping payment so that an equivalent tax is collected for what would have been due if the base erosion payment instead had been remitted as a tax deductible dividend to the foreign affiliate. The rebuttable presumption is that the base erosion payment represents, in its entirety, a transfer of residual profits.

2. *Refund Process.* If the U.S. payer believes that the amount of the Base Protecting Surtax is in excess of the amount needed to protect the U.S. tax base because, in fact, a portion of the base erosion payment represents a reimbursement of actual third-party costs and does not represent, in its entirety, a transfer of US origin profits between affiliates, then the U.S. payer could request a redetermination by the Internal Revenue Service (Service) through a "Base Clearance Certificate" process. However, the burden is on the U.S. payer to demonstrate that the Base Protecting Surtax was assessed on an amount that exceeded the amount of residual profits that were actually transferred by the U.S. affiliate to a foreign affiliate, and this burden would only be satisfied if the taxpayer demonstrated that a correct application of a profit split methodology[13] confirmed the taxpayer's assertion. Until the taxpayer meets this burden of proof, the surtax would not be refunded. So, the audit incentives for transparency in this posture are reversed as the government has collected the tax upfront and it falls to the taxpayer to develop

[12] For a more detailed analysis of the original formulation of the Base Protecting Surtax set forth in this testimony, see Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX L. REV. 535 (2012).

[13] For further detail on why I believe transactional transfer pricing methodologies are inadequate to address the transfer pricing issues of multinational enterprises and why I believe all transfer pricing results in the multinational enterprise context should utilize a profit split methodology as the primary transfer pricing methodology or alternatively should be used as a mandatory confirmatory check to all other transactional transfer pricing methodologies, see Bret Wells & Cym Lowell, *Tax Base Erosion: Reformation of Section 482's Arm's Length Standard* 15 FLA. TAX REV. 737 (2014).

the case for a refund, and so the taxpayer now has every incentive for transparency and expeditious handling of the audit proceeding.

The purpose of the base protecting surtax is to serve as a backstop to prevent elimination of the residual US taxation on any of the five categories of inbound earning stripping transactions that create "homeless income" out of US origin business profits. By imposing a base protecting surtax on all five of the enumerated inbound Homeless Income strategies, the base protecting surtax collects an upfront tax in an amount equal to the amount that would have been collected had those earnings instead been distributed as a dividend subject to the applicable withholding tax on the grossed-up dividend. A Base Protecting Surtax is essential in a dividends paid deduction regime because without it the foreign-based multinational enterprise has inbound earning stripping strategies at its disposal that affords it the opportunity to strip profits from its U.S. subsidiary in a manner that circumvents US taxation over US origin profits that are unavailable to US-based multinational enterprises.

The proposed Base Protecting Surtax is a surtax on the payer and is not a withholding tax on the payee. The Base Protecting Surtax seeks to collect the tax that is due on the payer's share (not the payee's share) of the residual profits that are earned by the multinational enterprises from the United States. The surtax makes the following two assumptions about inbound earning stripping strategies: (1) base erosion payments represent, in their entirety, a transfer of residual profits to the offshore recipient, and (2) the onshore payer should have reported and paid source country taxes on those residual profits that arose from the U.S. affiliate's activities within the United States. The transfer pricing penalty and documentation provisions do a fine job of ensuring that routine profits are reported by the onshore U.S. subsidiary, but these provisions have not been successful at ensuring the self-reporting of residual profits by the U.S. affiliate.

If the U.S. multinational enterprise discloses its overall books and proves that the combined profits of the multinational enterprise are less than the full gross amount of the base erosion payment, then a refund of the surtax (in whole or in part) could be made, but in this refund determination the taxpayer would be required to utilize a profit split methodology, not one of the transactional transfer pricing methodologies. The proposed Base Protecting Surtax relies on a profit split methodology (which is one of the accepted transfer pricing methods) and the surtax is refundable if it overtaxes the combined income. Moreover, the technical taxpayer for the surtax is the U.S. affiliate payer. Thus, because the surtax can be reconciled with the arm's length standard and because the surtax is not a withholding tax on the recipient, the proposal is consistent with existing treaty obligations.