

**THE NEED FOR COMPREHENSIVE TAX
REFORM TO HELP AMERICAN COMPANIES
COMPETE IN THE GLOBAL MARKET AND
CREATE JOBS FOR AMERICAN WORKERS**

HEARING
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
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**THE NEED FOR COMPREHENSIVE TAX
REFORM TO HELP AMERICAN COMPANIES
COMPETE IN THE GLOBAL MARKET AND
CREATE JOBS FOR AMERICAN WORKERS**

THURSDAY, MAY 12, 2011

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 9:02 a.m., in Room 1100, Longworth House Office Building, the Honorable Dave Camp [chairman of the committee] presiding.

[The advisory of the hearing follows:]

HEARING ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

Chairman Camp Announces Hearing on the Need for Comprehensive Tax Reform to Help American Companies Compete in the Global Market and Create Jobs for American Workers

Thursday, May 05, 2011

Congressman Dave Camp (R-MI), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on the burdens that the Tax Code imposes on American companies and how such burdens place them at a competitive disadvantage as they try to sell goods and services around the world. The hearing will explore the potential economic and job creation benefits of comprehensive tax reform. **The hearing will take place on Thursday, May 12, 2011, in Room 1100 of the Longworth House Office Building, beginning at 9:00 A.M.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing. A list of invited witnesses will follow.

BACKGROUND:

It has been almost 50 years since the last time Congress fundamentally reformed the tax rules governing international business and cross-border transactions. During that time, the nature of the global economy and the position of the United States within it have changed dramatically. There is a growing concern among employers, practitioners, economists, and academics that international tax laws that made sense when the United States accounted for 50 percent of the world's gross domestic product (GDP) might no longer make sense in today's increasingly competitive and global economy. According to recent testimony from the Chairman of the Business Roundtable's Fiscal Policy Initiative, the U.S. corporate tax system results in American companies being less globally competitive, less investment in the United States, fewer jobs for American workers and less economic growth.

In announcing this hearing, Chairman Camp said, **"It's been 25 years since we reformed the Tax Code, and almost 50 years since we undertook a bottom-up review of our international tax laws. During that time, our foreign competitors have lowered their corporate tax rates and updated their international tax regimes to reflect the realities of the global economy. As we pursue tax reform, we need to consider how to make American companies more competitive and how to make the United States a more attractive place to invest and create jobs."**

FOCUS OF THE HEARING:

The hearing will examine how the current structure of the international tax rules might distort economic decisions and the allocation of resources in ways that reduce employment for American workers and hamper the efforts of American employers to compete with foreign companies in global markets. In the context of comprehensive tax reform that substantially lowers marginal rates on individuals and corporations, the hearing will investigate which reforms to the international tax rules might improve the ability of American companies to compete and create jobs.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, <http://waysandmeans.house.gov>, select "Hearings." Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Thursday, May 26, 2011.** Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-3625 or (202) 225-2610.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at <http://waysandmeans.house.gov/>.

Chairman CAMP. Good morning, and thank you for joining us today for the latest in a series of hearings the Ways and Means Committee has convened to discuss comprehensive tax reform. Today we will examine the impact of the Tax Code on American companies that operate in the global economy, both here and abroad. In a future hearing I expect we will examine the opposite side of the international tax coin, namely the way the U.S. treats inbound investments by companies headquartered abroad.

But today, through the testimony of both our CFO panel and our panel of academics and practitioners, we hope to gain insight into how the current structure of the international tax rules affects the ability of U.S.-based businesses operating in a global environment to invest, grow, and create jobs.

It has been 25 years since we reformed the Tax Code, and almost 50 years since we undertook a bottom-up review of our international tax laws. In those five decades, the global marketplace has changed dramatically. So, too, has America's role in that marketplace.

To illustrate the intersection between America's tax environment and the global landscape, consider this single data point. In 1960, the largest worldwide companies were nearly all American companies. U.S.-headquartered companies comprised 17 of the world's largest 20 companies. That is 85 percent. By 1985, there were only 13, and by 2010 just 6, or a mere 30 percent U.S.-headquartered companies ranked among the top 20. And there are many reasons for this trend, and certainly some of that has to do with the emergence of other strong economies around the world. But without a doubt, a common complaint that we hear from American companies trying to compete abroad is that our Tax Code, with its complexity and its high corporate rates, acts as a hindrance.

The Tax Code's antiquated features have diminished the attractiveness of the U.S. as the premier country in which to locate a business. So, while the promise of the American Dream, having the ability to succeed and prosper might attract individuals to this country, too many employers and investors are finding that our Tax Code stands as a barrier to America being an attractive platform from which to grow abroad in ways that create jobs at home.

In our current economic environment in which our recovery remains in such a fragile state, our Tax Code ought to be helping create jobs. America's combined federal tax corporate rate at 39.2 percent is only outpaced by Japan's rate of 39.5 percent, and Japan has already indicated its intent to lower its rate. Such action will leave America with the highest corporate tax rate in the world, 50 percent higher than the 26 percent average for OECD countries.

As if that were not enough, the U.S. is one of the last major economies to operate a worldwide system for active business income, which many believe is a further barrier to the growth of American companies. Capital will find its way to the most profitable opportunities around the world. But when U.S. companies must pay an additional U.S. tax on top of the tax they pay in the foreign market, then that capital is more likely to be invested through foreign companies who do not face this additional tax. As a consequence, American workers lose out on the jobs that would have been created to support those opportunities.

Simply put, the international tax laws that were in place when the United States accounted for 50 percent of the world's gross domestic product may have made sense 50 years ago. But today, those same laws are causing America to lag further and further behind. Ensuring long-term prosperity in the face of increasing global competition requires Congress to re-examine the Tax Code. As we pursue comprehensive tax reform, this committee intends to develop solutions that empower American companies to become more competitive, and make the U.S. a more attractive place to invest and create the jobs this country needs.

Again, thanks to all of our witnesses for being here today. I will now yield to the ranking member, Mr. Levin, for his opening statement.

Mr. LEVIN. Thank you, Mr. Chairman.

Welcome. We are glad you are here, and thanks for coming.

It is important for us to consider corporate tax reform. It is also important for us to dig beneath the surface of the many issues it presents. International tax issues are inherently complicated. That is an understatement.

Some years ago, my colleague, Amo Houghton, and I sat down with the staff of the Joint Committee on Taxation, and essentially had a seminar on international corporate taxation for several days. We introduced a bill with a number of provisions designed to better reflect the realities of international competition, and a number of them became law. It was clear that some of the larger issues, like deferral and worldwide versus territorial systems, required further consideration and work, because there was no consensus about the effect of potential changes.

Unfortunately, in the next years, those issues remained dormant. In the meantime, the pace of globalization has only increased, heightening the need to restart the effort. I have said before that tax reform needs to start with an agreement regarding basic principles. When it comes to corporate tax reform, a key principle should be that reform must encourage job creation here in the United States.

Over the last 14 months, the economy has created more than 2 million private sector jobs. And economic recovery is slowly taking hold, in part because of the efforts of this Administration, and the then-Democratic majority.

But we still have a long way to go before we make up the nearly nine million jobs destroyed by the financial crisis and recession. So we must be extremely sensitive to the effect tax reform has on jobs. I would be concerned about any change to our tax laws that would create new incentives to move corporate profits and American jobs offshore.

My staff and I have spoken to many large, multinational corporations that are advocating a transition from our present worldwide tax system to a territorial system. We will hear from some of these corporations today.

It is important, I think, to recognize that there is no pure worldwide system or pure territorial system. The details matter a great deal, and there are many versions of territorial tax systems.

We also need to recognize that our current system does include incentives for job creation that we should be sensitive to as we consider reform. The three largest corporate tax expenditures are the Section 199 domestic manufacturing deduction, accelerated appreciation, and the R&D tax credit. All of these provisions are designed to encourage job creation here at home.

Finally, we must remember that there are many other factors that determine where a company does business in a global economy. Taxation is certainly an important factor, but it is just one factor companies use when deciding where to locate production, R&D, and even their headquarters. Workforce matters. Infrastructure matters. Rule of law matters.

So, I especially look forward to hearing our witnesses' testimony today. And, again, a warm welcome.

Chairman CAMP. Well, thank you, Mr. Levin. Today we will hear from two distinguished panels of witnesses. Our first panel is comprised of four chief financial officers from major U.S. companies United Technologies, Caterpillar, Zimmer, and Kimberly-Clark that operate around the world, and that, all together, provide nearly 150,000 jobs for hard-working Americans here at home. Each of these companies is headquartered or has a major presence in districts represented by Members of the Committee, and I will ask those members to formally introduce their constituents when it is their turn to testify.

Later we will hear from a panel of well-respected experts on our international tax rules, including an academic, a practitioner, and a staff member from the Congressional Research Service.

But we begin with our CFOs, each of whom has a front-row seat in seeing how our international tax rules affect the competitiveness of large American employers with substantial operations around the globe.

So, let me turn first to Mr. Larson of Connecticut to introduce the chief financial officer of UTC, Mr. Hayes. And then, after Mr. Hayes testifies, I will recognize Mr. Schock to introduce Mr. Rapp of Caterpillar, and so on.

So, Mr. Larson, you are recognized.

Mr. LARSON. Thank you, Chairman Camp, for providing me the opportunity to introduce Greg Hayes, the chief financial officer of United Technologies, a company located in Hartford, Connecticut, and in my hometown, the home of Pratt & Whitney Aircraft that flies the most dependable engines created anywhere, and built anywhere in the world.

[Laughter.]

Mr. LARSON. Greg joined the United Technologies team more than 11 years ago, when Hamilton Standard moved with Sundstrand Corporation to form what we now know as Hamilton Sundstrand. Over the years, he has risen through the ranks, and now has global responsibility for UTC's finances, and directs communications and interactions with UTC's board of directors and its investors.

I am happy that he is able to be here today to provide the committee with UTC's thoughts on international tax reform. Greg is often referred to as UTC's chief reality officer. We could use one of those here, in Congress. And because of this, and his straightforward, tell-it-like-it-is style, I am sure that the testimony here today will be no different.

It is an honor for me to introduce him to the committee, and I thank you, Mr. Camp, and look forward to the testimony.

Chairman CAMP. Well, thank you, Mr. Larson. Mr. Hayes, you and all of today's witnesses will be recognized for five minutes for your oral remarks. And each of your full written statements will be made part of the official record.

So, Mr. Hayes, you may proceed. Thank you, and welcome.

**STATEMENT OF GREGORY J. HAYES, SENIOR VICE PRESIDENT
AND CHIEF FINANCIAL OFFICER, UNITED TECHNOLOGIES
CORPORATION, HARTFORD, CONNECTICUT**

Mr. HAYES. Thank you, Congressman Larson, for that very kind introduction, and I will certainly try and keep reality front and center this morning in my comments. And also, thank you, Chairman Camp, Ranking Member Levin, and Members of the Committee on Ways and Means. It is a privilege to be here to testify on the need for a pro-growth tax reform agenda.

I am here as the chief financial officer of an established American manufacturing firm that does business around the world. Most people know United Technologies by our business units and our products: Otis elevators; Carrier air conditioners, Pratt & Whitney jet engines; Sikorsky Blackhawk helicopters, Hamilton Sundstrand aerospace systems, and UTC fire and security products.

United Technologies has employees in all 50 states. We have facilities, however, in 71 countries around the world, and we do business in 180 countries around the world. About 40 percent of our \$57 billion of sales are earned right here in the United States, and the remaining 60 percent are outside, in other countries. Our split of employees roughly tracks sales, about 75,000 employees here, in the United States.

But we also do most of our research and development right here in the U.S. About 70 percent, in fact, of the \$3.7 billion of annual R&D investment occurs right here. And we are a net exporter. Approximately \$7 billion of our products and services are exported on an annual basis.

I was asked to testify to shed light on some of the problems American-based companies face with the current tax system. My written testimony details several of these, but in my five minutes I would like to highlight one problem: in particular, the tax impediment U.S. companies face when we try and grow through acquisitions.

I was recently asked on an analyst call about a rumor that UTC would acquire a company that was headquartered in Switzerland. And the answer to that analyst question was obvious. It wasn't a great answer, but it was a true answer. Because of the high U.S. corporate tax rates, and the U.S. worldwide approach to taxing foreign income, UTC is at a serious disadvantage in trying to buy any foreign company. This is especially true as we compete against other bidders who are not domiciled here in the U.S.

Switzerland's income tax rates are 18 points lower than the United States. Switzerland also has a territorial system, unlike our worldwide system. Because of these tax disadvantages, it is much more likely that a foreign buyer would win the opportunity and they, not the American firm, would reap the benefits of a consolidation. That is a problem.

At UTC we like to focus on solutions. And from the perspective of a chief financial officer, there are three general areas of advice from business decision-making that may be useful in making decisions on how to improve the Tax Code for American worldwide firms.

First of all, remember economic fundamentals. Secondly, we need to benchmark against our competition—that is, other countries

around the world. And, lastly, we need to take a measured approach to tax reform.

First, on economic fundamentals, it is the way business decisions are made. In my world, business decisions must rest on economic fundamentals. We cannot ignore economics if we are going to plan for the long term. The defects in our current system are not conducive to job creation. It follows that fixing these problems will make American companies more competitive.

The second recommendation is benchmarking. When our businesses are trying to solve a problem, or improve a process, we benchmark against other companies for best-in-class results. Then we try to emulate them with adjustments for our own facts, cultures, values, and circumstances. The same thing should be done in developing and adopting a territorial tax system, and tax rates that are in line with international norms, but still responsive to American policy concerns.

Finally, I would urge the Congress to take a measured or balanced approach. UTC is aligned with the broader business community when we say we don't want tax reform to break the back of the U.S. Treasury. We are committed to tax reform that is fiscally responsible, and we oppose tax evasion. But please don't punish American companies for serving global customers or succeeding in global markets.

The tax laws should not single out certain industries for better or worse treatment. The Tax Code needs to be agnostic, and not pick winners and losers.

In conclusion, we look forward to working with policy makers to continue to be a resource on the way forward that allows old and new companies with American headquarters to succeed today and into the future. Thank you.

[The prepared statement of Mr. Hayes follows:]

**Testimony of
Mr. Gregory J. Hayes
Senior Vice-President and Chief Financial Officer
United Technologies Corporation**

**Before the
Committee on Ways and Means
U.S. House of Representatives**

**Hearing on
The Need for Comprehensive Tax Reform to Help American
Companies Compete in the Global Market and Create Jobs for
American Workers**

May 12, 2011

Chairman Camp, Ranking Member Levin, and members of the Committee on Ways and Means, it is a privilege to be here to testify on the need for pro-growth tax reform. I am here as the chief financial officer of an established American manufacturing firm that does business, and aims to succeed, around the world.

BACKGROUND ON UTC

United Technologies Corporation (UTC) is an American company with headquarters in Hartford, Connecticut. We provide high-technology products and services to the global aerospace and building systems industries through our diverse business units:

- Carrier heating, air-conditioning and refrigeration solutions;
- Hamilton Sundstrand aerospace and industrial systems;
- Otis elevators and escalators;
- Pratt & Whitney jet engines;
- Sikorsky helicopters;
- UTC Fire & Security systems and services; and
- UTC Power fuel cells.

Our company identity stems from our history of having been built by inventors. Many of our business units are named after pioneers whose innovations transformed the way people live and work. Gifted inventors like

Willis Carrier, Elisha Graves Otis, and Igor Sikorsky laid the foundation of United Technologies and left a legacy of innovation that our 205,000 employees continue to this day.

In addition to being an iconic American company, UTC is truly a worldwide organization. About 40% of our sales are earned in the United States, and the remaining 60% in other countries. The location of our workforce roughly tracks this split of sales. UTC has over 4,000 facilities across 71 countries. The company conducts business in virtually every country in the world as well as in all 50 states.

With this scale comes the ability to make positive contributions in the marketplace and communities where we invest. Last year, UTC spent \$3.6 billion on company and customer funded research and development, the lion's share in the U.S. We exported over \$7 billion in products and services. We match our employees' charitable contributions through various giving programs to many worthy causes. Through our Employee Scholar program, UTC has invested nearly \$1 billion to fund more than 30,000 educational degrees with no time commitment or financial payback required.

TAX CHALLENGES FOR U.S. COMPANIES IN A COMPETITIVE WORLD

Worldwide Taxation, High Statutory Rate

UTC is a publicly traded, NYSE listed, Fortune 50 enterprise. We are organized and pay taxes as a corporation. Because we are an American company, we are subject to tax on our worldwide income, no matter where it is earned, at the federal corporate tax rate of 35%. Combined with state income taxes, the U.S. statutory income rate imposed on corporations hovers at or near the highest among all developed economies. If the rate-lowering trend of our trading partners continues, the U.S. may soon, to its peril, be "number one."

These facts present a competitive difficulty that is becoming more and more typical for U.S.-based firms doing business around the world. That is, our non-U.S. competitors generally only pay taxes in the country in which their income was earned. They pay little or no taxes in their home country on overseas earnings.

The U.S. system for taxing its corporate citizens on their global income, even with the deferral feature, is an outdated remnant that inhibits our ability to compete globally and discourages reinvestment of overseas earnings in the United States. In fact, our system actually hinders success. It was designed when the U.S. was the dominant economy, and before globalization became an unmistakable market reality.

Policy Uncertainty

In today's global economy, capital is mobile. Competition is everywhere, and so are the growth markets where we need to compete in order to succeed. In such an environment, the focus of the tax code should be on the most efficient way to generate the revenue necessary for the government while allowing American companies to contend for business in markets around the world. Unfortunately, U.S. tax policy uncertainty acts more as an impediment to success than an enabler of it.

The R&D credit is a perfect example. In 2010, for the fourteenth time, this credit was allowed to expire. It was not re-enacted until December 17, when it was retroactively reinstated. These developments created a situation in which decisions on our most important investments, those that create intellectual property and innovation, had to be made without regard to the potential tax credit. Not only does this approach to tax policy undermine business decisions, it undermines prospects for American workers by inadvertently encouraging the migration of engineering and development activities to countries with more predictable, more favorable tax treatment.

Another example of uncertainty that is directly related to international competitiveness is the tax code provision known as "CFC look-through." This provision facilitates the kind of modern organizational structures that UTC and other companies use in their worldwide operations, managing debt and other financial activities on a regional basis. From a corporate treasury perspective, it allows capital to be put to its most efficient use. Active earnings under this provision can cross a country border within the regions where we operate, such as in Western Europe or Asia, without triggering a U.S. tax consequence.

Unfortunately, the CFC look-through provision is also subject to the annual extender legislation process. The uncertainty created by legal lapses and

short-term extensions is a hindrance to growth, efficiency, and sound planning. In the business world, a company that delivered on its promises more than eleven months late or kept its customers wondering what it could and could not do would feel marketplace consequences. Similarly, taxpayers need to know what they can and cannot count on in the tax law.

Tax Complexity

The complexity of our tax system is another costly hindrance to sound business planning. Because of its size, UTC is under continuous IRS audit. At any given time there are ten to twelve IRS agents on site at our headquarters, full time, year round. Our federal tax return is almost 19,000 pages. And that's just federal income taxes.

Complying with the tax laws is UTC's obligation as a corporate citizen. Our core ethical values are paramount, and compliance with laws and regulations is non-negotiable. But doing so comes at a price in terms of the time and productive resources that could otherwise be more efficiently employed. Simplifying the tax code where possible would drive down costs and make meeting our obligations less cumbersome. The U.S. economy, the government, and taxpayers would all benefit.

Tax Policy Impediments to Growth

The anti-competitive tax burdens which the United States places on its own companies become apparent when those companies attempt to grow through acquisition.

I was recently asked on an analyst call about a rumor that UTC would acquire a company with Swiss headquarters. It was not a tax question, but it inadvertently raised serious tax policy issues. According to the most recent OECD listing, Switzerland's income tax rate is 18 percentage points lower than that of the U.S. Furthermore, Switzerland only taxes income earned within its borders; earnings brought home from other jurisdictions are not taxed. By contrast, profits brought home by a U.S. corporation from its worldwide operations are subject to a top-up tax at 35%.

The answer to the analyst's question was obvious: as an American firm, UTC would be disadvantaged in trying to buy the Swiss company. The favorable tax characteristics of the target company would be lost if it

suddenly became a subsidiary of a U.S. parent. In short, the tax drag would kill the deal. A more likely result would be that a foreign buyer would win the opportunity to acquire the Swiss company. They, not the American firm, would reap the benefits that could include increased market share, access to a key supplier, greater cost synergies, or efficiency gains.

This example is representative of the challenges American companies face regularly. At UTC, our business units grow by developing game-changing technologies and providing superior value to customers, but they also look for opportunities to grow through acquisitions. Strategic acquisitions create opportunities for all of our stakeholders: employees, suppliers, communities, and shareowners. Yet in pursuing these opportunities, American companies bear a tax cost that their foreign competitors do not.

For American worldwide companies, the sad result of these structural defects in the tax system, over the long run, is that those who cannot win opportunities for growth abroad will inevitably shrink their capacity to export, see fewer headquarters and support positions at home, reduce their footprint in the marketplace, and curtail business for their local supply networks, which are often small and medium-sized companies. What is needed is a tax code that puts the U.S. on an equal footing with the competition.

USING SOUND PRINCIPLES TO FIND TAX REFORM SOLUTIONS

Many tax experts, academics, practitioners, and taxpayers have testified and provided input into the tax reform process, and many more will do so as these issues continue to be examined. As Congress considers changes to the tax system, my perspective as a finance officer leads me to offer the following recommendations:

- 1) Remember economic fundamentals.
- 2) Benchmark.
- 3) Take a measured approach.

In business, decisions are made after considering many factors, but must rest on economic fundamentals. We cannot ignore economics if we are going to plan for successful results over the long term. Similarly, policy makers should know that the worldwide imposition of tax (even with

deferral), the costs of complexity and uncertainty, and the distortive impact of narrowly focused policy choices have consequences that are not conducive to job creation. It follows that fixing these problems will make American companies more competitive.

The second recommendation, benchmarking, goes hand-in-hand with the first. When UTC's businesses are trying to solve a problem or improve a process, we benchmark against our peers and those companies known for excellence. We look for best practices, then we try to emulate them with adjustments for our own facts, culture, values, and circumstances. A benchmarking exercise comparing the United States with other countries on how we tax businesses would reveal the unmistakable fact of the high U.S. income tax rate, whether statutory rates or effective rates are examined. It would also show how uncompetitive the U.S. is with its worldwide system and insistence on reaching around the globe to tax its home companies.

Clearly, a better system can be designed. It doesn't have to be perfect. There are various ways a territorial system could be implemented that would vastly improve American efficiency and reduce the current prohibitive cost on bringing home income earned abroad. But it should be a system that is competitive with our trading partners.

Disallowing legitimate expenses incurred here would be a job-killing mistake, replacing one set of special burdens on American companies for another. Likewise, keeping the current system, but repealing deferral, would make the U.S. even more of an outlier than it is today. If Congress follows sound benchmarking practices, tax reform will produce a growth-oriented tax system that draws wisdom from other jurisdictions but is still uniquely American.

Finally, I would urge the Congress to take a measured and balanced approach in legislating on tax reform. An open process such as the hearing today, allowing a comment period when drafts are released, and continuing bipartisan discussions will help create a final product with the potential to attract broad support. In this effort, the perfect should not be the enemy of the good, and the good will broadly benefit the American economy.

UTC is aligned with the broader business community when we say we don't want tax reform to overburden the U.S. Treasury. We're committed to a fiscally responsible approach. We want rules in place to prevent tax evasion. We know we have to give up some current benefits in order for tax reform to succeed. We hope that political name-calling can be filtered out. American companies should not be punished for serving global customers or succeeding in multiple markets.

By adopting a businesslike problem-solving approach, policymakers can design a tax system that balances the government's obligations with the goals of providing greater tax certainty, reducing complexity, and improving American competitiveness.

CONCLUSION

It is time to modernize the U.S. tax system. Reforms should be agnostic, avoid picking winners and losers, and acknowledge the reality of globalization without punishing the business community. Having competitive tax rates and a competitive territorial system are worthy goals that ultimately increase confidence, create certainty, and ensure good jobs for America. These reforms will enable both old and new companies with American headquarters to succeed today and in the future, sharing their products, services, talents and technologies with the world.

Thank you.

Chairman CAMP. Thank you, Mr. Hayes. I will now yield to Mr. Schock of Illinois to introduce Mr. Rapp of Caterpillar.

Mr. SCHOCK. Thank you, Chairman Camp, and thank you for hosting this very important hearing. It is my honor to introduce to the committee Mr. Ed Rapp, the chief financial officer of Caterpillar, Incorporated, located in my hometown of Peoria, Illinois.

Mr. Rapp joined Caterpillar in 1979, and has held a variety of positions related to pricing, production scheduling, marketing, dealer development, manufacturing, and product development. Additionally, he worked for Cat Around the World, in such places like

Johannesburg, South Africa and Geneva, Switzerland, where he was the Europe region manager.

In 2000, Ed became an officer of Caterpillar, as the vice president of the Europe, Africa, Middle East marketing division, and he became a Caterpillar group president in 2007. Mr. Rapp has a bachelor's in finance from the University of Missouri, Columbia, and is a graduate of the University of Illinois executive development program.

Ed, it is great to have you in Washington. On behalf of the committee, welcome. We look forward to your testimony.

Chairman CAMP. Thank you, Mr. Schock.

Mr. Rapp, you are recognized for five minutes.

STATEMENT OF EDWARD J. RAPP, GROUP PRESIDENT & CHIEF FINANCIAL OFFICER, CATERPILLAR, INC., PEORIA, ILLINOIS

Mr. RAPP. Thank you. Chairman Camp, Ranking Member Levin, and Members of the Committee, it is really a pleasure to be here, and have the opportunity to talk about tax reform.

Just as background on Caterpillar, in 2010 our sales and revenues were about \$42.6 billion, and we expect that number to exceed \$50 billion in 2010. Foreign markets account for about 70 percent of our revenues, and are the fastest growing. Our success stems from our ability to compete globally from a significant U.S. production base. In 2010 our exports exceeded \$13 billion, which was roughly equal to our total U.S. sales. And half of the \$3 billion that we are spending this year in capacity expansion will be invested in the United States.

We directly employ about 47,000 employees, after adding 7,000 over the last 12 months. Our dealer network employs another 34,000. And in 2010 we invested \$4 billion with about 4,900 small and medium-sized businesses, making them a key part of our exports and our global supply chain.

Before I explain more, let me just say up front I didn't come here asking for a free lunch. What we are asking for is a level playing field as we compete with foreign competitors.

We believe a key to our nation's competitiveness is the success of American companies with worldwide operations. Numerous studies indicate that U.S.-based companies with worldwide operations are critical to the health and growth and potential of the U.S. economy. We also believe that Americans cannot enjoy a high standard of living without manufacturing being a pillar of the U.S. economy.

To continue to win in worldwide markets we need a level playing field. Unfortunately, the U.S. Tax Code too often tilts the field against us. Other OECD nations that have dropped their tax rates an average of 19 points since the 1986 reform.

What does it mean for Caterpillar? Let me just give you a couple of examples. In China, the corporate tax rate is 25 percent. If Caterpillar earns \$1,000 there, we pay \$250 in taxes. And if we bring the money back to the U.S. we pay another \$100 in taxes. A UK competitor selling in China would pay the \$250 in taxes, and the balance, that \$100, they can use to price discount for market share or invest in R&D.

But perhaps the biggest challenge we have is just the lack of consistency over time. We have had to deal with 14 extensions to the R&D tax credit over the past 30 years. We commit to financing contracts over periods of four to five years, but can't predict our tax cost over that time, due to the continually expiring active financing exception. And while our global competitors freely move capital between countries, we have to deal with incredible complexity and the potential of added tax costs.

You know, my intent here is to be constructive. And I would like to provide an outline of what we think are some of the key opportunities.

You know, in our business, when we have to assess our competitiveness versus a key competitor, we take a simple approach. We buy their machine, we run it through its paces, and we tear it down. We gain a complete understanding of how it compares to our equipment, and what we have to do to maintain our competitive edge.

Mr. Chairman, I would encourage you to do a foreign Tax Code tear-down. There are valuable lessons to be learned that would be instructive as you look to make improvements to the U.S. system.

As we look around the world, we see common characteristics that we believe ought to be part of any tax reform. First, lower the corporate tax rate, which encourages businesses both at home and abroad to invest in the U.S. Second is implementation of a territorial tax system like the rest of the industrialized nations. Third, provide the incentives for the development and retention of intellectual property. And, lastly, give serious thought to the types of jobs you want.

You know, other countries have given this serious consideration, and built their tax structures around the desire to maintain manufacturing as a base, versus moving strictly to services-based economies.

Mr. Chairman we are really betting on you and your colleagues to get this right. Although we have opportunities around the world, we are heavily invested in the United States through bricks and mortar, through R&D, and more importantly, through our American workforce. We believe that we can compete and win in the global markets against any competitor, foreign or domestic. We just need the level playing field that only you can provide.

Thank you for the opportunity to present my views, and I look forward to the discussions and questions from Members of the Committee.

[The prepared statement of Mr. Rapp follows:]

Testimony of Mr. Edward J. Rapp
Group President & CFO
Caterpillar Inc.
Peoria, Illinois

U.S. House of Representatives
Committee on Ways & Means

Hearing on the Need for Comprehensive Tax Reform to Help
American Companies
Compete in the Global Market and Create
Jobs for American Workers

Thursday, May 12, 2011
1100 Longworth House Office Building
Washington, D.C.

Chairman Camp, Ranking Member Levin and Members of the Committee:

I am Ed Rapp, Group President and Chief Financial Officer of Caterpillar Inc. based in Peoria, Illinois. Thank you for the opportunity to present our views on corporate tax reform. It's truly a critical topic that needs to be addressed when considering how to make the United States a more attractive place to invest and create jobs and how to help keep U.S.-based businesses competitive in the global economy.

For more than 85 years, Caterpillar Inc. has been making sustainable progress possible. Caterpillar is the world's leading manufacturer of construction and mining equipment, diesel and natural gas engines, industrial gas turbines and diesel-electric locomotives. The company also is a leading services provider through Caterpillar Financial Services, Caterpillar Remanufacturing Services, Caterpillar Logistics Services and Progress Rail Services. We are headquartered in Peoria, Illinois and have manufacturing facilities, distribution facilities and offices across the United States. In 2010, Caterpillar's sales and revenue totaled \$42.6 billion, and we expect that number to exceed \$50 billion in 2011.

Much of our success stems from our ability to successfully compete globally from a significant U.S. production base. Approximately 70 percent of our 2010 sales were outside the United States, and we had \$13.4 billion in export sales, roughly equal to our U.S. sales. Our global business supports our operations and people in the United States. We directly employ 47,000 people in the United States, our dealer network employs an additional 34,000. We've added more than 7,000 people to our U.S. workforce in the past year. In 2010, we purchased nearly \$4 billion from more than 4,900 small and medium-sized businesses¹ in the U.S., making them a key part of our global supply chain. This year, we estimate that we will purchase closer to \$5 billion from these firms, making them significant contributors to our exports.

Competing and Winning from the United States

The fundamental question at hand for Congress is this: how do we advance the long-term global competitiveness of the United States? For Members of the Ways and Means Committee, I believe that requires making long overdue reforms to the U.S. tax code.

Before I explain more, let me say I did not come to Washington to ask for a free lunch. I am not asking for special treatment, but am simply asking for a level playing field versus our foreign competitors.

As a business, we've had to adapt to effectively compete in today's fast changing global economy. We are constantly improving how we design, build and support our products to compete with strong global competitors. Everything we have done in the past

has to be evaluated through a new lens, and policy decisions need to be looked at differently too.

We believe one of the keys to our nation's competitiveness is the success of worldwide American companies. Furthermore, we believe that Americans cannot enjoy a high standard of living without manufacturing being a pillar of the U.S. economy.

From the earliest days as a company, Caterpillar's success has been built upon our ability to compete in markets at home and abroad. We decided more than 60 years ago not to give any competitor free rein in its home market. That decision led us to build the global manufacturing footprint that continues to serve us well today. While our business has grown globally, at the same time we firmly believe that manufacturers can compete and win from a strong U.S.-base. In fact, we are heavily investing to expand U.S. capacity. In 2011, we'll invest roughly \$3 billion in our facilities, with \$1.5 billion of that in the United States. This has a multiplier effect when you consider the significant investments also being made by our suppliers and dealers from across America to support our plans for growth. We want to continue to invest more here at home and, with your help, we are convinced we can carry the philosophy forward.

Caterpillar's story is not unique. By every important measure, U.S.-based companies with worldwide operations are vital to the U.S. economy. Roughly 25 percent of the U.S. Gross Domestic Product (GDP) comes from these firms and, when you include their U.S. supply chains, it is nearly 50 percent of the U.S. GDP. Worldwide American companies and their suppliers also comprise nearly 42 percent of the jobs in the U.S. and 46 percent of payroll. U.S. multinationals also create jobs that pay nearly 24 percent better than U.S. companies with domestic-only operations.ⁱⁱ Worldwide American companies alone account for more than 74 percent of the research and development done by U.S. firms, worth more than \$200 billion in 2007.ⁱⁱⁱ

The numbers are clear—U.S.-based companies with worldwide operations are critical to the health and growth potential of the U.S. economy. The fact that you called this hearing demonstrates to me the commitment of Congress to help these companies compete through good economic and tax policy.

Global Competition for Capital

Mr. Chairman, you and I have similar challenges. As a company, we have strong and emerging global competitors. As we work hard to compete, we have to provide our customers with a competitive mix of a great product supported by outstanding service. To the degree we do this successfully, we attract capital to our business which leads to growth, profitability and jobs. As a country, our position relative to the rest of the world has changed and we too have strong and emerging global competitors. Since the end of World War II, the U.S. share of GDP fell from 40 percent to 20 percent in purchasing power parity terms. There are emerging countries that want our jobs and our standard of living.

At the same time, those emerging countries and their billions of people represent potential customers for Caterpillar and other U.S.-based firms. We are in those overseas markets because of the growth potential that it represents for Caterpillar sales. If we cannot compete in those foreign markets, our competitors will gain an advantage they will use to attack us here in the United States.

Again, this is no free lunch. We know we will have to continue to work hard to compete and, to the degree we do this successfully, we can attract capital to our company, which will lead to growth, prosperity and jobs. The same opportunity exists for our country.

Tax Code Hinders U.S. Companies

For Caterpillar to continue to be able to compete and win in markets around the world, we need a level playing field. Unfortunately, the U.S. tax code too often tilts the field to the advantage of our growing foreign competitors.

In 1986, the United States took a major step forward when we established a competitive corporate tax rate relative to other countries around the world. However, while we have done little to change since the mid-1980s, other nations of the Organisation for Economic Co-operation and Development (OECD) have dropped their tax rates an average of 19 percentage points during that time.^{iv} In 2011, the U.S. maintains one of the highest corporate tax rates in the world and is one of the few remaining countries with a worldwide tax system.

What does that mean for Caterpillar? The high tax rate and worldwide system puts us at a competitive disadvantage against foreign competitors in markets both at home and abroad. It also creates inefficiencies in the way we allocate capital in the United States and around the world. The temporary nature of important tax provisions like the R&D tax credit, active financing exception and look-through also makes it difficult to make long-term business investments with any certainty of our future cost of taxes.

Let me give you some examples.

- In China, the corporate tax rate is 25 percent. If Caterpillar earns \$1,000 there, we pay \$250 to China. If we bring that money back to the U.S., we must pay another \$100 to the U.S. Treasury, bringing the total tax rate to 35 percent. However, if a competitor from the U.K. earns \$1,000 in China, it pays only the \$250 Chinese tax. The U.K., with its territorial system, taxes only the corporate income earned inside its borders. Thus our competitor has \$100 more of profit that can be used for price discounts to grow market share or to invest in capacity or R&D.

- Caterpillar Financial Services Corporation provides financing for Cat equipment all over the world, including products exported from the United States. We've found that Cat Financial gives us an important competitive edge in the market place because they better understand the value of our equipment. The active financing exception allows us to defer the U.S. tax on income earned on financing Cat sales in foreign markets in order to be competitive with local financing options. However, the exception has lapsed and, even when extended, it is only for a couple of years at a time. On a five-year financing contract, we cannot predict whether the exception will be in place over the life of the deal.
- Given the global markets Caterpillar is serving, we need to be able to move capital around the world to meet business needs. Unfortunately, moving cash from a German subsidiary to a French subsidiary, or back to the United States, could cause a U.S. tax. While look-through and foreign tax credits can mitigate that tax hit, it requires implementing complicated and costly monitoring and plans. Conversely, our competitors from countries with territorial systems can deploy capital around the world as needed without the added costs of taxes, or complicated and costly planning.
- Caterpillar spent a record \$1.9 billion on R&D in 2010 and will spend more than \$2 billion in 2011. But the U.S. R&D tax credit is a temporary provision that has been extended 14 times over the past 30 years, often retroactively. This lack of predictability means we cannot include the benefit of the credit in our business plans. Instead, the credit ends up working like a surprise tax refund. Officials from taxing authorities all around the world regularly visit our offices to offer more generous and predictable tax incentives to do research in their country.

As Caterpillar's CFO, I am not a tax expert, but having lived and worked around the world I do understand global competitiveness. I know if Caterpillar doesn't adapt to meet changing market conditions, we won't attract capital to grow our business and create new jobs. The same is true for the United States and our economy.

Recommendations for Tax Reform

I'd like to provide an outline of what we consider a viable way forward. We believe the U.S. economy would benefit tremendously from the right kind of corporate tax reform. While the United States doesn't need to model its tax system on any one country, we do need a tax system that looks more like the rest of the industrialized world.

In our business, when we want to assess our competitiveness versus a key competitor, we take a very simple approach. We buy one of their machines, take it to a

test facility and tear it down. As our technicians dismantle the machine, they learn how it compares to a similar Cat product. If we find our competitors have better features or a lower cost, we go back and make improvements to our own machines in order to maintain our competitive edge.

Mr. Chairman, as your Committee continues its work on tax reform, I would encourage you to do a foreign tax code tear down. There are valuable lessons to be learned from tax reform efforts undertaken by other nations in recent years that would be instructive as you look to make improvements to the U.S. system.

As we've looked at tax systems around the world, we see common characteristics we believe ought to be part of any tax reform in the United States.

First, lower the corporate tax rate. As other nations have realized, a significant cut to corporate tax rates would encourage businesses both at home and abroad to invest in the United States.

Second, do away with the worldwide structure and implement a territorial tax system like those in most other industrialized nations. This would provide a level playing field for American companies competing in markets at home and abroad.

Third, provide incentives for the development and retention of intellectual property. By enhancing and making permanent the R&D tax credit, the United States could have a world-class research incentive.

Lastly, give thought to the type of jobs you want in the United States. Other countries have given this serious consideration and built their tax structures around a desire to maintain a manufacturing base versus moving strictly to services-based economies. You need to think this through.

Comprehensive tax reform that addressed these four issues would give us the level playing field we need. Furthermore, making these reforms permanent would give us stability and predictability needed to make long-term plans and investments in the United States.

Conclusion

Mr. Chairman, Caterpillar and its employees, dealers, suppliers and investors are betting on you and your colleagues to get this right. Although we have opportunities around the world, we've invested heavily in the United States through bricks and mortar, research and development and, most importantly, our American workforce. We believe that we can win in global markets and compete with any competitor—foreign or domestic. We just need the level playing field that only you can provide.

Thank you for the opportunity to present my views. I look forward to the discussion and questions from Members of the Committee.

ⁱ Businesses with 500 or fewer employees.

ⁱⁱ Business Roundtable, *The United States Economy Depends on Worldwide American Companies*, July 2009.

ⁱⁱⁱ Matthew J. Slaughter, *How U.S. Multinational Companies Strengthen the U.S. Economy*, March 2010.

^{iv} PricewaterhouseCoopers LLC, *International Comparisons of Statutory and Effective Corporate Tax Rates*, April 27, 2011.

Chairman CAMP. Well, thank you very much, Mr. Rapp. I will now yield to Mr. Paulsen of Minnesota to introduce Mr. Crines of Zimmer.

Mr. PAULSEN. Thank you, Chairman Camp. I appreciate the opportunity also to introduce one of our witnesses, Jim Crines, who is the CFO of Zimmer, a medical technology company whose spine division is actually headquartered in Minnesota, in my district.

Over the years, Zimmer has gone through much change, from being spun off from Bristol-Myers Squibb to acquiring a large foreign competitor. And since 2001, Zimmer grew U.S.-based jobs by 80 percent. And I believe we do need a Tax Code that is going to allow companies like Zimmer to continue to grow and be internationally competitive.

Mr. Crines has been with the company since 1997. I look forward to his testimony, his ideas, his thoughts, and advice. And I thank him for being here today, Mr. Chairman.

Chairman CAMP. Thank you very much. You are recognized for five minutes, Mr. Crines.

STATEMENT OF JAMES T. CRINES, EXECUTIVE VICE PRESIDENT, FINANCE, AND CHIEF FINANCIAL OFFICER, ZIMMER HOLDINGS, INC., WARSAW, INDIANA

Mr. CRINES. Congressman Paulsen, thank you for the introduction and your support for the medical device industry. Mr. Chairman, Ranking Member Levin, and distinguished members of the Ways and Means Committee, I appreciate the opportunity to present the views of Zimmer Holdings, Inc. on the need for reform of our nation's corporate tax laws.

Zimmer is a global leader in the design, development, manufacturing, and marketing of orthopedic reconstructive devices, spinal and trauma devices, dental implants, and related surgical products. Zimmer is a member of the medical device competitiveness coalition, which consists of seven U.S.-based medical device manufacturers that have been working together the last 18 months on the very topic of this hearing: comprehensive tax reform to help American companies compete in the global market, so that U.S. multinational firms are no longer placed at a competitive disadvantage to their foreign counterparts. And the U.S. will be a more attractive location for investment.

While the United States is currently the world leader in medical device innovation and manufacturing, the U.S.-based medical device industry faces both immediate and longer-term challenges from foreign competitors. Many foreign countries offer significant incentives to attract research and development, as well as manufacturing. Additionally, most of our foreign competitors are headquartered in countries with both lower tax rates and territorial tax systems.

Growing overseas has a positive impact on the U.S. economy and U.S. jobs. For example, as Zimmer expanded overseas from 2001 to 2010, we increased U.S.-based employment by 80 percent. These laws should be designed to support the global growth and competitiveness of American companies, and encourage those companies to reinvest their foreign profits in the United States without additional taxation.

We believe the following principles should guide any reform: the U.S. tax system should transition to a territorial tax system; reform should focus on simplicity; tax reform should retain incentives that encourage research and development, as well as manufacturing in the U.S.

To accomplish these goals, we recommend the adoption of tax laws, again, that move the U.S. system towards a territorial tax regime consistent with the approach utilized by the overwhelming majority of our major trading partners. Under a territorial tax system, U.S. companies like Zimmer will have the ability to access our foreign resources for investment here, in our home country. This would eliminate the so-called lock-out effect inherent in today's U.S. tax system.

We realize that the development of a territorial tax system in the United States raises numerous design issues. Additionally, it is important that policy makers modernize our current system, while retaining safeguards to prevent erosion of the U.S. tax base. We support a simplified approach that ensures the appropriate level of expenses are allocated to repatriated foreign earnings. Our approach would provide for a proxy in place of complex expensive allocation rules. Most countries with territorial tax regimes have adopted this approach, which imposes a tax on a small portion of repatriated foreign earnings. Such an approach would simplify the U.S. Tax Code.

Another important issue that must be considered in the context of moving towards a territorial tax system is the retention of incentives for U.S.-based research and development, as well as manufacturing. A number of countries in Europe have begun to implement such incentives, in addition to having lower corporate tax rates within their territorial systems. Appropriately designed incentives could create a meaningful carrot for U.S. companies to retain high-paying and important research and development jobs in the United States.

On behalf of Zimmer, I would like to thank the Ways and Means Committee for the opportunity to provide views on proposals to modernize this country's corporate tax laws by beginning a comprehensive examination of our nation's corporate tax laws and the impact they have on our global competitiveness. Your committee is undertaking a difficult, controversial, but fundamentally important task. We look forward to working with the committee and other tax policy makers as this effort moves forward.

[The prepared statement of Mr. Crines follows:]

TESTIMONY OF JAMES T. CRINES

EXECUTIVE VICE-PRESIDENT, FINANCE AND CHIEF FINANCIAL OFFICER OF ZIMMER HOLDINGS, INC.

BEFORE THE

COMMITTEE ON WAYS AND MEANS

HEARING ON INTERNATIONAL TAX REFORM ISSUES

MAY 12, 2011

Mr. Chairman, Ranking Member Levin and distinguished members of the Ways and Means Committee, I appreciate the opportunity to present the views of Zimmer Holdings, Inc. ("Zimmer") on the need for reform of our nation's international tax laws.

My name is Jim Crines. I am the Chief Financial Officer of Zimmer, a global leader in the design, development, manufacture and marketing of orthopaedic reconstructive devices, spinal and trauma devices, dental implants and related surgical products. Our history dates to 1927, when Zimmer Manufacturing Company was founded in Warsaw, Indiana, which remains the location of our world headquarters. For 2010, Zimmer reported global net revenues of over \$4 billion and employed approximately 8,000 people worldwide. More than half of Zimmer's revenues and workforce are attributed to the United States.

Zimmer is a member of the Medical Device Competitiveness Coalition, which consists of seven U.S.-based medical device manufacturers that have been working together the last 18 months on the very topic of this hearing: How should Congress modernize and improve the U.S. international tax rules so that U.S. multi-national firms are no longer placed at a competitive disadvantage to their foreign counterparts. Zimmer, as part of the Medical Device Competitiveness Coalition, supports international tax reform that transitions the U.S. international tax system from a 'worldwide' towards a 'territorial' system. Such a system would permit companies to deploy funds for business-driven purposes without overly burdensome tax penalties, making the United States a more competitive home country for U.S.-based medical device companies, leading to increased investment in U.S. based operations.

In this testimony, I will provide a brief overview of the medical device industry, discuss how corporate tax rates factor into investment decisions, and will make the following recommendations that, if adopted, would make U.S.-based companies like Zimmer more competitive globally and would make the United States a more attractive place for investment: (1) The United States should move from its current worldwide tax system towards a territorial tax system; (2) Until a territorial tax system is established, the United States should maintain its current deferral system, which allows U.S.-based companies to defer paying U.S. tax on foreign earnings until these earnings are repatriated to the United

States; and (3) Additional tax-related incentives should be established, such as permanent expansion of the R&D tax credit, domestic retention of intellectual property developed in the United States, and lower corporate tax rates.

The U.S. Medical Device Industry

U.S. medical device manufacturers lead the world in the design and development of innovative devices that save and improve the lives of patients around the world. Zimmer is committed to U.S.-based research and manufacturing. In 2010 we spent approximately 75 percent of our 220 million research and development dollars here in the United States. Moreover, the large majority of our global manufacturing operations are based here in the United States. In addition to Indiana, Zimmer has operations in Ohio, California, Minnesota, New Jersey, and Texas.

While the United States is currently the world leader in medical device innovation and manufacturing, the U.S.-based medical device industry faces both immediate and longer-term challenges from foreign competitors. As this Committee is well aware, many foreign countries offer significant incentives to attract foreign direct investment in research and development as well as manufacturing. Additionally, most of our foreign competitors are headquartered in countries which offer corporate tax systems that provide those companies with a competitive advantage. These countries have lower corporate statutory tax rates than the United States, as well as more favorable rules for taxing the international income of their headquartered companies. In almost all cases, these foreign tax systems employ a territorial approach to the taxation of foreign earnings, as opposed to our worldwide system for taxing international profits.

Of particular concern to Zimmer, this tax imbalance has been exacerbated by the recent enactment of the 2.3% medical device excise tax contained in last year's health care reform law. When this new tax becomes effective in 2013, it will significantly raise the cost of doing business for Zimmer in the United States. If we include the impending excise tax with the corporate income tax, our U.S. effective tax rate would be nearly three times our foreign effective tax rate of 15 percent. Already, we have been forced to restructure our U.S. operations to position Zimmer to allow us to offset this impending cost. The restructuring measures have forced us to eliminate less profitable product lines and restrict growth-oriented investment, often leading to loss of both current and future employment opportunities. Other medical device companies have recently announced similar restructuring initiatives.

U.S. International Tax Laws a Key Factor in Zimmer's Ability to Be Globally Competitive

As Chairman Camp pointed out in announcing this hearing, today's global economy bears little resemblance to the global economy of 1961, when the framework of our nation's international tax laws was enacted. In 1961, Zimmer was primarily focused on the U.S. market; today, by contrast, we sell products in over 100 countries. More than 42 percent of our revenues come from overseas markets, up from less than 33 percent in 2001, helping Zimmer's revenues grow from \$1 billion in 2001 to over \$4 billion in 2010. Approximately 70 percent of our overseas revenue is generated from products manufactured in the U.S. and Puerto Rico. Many of our U.S.-based research and development and manufacturing jobs are dependent on our continuing success in foreign markets, with U.S.-based jobs

growing about 80 percent from 2001 to 2010. In today's world, few U.S. companies that seek to manufacture and sell cutting edge technological products can survive, let alone prosper, by failing to compete effectively in overseas markets.

The global nature of our business and the highly specialized nature of our products make it vitally important that we also locate certain business operations outside the United States – product exportation alone is not feasible. Companies like Zimmer must continue to innovate in order to improve patient care and meet the unique needs of local markets. That requires that we operate close to our customers, both within and outside the United States.

Zimmer believes that the tax laws of the United States should not penalize American companies for operating in global markets. Rather, these laws should be designed to support the global growth and competitiveness of American companies, and encourage those companies to re-invest their foreign profits in the United States without additional taxation. Zimmer's foreign headquartered competitors do not operate under tax systems that impose such steep barriers to the repatriation of foreign earnings. Moreover, our foreign competitors are headquartered in countries that offer significantly lower corporate tax rates than the United States federal rate (35%) and combined federal/state rate (38%-40%).

Zimmer Supports the Movement Towards a Territorial Tax System

As part of the Medical Device Competitiveness Coalition, Zimmer has examined numerous options for modernizing the U.S. international tax system in a manner that takes into consideration the specific issues relevant to U.S.-based medical device companies that serve global markets. Some preliminary observations from this analysis are set forth below.

We would recommend the adoption of international tax laws that move the U.S. tax system towards a territorial tax regime – consistent with the approach utilized by the overwhelming majority of our major trading partners – by generally exempting from U.S. tax dividends from our foreign subsidiaries, or controlled foreign corporations (CFCs). A dividend-exemption approach would enable U.S. corporations to address capital needs in one jurisdiction (including the United States), by tapping excess liquidity in other jurisdictions without imposing a U.S. tax penalty. This would eliminate the so-called “lock out effect” inherent in the existing U.S. system that often makes it too costly to repatriate earnings to the United States. A territorial system would enable companies to deploy funds in an economically rational manner without overly burdensome tax penalties, making the United States a more competitive home country for medical device companies, in turn, leading to increased investment in productive U.S.-based operations.

We realize that the development of a territorial tax system in the United States raises numerous design issues. Policy makers need to balance the desire to modernize, rationalize, and simplify our current system while establishing safeguards to prevent erosion of the U.S. tax base. Some argue, for example, that a system that exempts foreign dividends from U.S. tax must include complicated expense allocation rules to ensure that certain U.S. expenses, incurred to benefit the global organization, are allocated to the “exempt” foreign earnings and, thus, are not deducted in the U.S. Many countries have examined

such an approach and found it wanting, in part because the rules are far too complicated to implement and administer, and also because they will result in some home country expenses not being deductible in any jurisdiction. Inevitably, such tax complexity results in significant government resources expended on tax administration and litigation. In order to avoid these problems, some countries have adopted an alternative approach that, among other things, imposes home country tax on a small portion of a company's foreign earnings as a proxy for detailed expense allocation rules. We would agree that a proxy U.S. tax on a percentage of foreign earnings is preferable to complicated and likely inexact expense allocation rules.

Importance of Deferral in a Worldwide Tax System

Zimmer and other U.S. medical device makers have managed to succeed in international markets and overcome the inherent economic costs and structural disadvantages of the U.S. corporate tax system in large measure because our rules allow us to defer paying U.S. tax on our foreign earnings until they are repatriated to the United States. This "deferral" system, a long-standing feature of our tax code, somewhat levels the tax playing field from a capital deployment standpoint. However, it produces a perverse cash-management structure because our 50-year-old tax system was designed to accommodate a way of doing business that no longer exists. We believe the current U.S. tax system (combining both a "worldwide" and "deferral" system) encourages U.S.-based multinational companies to implement highly-complex tax structures and adopt restrictive capital deployment strategies that often place significant debt within the United States, while maintaining significant levels of cash within their CFCs. Certainly such tax and treasury structures do not serve the long-term economic interests of the United States.

At Zimmer, we particularly appreciate why "deferral" is so important because it was among the critical factors that enabled us to be the winning bidder in the acquisition of a foreign-based competitor. In 2003, Zimmer prevailed in a competitive bid against a U.K.-based competitor for a leading European joint replacement manufacturer, Centerpulse AG. Absent Zimmer's ability to use the deferral mechanism within the U.S. worldwide tax system, that transaction would likely not have occurred since Zimmer's *after-tax* return on capital invested would have been significantly impaired by the immediate burden of added U.S. taxes. Our U.K.-based competitor would have been positioned to provide the best offer and thus obtain control of Centerpulse. By winning the bid, Zimmer significantly expanded its overseas operations, and from 2003 to 2010 grew U.S. research and development jobs by more than 50 percent, and grew U.S. manufacturing jobs by 36 percent. It is highly unlikely that this U.S. expansion would have occurred had Centerpulse been acquired by a U.K.-based company.

Ensuring Continued U.S. Innovation

Another important issue that must be considered in the context of moving to a more territorial tax system is the treatment of royalties relating to products that are created through U.S.-based research. One option is to develop an innovation-incentive regime (often referred to as a "patent box regime") to provide a reduced U.S. corporate tax rate for certain royalties earned by the U.S. company. A number of countries in Europe have begun to implement such regimes in addition to having lower corporate tax

rates within their territorial systems, but many are relatively new and deserve further study. These types of rules could create a meaningful "carrot" approach for U.S. companies to retain high-paying and important research and development jobs in the United States. Of course, another proposal, which Zimmer supports, is strengthening and permanently extending the research tax credit.

Conclusion

On behalf of Zimmer, I would like to thank the Ways and Means Committee for the opportunity to provide our views on proposals to modernize this country's international tax rules. By beginning a comprehensive examination of our nation's international tax laws and the impact they have on our global competitiveness, your Committee is undertaking a difficult, controversial, but fundamentally important task. We look forward to working with the Committee and other tax policy makers as this effort moves forward.

Chairman CAMP. Well, thank you very much, Mr. Crines.
I will now yield to Mr. Marchant of Texas to introduce Mr. Buthman of Kimberly-Clark.

Mr. MARCHANT. Thank you, Mr. Chairman. Mr. Mark Buthman is the senior vice president and chief financial officer of Kimberly-Clark Corporation in Irving, Texas. Kimberly-Clark has its world headquarters in my district in Irving, Texas, and employs 140 people there.

I am also very proud to represent Mark as a constituent of South Lake, Texas, his hometown.

And Kimberly-Clark also employs another 930 people in Texas.

Mr. Buthman joined Kimberly-Clark in 1982. Throughout his tenure he has held a wide range of leadership roles, and is an active participant in the Dallas area CFO roundtable.

I am very pleased to introduce Mr. Buthman and have Kimberly-Clark represented regarding these very important issues before the committee this morning.

Thank you, Mr. Chairman, and I yield back.

Chairman CAMP. Thank you. Mr. Buthman, you are recognized for five minutes.

STATEMENT OF MARK A. BUTHMAN, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, KIMBERLY-CLARK CORPORATION, IRVING, TEXAS

Mr. BUTHMAN. Thank you, Congressman Marchant, for that introduction. Good morning, Chairman Camp, Ranking Member Levin, and distinguished Members of the Committee. Thank you for this opportunity to share our views on the need for comprehensive U.S. tax reform.

First I want to start with a brief overview of Kimberly-Clark, and then I want to address three key opportunities to improve the U.S. tax system to increase the competitiveness of American companies as we compete in the global marketplace.

For nearly 140 years, Kimberly-Clark has been providing consumers with essentials for a better life. With brands like Kleenex, Kotex, Scott, Huggies, and Depend, we estimate that one out of every four people in the world use a Kimberly-Clark product every day.

Due to the nature of the products that we sell, which are bulky and costly to ship, our manufacturing operations need to be close to our consumers. Our products are sold in 150 countries around the world, we operate more than 100 facilities, and we employ 57,000 people worldwide. Over 15,000 of those employees are based here in the United States, with production facilities across 20 different states.

Most of the products we sell in the U.S. are developed and manufactured here. In fact, the majority of our \$300 million research and development budget is spent in the United States. The U.S. is by far our largest market, representing more than half of our sales, but the categories in which we compete are relatively mature in our country. In addition, Kimberly-Clark has a long-standing presence outside the United States, and given relatively low consumer usage of our products in those developing markets, we view this as an important growth opportunity.

Kimberly-Clark has a strong track record of investing in the U.S. through research and development, capital investment, and by paying dividends to our shareholders. In addition to supporting jobs at Kimberly-Clark, our investment generates jobs and economic activity through our suppliers and in the communities in which we operate.

To be able to effectively compete in today's global market, we need to expand and grow in the U.S. and abroad and we need a tax system that enables us to compete in the global marketplace. There are three key ways we believe our tax system could do more

to encourage investment, job creation, and economic growth in the United States.

First, we need to have a more competitive tax rate. Second, we need to move to a territorial system of taxation. And, third, we need to simplify our tax rules.

American companies have a terrific base of talent, an unrivaled track record of innovation, and some of the greatest products and brands in the world. Unfortunately, American companies face a clear disadvantage as a result of our U.S. tax system. A good first step to improving the competitiveness of the U.S. tax system would be to reduce the combined federal and state tax rate to a level comparable to the combined rates of the rest of the OECD countries. As you know, the current combined U.S. federal and state tax rate is more than 50 percent higher than the average of other OECD countries.

The second step would be to adopt a so-called territorial system which does not layer U.S. tax on the income earned overseas that has already been subject to tax in the country in which it was earned. This includes taxing dividends being returned to the U.S. and taxing royalties that are paid by foreign affiliates for U.S.-based technology and intellectual property. By eliminating this extra layer of tax, the disincentive for American companies to reinvest their foreign earnings in the U.S. would be significantly reduced.

The third way to improve our tax system would be to simplify our tax rules. The current international tax system is highly complex. This requires companies to devote significant resources to compliance activities rather than product innovation and growth. We need a system that reduces the cost of administration, reduces the risk of inadvertent error, and is easier to monitor.

To continue to prosper and be relevant for the next 140 years, Kimberly-Clark must grow our business at home and around the world. We have to be responsive to the needs and desires of our diverse global consumers, we must continue to innovate and reinvest for future growth. To do all this, we need a tax system that is competitive with global norms; which is less complex and easier to administer, a system which gives us the flexibility to manage global operations in the most efficient manner, and finally, which incentivizes the deployment of capital to the U.S., and which promotes U.S. economic growth and job creation.

This is an important debate, and I commend you for tackling it. Thank you for giving us the opportunity to share our views on tax reform, and I look forward to the question and answers session.

[The prepared statement of Mr. Buthman follows:]

**Testimony of
Mr. Mark A. Buthman
Senior Vice-President and Chief Financial Officer
Kimberly-Clark Corporation**

**Before the
Committee on Ways and Means
U.S. House of Representatives**

**Hearing on
The Need for Comprehensive Tax Reform to Help American
Companies Compete in the Global Market and Create Jobs for
American Workers
May 12, 2011**

Good morning Chairman Camp, Ranking Member Levin, and distinguished members of the Committee. Thank you for this opportunity to share my views on the need for comprehensive tax reform.

First, I would like to provide a brief overview of Kimberly-Clark and our global businesses, and then address some of the reasons we believe the current U.S. tax system puts American-based companies at a disadvantage when they compete globally.

For nearly 140 years, Kimberly-Clark has been providing consumers essentials for a better life. With brands like Kleenex, Scott, Huggies, Pull-Ups, Kotex, Poise and Depend, we estimate that one out of every four people around the world use our products each day. We hold the No. 1 or No. 2 brand share positions in more than 80 countries.

Our consumers live in more than 150 countries, and it is critical that we have a global presence to serve them. Being close to our consumers, and the retailers through whom we sell our products, is necessary to effectively develop products which meet our consumers' diverse needs and to enable the effective marketing and efficient distribution of those products. Additionally, due to the nature of many of the products we sell, which are lightweight, bulky, and costly to ship, our manufacturing operations need to be close to our consumers.

To meet the needs of our consumers, we operate more than 100 facilities in 36 countries and have 57,000 employees worldwide. Over 15,000 of those employees are based here in the United States. The rest work in other regions of the world and support our local businesses there.

Most of the products we sell in the U.S. are designed, developed, and manufactured here in the U.S. In fact, a large portion of our annual \$300 million research and development budget is spent in the U.S. We have more than 1,400 employees conducting research in the U.S. Meanwhile, our U.S. manufacturing footprint is significant. We employ 10,000 people at 27 production facilities in 20 different states.

The U.S. market is our largest market but the categories in which we compete are mature. Although we already have a major presence outside the U.S. – almost half of our net sales are to consumers based outside the U.S. – we consider developing and emerging markets to be among our biggest growth opportunities. Profit generated by Kimberly-Clark's overseas affiliates is directly related to foreign business activity.

The U.S. Tax System Puts U.S. Multinationals at a Disadvantage

The U.S. system of taxation puts American companies at a disadvantage when competing in the global marketplace. A high statutory tax rate, the taxation of worldwide earnings, and the complexity of our international tax rules combine to create a high cost and complex tax environment for U.S.-based companies.

High Statutory Tax Rate

The combined Federal and State tax rate in the U.S. averages approximately 39 percent, which significantly exceeds the rates in most other countries. For example, our largest foreign markets include Canada, the United Kingdom, Korea and Australia, which have combined Federal and Local tax rates that range from 24% to 30%. Both Canada and the United Kingdom are expected to reduce their rates further in the near future. The average combined tax rate among the member countries of the Organisation for Economic Co-operation and Development (OECD) is now 25 percent and is expected to continue to decline. Even many developing and emerging countries have lower income tax rates than the U.S. For example, China and Russia

are among our most significant growth markets and their tax rates are 25% and 20%, respectively. In the increasingly aggressive and competitive global market, it is difficult for U.S.-based multinationals to compete effectively with non-U.S. companies who benefit from lower tax rates in their home countries.

The higher tax rates in the U.S. also put American companies at a significant disadvantage when evaluating foreign acquisitions. Expansion through acquisition can be an effective approach for entering a new market segment, a new country, or acquiring technology. Due to lower tax rates, foreign companies can generally afford to pay more to acquire a foreign company and still earn their targeted return.

Taxation of Worldwide Earnings

In addition to its high tax rate, the U.S. taxes the worldwide earnings of U.S. companies, whereas most developed countries do not tax their local companies in a similar manner. Under the current U.S. system, all income of U.S.-based companies is subject to U.S. tax whether it is earned in the U.S. or abroad which creates an incentive for companies to leave their cash outside the U.S. While deferral of tax on the active business earnings of foreign subsidiaries until those earnings are repatriated to the U.S. provides some relief from this burden, the relief is only temporary. Ultimately our goal is to repatriate our surplus foreign income to the U.S. so that it can be reinvested in product development, capital spending or returned to our shareholders. Kimberly-Clark has a strong history of capital investment in the U.S. and of paying dividends to our shareholders. For the last five years, we have averaged over a half a billion dollars of capital spending in the U.S. In addition to supporting jobs at Kimberly-Clark, our investment generates jobs and economic activity at our suppliers and in the surrounding communities. 2011 marks the 77th consecutive year that Kimberly-Clark has paid a dividend and we have increased our dividend per share 39 years in a row. These dividends are an important source of income to our shareholders, which include a significant number of mutual funds, state and local and pension plans and individual investors. Ultimately these dividends lead to further spending and reinvestment in the American economy.

Our current system of taxation results in American companies facing much higher tax rates than most of their foreign-based competitors, which pay little or no home-country tax on income earned abroad. For example, one of our primary global competitors is headquartered in

Sweden. Sweden has a 26 percent tax rate and exempts foreign-source dividends from domestic taxation. When competing in a foreign country, both companies pay the same rates of tax. However, the Swedish headquartered company can repatriate its foreign earnings to Sweden and reinvest those earnings in product development without paying additional tax. In contrast, for Kimberly-Clark, repatriation of those earnings to the U.S. results in an additional layer of tax. This extra layer of tax causes many U.S. multinationals to delay repatriation of foreign earnings and, consequently, creates an artificial barrier to investment in the U.S. Rather than impede the free flow of capital, we need a tax system which facilitates the deployment of capital in a manner that supports the needs of the business.

Ironically, the U.S. system can even result in U.S. companies paying higher tax on the profit earned on products sold to U.S. consumers than do their foreign-based competitors who sell into the U.S. Companies such as Kimberly-Clark, who own their intellectual property in the U.S. and conduct their research, development and manufacturing in the U.S., tend to have a significant percentage of income subject to the higher U.S. tax rates. In contrast, foreign-based competitors, who manufacture outside the U.S. and develop their intellectual property outside the U.S., tend to have a lower percentage of overall profit subject to the higher U.S. tax rates. As a consequence, U.S. companies have less money available to reinvest in their U.S. businesses or to fund dividend payments to their shareholders.

Excessive Complexity

Finally, the U.S. international tax system is highly complex. This complexity requires U.S. companies to devote significant resources to compliance related activities rather than product innovation and market growth. As the world has globalized and U.S. businesses have generated more sales outside the U.S., the U.S. rules for taxing foreign-source income have become increasingly complex and uncertain creating an additional layer of risk and administrative burden for American companies. The U.S. needs a system of international taxation that reduces the cost of administration, reduces the risk of inadvertent error, and is easier to monitor.

America Needs a Tax System Which Promotes Investment in the U.S. and the Creation of American Jobs

America needs a tax system that encourages companies to invest in the U.S. economy to create and retain jobs. A key component of such a system is a permanent research and development credit. Healthy American companies which compete effectively in the global marketplace are good for the American economy. They support innovation, job creation and economic growth in the U.S. Innovation through robust research and development is key to a successful company. At Kimberly-Clark, we spend more than \$300 million annually on research and development and employ over 1,400 people at our U.S. research facilities. In addition to using the technology in our U.S. business, we license intellectual property related to proprietary technology and our well-known brands to our foreign affiliates. Royalties from our foreign affiliates support high quality U.S. jobs in our research and development function.

In addition to providing a permanent research and development credit, the U.S. tax system should encourage the generation of royalty income. A territorial system can result in disparate treatment of dividend and royalty income; dividend income being exempt from U.S. tax and royalty income being fully taxed. The U.S. should follow an emerging trend among those OECD countries seeking to encourage the domestic ownership of intellectual property and provide for a competitive tax rate on royalty income.

Recent proposals to move the U.S. tax system further away from competitive global norms by increasing U.S. tax on foreign earnings would put U.S. companies at a significant disadvantage. Retaining a worldwide system and ending deferral would impose an immediate 35 percent tax on foreign earnings of U.S.-based companies and require the payment of tax even though their U.S. operations may not generate sufficient cash from which to pay the liability. Burdening U.S.-based companies with a significantly higher tax rate than incurred by foreign competitors would significantly reduce the ability of U.S.-based companies to compete globally. This, in turn, would slow economic growth in the U.S. and impede the creation of U.S.-based jobs.

Summary and Conclusion

American companies have a terrific base of talent, an unrivaled track record of innovation, and some of the greatest products and brands in the world. Unfortunately, American companies

face a clear disadvantage as a result of the U.S. tax system. A good first step to improving the competitiveness of the U.S. tax system is to reduce the combined Federal and State tax rate to a level comparable to the combined rates in the rest of the OECD countries. The current combined U.S. tax rate is more than 50 percent higher than the average of the other OECD countries.

The second step is to adopt a territorial system which exempts dividend income from U.S. taxation and taxes royalty income at a reduced rate. The current U.S. worldwide tax system imposes a significant tax on foreign earnings that are brought back to the U.S. for reinvestment here at home, discouraging job-creating domestic investment. By eliminating this extra layer of tax, the disincentive for American companies to reinvest their foreign earnings in the U.S. would be significantly reduced.

To continue to prosper and be relevant for another 140 years, Kimberly-Clark must grow our business at home and around the world. We must listen to the needs and desires of our diverse global consumers, we must continue to innovate and reinvest for future growth. To do all this, we need a tax system that is competitive with global norms; which is less complex and easier to administer, a system which gives us the flexibility to manage our global operations in the most efficient manner, which incentivizes the deployment of capital to the U.S., and which promotes U.S. growth.

Thank you for giving me the opportunity to share my views on tax reform. I would be pleased to take any questions you may have.

Chairman CAMP. Well, thank you. And thank you all very much for taking time out of your busy schedules to come and talk to us today about international tax issues.

I have a question I would like each member of the panel to address. We often hear that there are sort of two sides to this debate. Some people feel that the global economy is a zero-sum game, and that as a U.S. company expands overseas, it must be contracting at home. And others argue that when U.S. companies compete overseas, it leads to more jobs for American workers who are needed to support the foreign operations, and that leads to more tax revenue for the U.S. Government.

In your company's experience, have your foreign operations benefitted your domestic operations, or have they come at the expense of your domestic operations? And if we just want to start with Mr. Hayes, and each of you take a shot at answering the question, I would appreciate it.

Mr. HAYES. Thank you, Chairman Camp. I would say that, in general, the expansion that we have seen overseas has been a significant benefit to the domestic operations. And I say that—as you think about United Technologies, about 20 percent of our revenues today come from the emerging markets. That has more than doubled in the last 10 years. That growth overseas is allowing us to grow domestically, and allowing us to invest in R&D at home.

Think about the Otis elevator company. Otis is a \$12.5 billion worldwide company. The R&D for Otis elevators happens right here, in the United States. It happens, in fact, in Bloomington, Indiana, and it happens in Farmington, Connecticut. That R&D, then, is shared with our operations around the world, and allows us to compete globally.

Unfortunately, you can't build an elevator in Hartford, Connecticut, and ship it to Shanghai. You have to be in these local markets. You cannot service an elevator—and we service 1.7 million elevators around the world—you can't do that from the U.S. You have to be in these local markets. But the earnings associated with those foreign operations drives growth here. It drives growth in the professional ranks, growth in the engineering ranks, and allows us to continue to invest to grow the business globally.

And Otis is just one example. I would tell you that happens with our Carrier air conditioning. Again, the R&D for Carrier happens in Syracuse, New York. That technology is exported around the world, and we use that technology to grow the business globally.

Pratt & Whitney, again, a very large company, \$13 billion in revenue. We have some of the best technology in the world today. We have a new, very efficient jet engine called the geared turbofan. It is going to reduce energy costs by 15 percent for airlines. That technology, which was developed in East Hartford, Connecticut, is going to allow us to expand globally.

So, I would tell you, you know, taking advantage of global markets requires investment at home. Expansion in the global economy also allows us to reinvest at home in the things that are important, like research and development. And it is that R&D that ultimately creates jobs back here in the United States.

Chairman CAMP. Thank you. Mr. Rapp.

Mr. RAPP. Yes. Chairman Camp it has been a key driver for U.S. jobs growth since we started back in 1925. And I think there is probably no better example of that than what we have experienced over the last 12 months.

In spite of a U.S. economy that is still weak, as we have all seen, in terms of the recent statistics, we have added 7,000 jobs over the last 12 months. And that is based on the strength that we have in global markets. Because for us, as we grow globally, a lot of the central services that we provide, in terms of support, are headquartered here.

I have the responsibility of our IT organization, headquartered in Peoria, Illinois. I have a responsibility for our purchasing organiza-

tion headquartered in Peoria, Illinois. HR is in Peoria, Illinois. We are financing product around the world, headquartered in Nashville, Tennessee. Our corporate treasury services, tax services—you can just go down the list—are all headquartered out of the U.S. And as we grow globally, it drives growth and employment.

And, of course, a key driver for us is R&D. We will invest about \$2 billion this year in R&D. And the vast majority of that is going to be invested in the U.S. We have a great research and development center just outside of Peoria.

The other place that it benefits U.S. jobs is with our growth overseas, and the exports, about \$13 billion last year, 8 out of 10 tractors that we built at our East Peoria plant go export. If you go to the plant, you walk down the aisle, and you look at each tractor, and it designates where it is being shipped. I mean it is like going to the United Nations. If you go to Decatur, Illinois, 9 out of 10 of our mining trucks go export.

So, our ability to compete and win in export markets, for us, has always driven jobs back here, in the U.S.

Chairman CAMP. Thank you. Mr. Crines.

Mr. CRINES. Mr. Chairman, I would go back to maybe 10 years ago, when I joined the company. At that time, the company was about a quarter of its current size. So, about \$1 billion in revenue, globally, most of that then was coming from our U.S. market.

And then, as a consequence of an acquisition, a transformational acquisition that took place in 2003, where the company prevailed in a competition for a European-based manufacturer, the company has been able to grow, and grow significantly to where we are today, with \$4 billion in revenues and 8,000 employees, globally. That revenue today, that \$4 billion in revenue, is predominantly sourced out of our U.S. manufacturing facilities. Seventy percent of our foreign revenues are sourced either out of our manufacturing facilities in Warsaw, Indiana, in Carlsbad, California, in Parsippany, New Jersey.

And, as well, today we now have approximately, out of the 8,000 employees, about 1,000 employees dedicated to research and development. Innovation really is the life blood of this industry. And 75 percent of those research and development employees are based in our U.S. development operations.

So, there is no doubt in my mind that the expansion of our business overseas has led to growth in jobs here in the U.S.

Chairman CAMP. Mr. Buthman.

Mr. BUTHMAN. Thank you, Mr. Chairman. I will take a little different spin. I think there are two key elements for Kimberly-Clark. One is research and new ideas and innovation, and the other is cash flow. I worked most of my adult life at Kimberly-Clark. When I first joined the company back in the early 1980s, we were largely a U.S.-based company. Our growth internationally has increased dramatically over that time. In the last 10 years it is particularly true in developing and emerging markets.

Ten years ago, about twenty percent of our business was in developing and emerging markets outside of the United States and Europe. That is where 80 percent of the world's population resides. And for our company, many things that we take for granted in the United States—things we use every day—either are not used, or

are used in very rudimentary forms. So today more than one-third of our top-line growth is in those developing and emerging markets.

So, our ability to export technology and U.S.-based ideas around the world is an important part of the growth opportunity for our business. In fact, Kimberly-Clark invented five of the eight categories in which we compete, things that I am sure many of you may have used today, as a matter of fact. And so, our opportunity to bring ideas from around the world—which is increasing, the pace of innovation is increasing around the world—our ability to bring those ideas to the United States, developing them in our research and development facilities here, which are principally based in Neenah, Wisconsin and Roswell, Georgia, where we have—between those 2 locations, about 1,400 research and development employees. It is a great opportunity for us to grow.

And I will just conclude by saying outside the United States we generate far more cash than we have opportunities to invest overseas. We have great opportunities to invest. But we constantly battle excess cash flow. We would like to return more cash to the U.S., both to invest in research, to invest in capital, and also to use as dividends to our shareholders, which can be redeployed elsewhere in the economy.

Chairman CAMP. All right, thank you. Mr. Levin may inquire.

Mr. LEVIN. Thank you. Interesting testimony. I think the testimony of the four of you, with all of your expertise and background, illustrates in each case the need for our committee, Mr. Chairman, to try to dig out the facts and see if we can find a common basis from which we can proceed.

For example, I think we need to explore the issue of effective tax rates, and make sure that we really understand what are the effective tax rates in the U.S. and, for example, the OECD countries. We will have some testimony later on that indicates that, in terms of effective tax rates, there is not the differential that there would first appear to be.

Secondly, and you have testified to this, to some extent, we need to understand more clearly the pattern of job growth here and overseas for the multinational corporations, because this is often something that becomes very, very significant and very controversial.

For example, just last month in the Wall Street Journal there was an article by Dave Wessel April 19, 2011, it was headlined, “Big U.S. Firms Shift Hiring Abroad, Workforces Shrink at Home, Sharpening the Debate on Economic Impact of Globalization.” You have touched on this, but I think, Mr. Chairman, we need to try to dig out the facts.

Thirdly, a number of you have mentioned the issue of permanence. I think everybody on the committee would agree that it has been a real problem that many of these provisions are simply renewed year after year, that there has not been anything close to permanence. We use the word “permanence,” but these provisions are temporary. And it is difficult, I think, for companies to plan. And I think we really need to dig out what the impact has been, because there are many different views of that.

And, fourthly, I think we need to have an honest discussion about the tax expenditures. I mentioned the ones that are predomi-

nant in corporate taxation: Section 199, the accelerated depreciation, the R&D tax credit. I would simply urge that we beware of some of the rhetoric we sometimes use. For example, “picking winners and losers.” Because one of the criticisms of the R&D tax credit is that we are doing exactly that.

I think the more we look at it, the less valid that designation is. But I think we need to look at the importance of these tax expenditures because shifting to a territorial system has some major revenue implications. And there are some who think that the answer is to eliminate these tax expenditures in return for a lower rate.

But I think in the case of each of your companies there has been effective use of these tax expenditures. And to simply propose their elimination would have a major impact. For example, Caterpillar has effectively used these, and Section 48C has been effectively used in some cases.

And I think if we are worried about the impact on jobs in the United States, Mr. Chairman, we have to have a very full discussion of the impact of each of these. Thank you very much.

Chairman CAMP. Thank you. Mr. Herger is recognized.

Mr. HERGER. Thank you, Mr. Chairman. I want to join in thanking our witnesses for your testimony. It is always very important to hear from those individuals who were actually being affected by the tax policies that we in Congress pass.

It is very important for us to get this area of international taxation right, because it seems like the United States is falling behind in global economy. As Chairman Camp mentioned in his opening testimony—and I think it bears repeating—in 1960, 17 of the 20 largest companies were headquartered in the United States. But in 2010 only 6 of the top 20 are U.S.-headquartered companies.

I would like to ask a question for each of our witnesses with whatever time we have. In our world of increasingly mobile capital, how does the very high corporate tax rate make business investment and job creation in the U.S. less attractive? And I would like to begin with you, Mr. Hayes.

Mr. HAYES. Thank you, sir. I guess, just to start out, as we look at the investment horizon, we all understand that capital is mobile on a global basis. I mean we can make investments anywhere around the world.

And the question for us is, on a long-term basis, where is the most efficient place to put those investment dollars? And tax policy plays a part, although it is not the end-all, in terms of the investment decisions. Clearly, having a 35 percent statutory tax rate is an impediment, versus the OECD, which has an average tax rate of about 25 percent. So the U.S. is at a disadvantage as we begin each of the analyses. It is not the ending point, though, it is simply one of the factors that we have to consider.

Ranking Member Levin talked about our effective tax rates and how they are lower than the statutory rates, and that is obviously clear. Our effective tax rate is just under 28 percent. But at the end of the day, we make investment decisions based upon the statutory rates that are in effect in the countries as they stand today. And the same goes with the R&D tax credit. To the extent that the R&D tax credit is not going to be renewed, you can't make decisions based upon the hope that you are going to have a short-term

renewal of each of these tax expenditures. And I think permanence is critically important.

And so, as we think about the long-term rate, the 35 percent rate here, it puts us essentially 50 percent higher on the tax cost than any other OECD country, and certainly lower than any of the emerging market economies where we had opportunities to make investments. At the end of the day, we are going to make investments where the customers are, and where it makes the most economic sense.

Mr. HERGER. Mr. Rapp.

Mr. RAPP. Yes, Congressman, I would maybe touch on two points relative to the kind of the impact it has in terms of the attractiveness of the investments that we make.

I think, first of all, if you look at the dynamics of the world that we operate in today, I don't have to explain to you just how dynamic and how volatile it is. Different markets growing at different rates around the world, and the ability to freely move capital to take advantage of those opportunities that drive those jobs back in the U.S., for me, is absolutely critical. Today our ability to do that relative to the foreign competitors that want our customers, want our jobs we are hamstrung, based on the current code.

The other one—the nature of our business, when we make a decision to put down a plant, it is a 25 to 30-year type investment. Major facilities, big cap-ex, R&D. And when we make that, we are making it off of that view of what that statutory rate is going to be.

So, as we look at that investment decision today, we are looking at a 35 percent rate here, versus if we make that investment to pursue opportunities in other parts of the world—with on average, a 25 percent rate. So it does, you know, skew it toward other opportunities to invest in other parts of the world.

Mr. HERGER. Good. Mr. Crines.

Mr. CRINES. Yes, sir, I would tell you that if tax rates were the only factor considered in where to locate, we would move most of our manufacturing operations offshore.

The fact of the matter is that there are a number of factors, you know, that weigh into decisions around where to locate manufacturing operations. Zimmer operates in a highly regulated industry, and it is very important to us to be able to produce the highest quality products. We need to have access to people who have an understanding of quality systems regulations. We need to have access to highly-skilled labor. We are very fortunate in having access to a large skilled labor pool in northeastern Indiana, where we have been located since 1927.

We also like to locate our facilities—we have a preference, if we can, to locate them near our research and development functions, because our research and development people are not only focused on product innovation, but also process innovation.

Chairman CAMP. All right, thank you.

Mr. HERGER. Thank you.

Chairman CAMP. Mr. Rangel is recognized.

Mr. RANGEL. Thank you, Mr. Chairman, and let me thank you for you and staff for picking such an outstanding panel for us to learn a lot from today. I think it is abundantly clear that we read

from the same page. We are so proud of the genius of our private sector in maintaining a leadership position throughout the world. And you should know we don't want anything that we do to impede that, because it affects not just your companies, but it affects our constituents.

Let me first ask, since five minutes is just too short, I assume that all of you have a representative in Washington that represents the thoughts that you expressed today?

Mr. HAYES. Yes.

Mr. RAPP. Yes.

Mr. CRINES. Yes.

Mr. BUTHMAN. Yes.

Mr. RANGEL. Good. Okay. Well, we have to find out their names—at least I do—so that the chair and the leadership here can continue this discussion.

Now, I think you all agree that 35 percent is too high of a corporate rate, and it does not make us competitive internationally. Who at this table pays 35 percent corporate taxes? Who pays 30 percent corporate taxes? Okay. There are people at the table that pay no taxes.

Mr. HAYES. No, sir.

Mr. RAPP. No, sir.

Mr. RANGEL. I don't mean at this table. People who are not at this table—little or no taxes.

[Laughter.]

Mr. RANGEL. And so, what we have to do is to determine how we can bring equity because there is some outrageous incentives that we have in the Tax Codes. Billions of dollars are there with hundreds of incentives, loopholes, credits, waivers. And if we all could agree, of course we could dramatically bring down the tax rate.

Now, when Richard Neal and I and certainly our distinguished chairman here talks about it, or when we started moving forward, bringing what we call equity, a lot of people started screaming that we were increasing taxes. And technically, if you are not paying any tax, and we say, "Pay a fair tax," we are doing what, increasing taxes.

So, you know and we know that the problem is going to be: Whose ox is being gored?

Now, is there—I am going to make certain that your representatives talk with us. Because being candid and frank as to how far we can go is the key to this whole thing. And you are not going to find someone that has an unfair advantage over you looking for reform. He or she, the company, wants it the way it is.

So, I assume that the business roundtable does not speak for all of you.

Mr. HAYES. That is correct.

Mr. RANGEL. I assume that the Chamber of Commerce does not speak for all of you, because their members have divided opinions as to what we should do.

But if we did have some way of finding out what is painful, but fair, what gives you maybe not an unfair advantage, but certainly puts American in a very competitive way, which we would really want within the restrictions of the WTO, then that is what we

want, and we are not ashamed of that. We have to find out what happens with sales when our people know it is made in the USA? Hey, that has to count for something, even though our wages may be higher than some other competitive countries.

And so, I want the names of the people that we can extend this to, because doesn't our national efforts in education mean something to you, besides just research and development? Doesn't our health system, in terms of your employees here, mean something? Not just morally, but in dollars and sense? And so, you are not going to find problems with those people that agree with you. It is those people who are not at the table that have to be brought on board, because it is going to cause problems for all of us.

I think that you make an outstanding contribution to make American great. And we support what you have. And I assume all of you think that it is a good idea to continue this discussion through your representatives here in Washington.

Mr. RAPP. Absolutely. That is why we are sitting here in front of you today.

Mr. RANGEL. Do all of you want—

Mr. HAYES. Yes, sir.

Mr. BUTHMAN. Yes, we do.

Mr. CRINES. Absolutely.

Mr. RAPP. We are not Washington-based, we have got a lot going on. But this is important to our competitiveness, it is important to the growth of our company and countries—

Mr. RANGEL. Well, I am not going to—

Mr. RAPP. We will engage.

Mr. RANGEL. I am not going to let you leave until we get who you have anchored here.

Mr. RAPP. You know what? He is sitting right behind me.

[Laughter.]

Chairman CAMP. I think I see many of them right from where I am sitting.

Mr. RANGEL. Well, I yield back the balance. I want to thank you, Mr. Chairman, and Chairman Levin, because being honest and fair, rather than just public and talking about—you know that if we took away a whole lot of these expensive exceptions and preferential treatment, that would be no problem, and no profile and courage for us to reduce the corporate rate. Right?

And so, let's get together and let's do it. And it is going to take courage, but we need some political cover from those people that want to be competitive with foreigners.

Chairman CAMP. All right, thank you.

Mr. RANGEL. Thank you.

Chairman CAMP. Mr. Brady is recognized.

Mr. BRADY. Thank you, Mr. Chairman. When Chairman Rangel speaks and asks questions, I never know whether I am supposed to answer them or not.

[Laughter.]

Mr. BRADY. But I appreciate the approach you take.

You know, our panel makes a compelling argument that, to grow America's economy, it is simply not enough to buy American, we have to sell American, and that our Tax Code is a hindrance to competing and winning abroad, in its design, its rate, and its unre-

liable incentives to research and development. It is a discouragement to bring U.S. profits back home to invest in America. All that contributes to the anti-competitive Tax Code we have today.

I want to ask each of you, starting with Mr. Buthman and working our way down, this question. We hear two claims in Washington these days. One is that our current Tax Code is filled our international Tax Code is filled—with corporate loopholes like deferral that encourage companies, American companies, to ship our jobs overseas.

We also hear that if America moves to match our competitors with a territorial tax system, that that will also encourage you to ship American jobs overseas. Is either of those claims accurate? And, if not, why?

Mr. BUTHMAN. That is a great question, Congressman. I would say certainly today the complexity of our Tax Code influences behavior in the corporate community for the reasons we talked about. We make long-term investments. A tissue machine goes in, and it is around for 100 years. And we have to think about tax as not the only driver, for sure, but it is a very important component of that decision.

So, I think the idea of moving to a simpler system, where you have more transparency coupled with a lower rate, is a good idea. Congressman Rangel made a great point. This is a very challenging problem to solve, and I think it should be only based on thoughtful reflection. But I think, in general, moving to a simpler system with a lower tax rate makes a lot of sense.

The fact that we are—the more competitive we are overseas, the more cash we generate overseas—today, the fact is that it is very difficult to bring it back to this country. If we can eliminate that obstacle, there is no question that much of the cash we refer to as “trapped” overseas would return here, to be invested in some way, shape, or form in the United States.

Mr. BRADY. Yes.

Mr. CRINES. I would just point out that, with respect to deferral, Congressman Brady, I mentioned earlier that Zimmer prevailed in a bid for a large, European-based orthopedic manufacturer in 2003. I don't know that Zimmer would have prevailed. We were competing against a UK-based competitor of ours who was—also had expressed interest in buying that same business. Deferral is what allowed us to compete effectively, and win, ultimately, in that battle.

So Zimmer is very much in favor of reform that leads to less complexity and a more simpler system. If deferral were to be eliminated, in our view, it would have to be replaced by a lower tax rate, such that we are in a position to compete on a level playing field with our foreign-based competitors.

Mr. RAPP. Yes. Congressman Brady, I would look at it—if we leveled the playing field around the world, I think a lot of the motivation, in terms of arbitrage, goes away. And there you really get down to the fundamentals of what does it take to compete, and when, the customers that you are trying to draw to your business, to grow your business.

We build skidsteer loaders in Sanford, North Carolina, because a customer won't wait eight weeks for it to be shipped from an

overseas location. The shipping cost relative to the total price, it doesn't make sense.

So, I think it really gets down to get a level playing field, and then allow companies to compete for that customer base. And, as I said earlier, we are absolutely convinced, given that level playing field, we can compete with anybody around the world.

Mr. HAYES. Yes, Congressman, I would just add I think, you know, as we look at deferral—and I mean we can call it a loophole, we can call it a tax expenditure—I think any of the changes that we are talking about half to be done in the context of global reform.

To Congressman Rangel's point, these tax expenditures have to be looked at holistically. We have to look at each one, and trade off the impact on job creation in the U.S. versus the cost of the U.S. Treasury. And I think we, as we sit here today, as well as many other of the large companies with large, export businesses, we would support this broad type of tax reform, which takes a look at all of these tax expenditures, and would be willing to put all of it on the table.

Mr. BRADY. Thank you.

Chairman CAMP. Thank you. Mr. Lewis is recognized.

Mr. LEWIS. Mr. Chairman, I came in late, and I—

Chairman CAMP. I have you here as here at the gavel, so—

Mr. NEAL. Want to switch?

Mr. LEWIS. Yes.

Mr. NEAL. Mr. Chairman.

Chairman CAMP. Okay. Mr. Neal is recognized. Are you—

Mr. LEWIS. Yes, yes.

Chairman CAMP [continuing]. Wishing Mr. Neal to question?—

Mr. NEAL. Thank you, Mr. Chairman. And these hearings are very instructed. I am delighted with the panel. And I hope that the testimony can lead to a conversation.

And on one point, where Mr. Rangel is right on target, is that in Washington a conversation about tax reform generally begins with histrionics, and it moves to fact shopping, and then it moves to intransigence. And it is very hard to have this conversation, but let me throw something out to you which I think is something that, by way of definition, we all ought to be able to agree to, and that is, what tax system will improve the quality of life for the American people? I mean that ought to be the fundamental goal, the cornerstone of the conversation that we are having.

Pleased that Mr. Hayes raised that example of the Otis elevator, because that certainly unites the four panelists. I don't have to tell you, Mr. Rapp, what the R&D tax credit means in Massachusetts, where so much research is done every single day with terrific companies. But a couple of questions, and the panelists should feel free to give their views.

One, wage pressure in China, and what is happening as to how the anxiety level that the American people currently feel about their job stature might be enhanced down the road because of the changes that you are witnessing on a firsthand business.

And, secondly, given my lead-in question on R&D and the issue that you have raised with deferral, another thought that I think is

very important, and that is what preferences in the code might you be willing to concede to lower the corporate rate?

So, you are free to take your best shot.

Mr. HAYES. Let me start with the China question if I can, Congressman Neal. I think, you know, there has been much rhetoric about the yuan, and the way that the Chinese have held down the value, relative to the U.S. dollar.

But, as I said, we have 16,000 employees in China. And China is not the low-wage country that it was 10 years ago. As I look at the wages that we pay in China today, they have more than doubled in the last five years. And with inflation running at more than double digits, we expect wages to double again in the next five years. In fact, to have an aircraft mechanic in Shanghai at our overhaul repair facility, where we had a 75 percent cost advantage 5 years ago, that advantage is less than 30 percent today.

So, the fact is, we have to be in China, because that is where the customers are. But they are not taking jobs away from the U.S. We don't export product from China to the U.S. We build product in China for the Chinese market, and you have to be there.

And, again, I think the Chinese are having to deal with a very difficult problem around inflation, and they are having to do the same things that we have done in the states for the last 50 years, which is find productivity in their factories, and adopt lean manufacturing technologies, and put technology to work in their factories, just as we have done here.

You know, China is really not the threat, I believe, that people make it out to be, from a low-wage jurisdiction any long.

Mr. RAPP. Yes, Congressman, I would agree. We have got more than 5,000 employees there, and it is really to build product to sell to China. In fact, we are an importer to China. In spite of the large manufacturing base there, and a lot of people there, that serves that local market. And we see it as a natural, if you would, migration of a society. The mass urbanization that has taken place, people searching for that higher quality of life, standard of living that only comes through the build-out of infrastructure.

And so, we think that pressure on wages is going to be there, and we are going to be there with factories to serve the opportunities in China.

On preferences in the code and what we would be willing to give up, I think, for us, back to the earlier discussion—and I think you described the emotions around this topic up front very well—that is why we try to do, in our business, take emotion out of it. If somebody says we are not competing with a competitor, as I said earlier, we just tear it down. We do the tests with independent people who really know how equipment operates, and then we have a very objective assessment of our competitiveness versus theirs. I think if we get to a low enough rate that is based on making us competitive, I think everything is on the table.

Mr. CRINES. Congressman Neal, with respect to China, I agree with the other witnesses here that, over time, wage inflation will eliminate that comparative advantage that the Chinese have had over the past several years.

We, Zimmer, is a net exporter to China. And with respect to medical devices the market there is tiered. At the high end of the

market there is a great deal of interest in Western technology, and we compete very successfully in that end of the market. There is a growing middle-tier market that is serviced by some local manufacturers, smaller European-based manufacturers. Zimmer did complete an acquisition in the fourth quarter of last year to acquire a local manufacturer that will service that segment of the market.

So, over time, we are going to compete in the high end of the market with the products that we develop and produce here, in the U.S., and we will be competing in that mid-tier by sourcing product out of the local manufacturer that we acquired in the fourth quarter.

Mr. BUTHMAN. Congressman, just—I would echo the—

Chairman CAMP. Thank you. I am afraid time has expired, so we will need to go on. Mr. Nunes is recognized.

Mr. NUNES. Thank you, Mr. Camp. I am going to ask this question of all of the panelists. And maybe we will start on the right here, so that Mr. Buthman gets a chance to go.

If we were to—if this committee was to get rid of all of the corporate tax deductions, every single one of them, if every one was on the table and we got rid of all of them, what rate would you like to see? And would you support that policy out of this committee?

Mr. BUTHMAN. It is a challenging question, and a complex one.

I think a place to start is our incremental rates, which are about 50 percent higher than the average of the OECD, which is something like the mid-twenties. So I think, if you wanted a place to start, that would be a good place. I think Congressman Rangel makes a great point. To unravel the behaviors that have been created over the last 50 and 25 years with our Tax Code is going to be complex. But from a base rate, that is where I would start. I would think about—

Mr. NUNES. Low twenties? Mid-twenties?

Mr. BUTHMAN. Mid-twenties.

Mr. NUNES. Would be sufficient enough for you to give up all of the different—corporate tax deductions?

Mr. BUTHMAN. I think we would love a simpler Tax Code with a lower rate. I think that objective is a good one.

Mr. NUNES. Thank you. Mr. Crines?

Mr. CRINES. Our effective tax rate, first of all, was just over 30 percent in 2010, as a consequence of accruing tax on our U.S. earnings and profits at around 40 percent, including what we have to accrue for state taxes, and accruing tax at a rate of about 15 percent on our foreign earnings and profits.

A rate in the mid-twenties would provide us with opportunity to invest more aggressively in innovation, given the fact that we are paying and accruing taxes at a higher rate than that today, even though we will be competing against European-based medical device manufacturers that, in some cases, are accruing and paying taxes at a rate of around 15 or 16 percent.

Mr. NUNES. So if we were to get rid of all the deductions, would you prefer to see a rate at 15 or 16, or 20, or—

Mr. CRINES. If you can do that, absolutely.

[Laughter.]

Mr. NUNES. So you are in the mid-twenties.

Mr. CRINES. Yes.

Mr. NUNES. All right.

Mr. RAPP. And I would say we would be in the mid-twenties, as well, but all inclusive, including state income tax. And I think that is an important distinction. So that leaves you with the federal rate somewhere probably in the 20 percent range

On getting rid of—

Mr. NUNES. You may be moving states, then? No offense to Mr. Schock here, but—

Mr. RAPP. We have such a good relationship locally, I don't see—

Mr. NUNES. Just joking.

Mr. RAPP. The other one, on getting rid of all the deductions, I will go back to the comment I made earlier. I do think—and it tails back to the earlier discussion about quality of life. If you look around the world at Tax Code, in most cases countries have determined what industries do they want to drive their local economy.

I mean you can move to a low rate with no preference for manufacturing or anything else. You do run the risk in that kind of environment that you end up with just a services-based industry. And I think, if you do that, you just need to understand what the implications are for quality of life and what kind of economy you build. That would be my only caution on that one.

Mr. HAYES. I would say just again, as we talk about taxes, obviously, deductions for payroll, deductions for cost of goods sold, those types of things that, you know, we all are—deductions I think everybody agrees that are relevant, and is part of a GAAP income statement—but as you think about the tax preference items, I think accelerated depreciation is one of those things that ought to be on the table. I think the domestic production allowance should be on the table. R&D tax credit ought to be on the table.

Again, I think what we need to do is to benchmark our corporate tax rate versus what the other OECD does. And we don't have to have the lowest rate. I think if we have a rate in the mid-twenties that promotes job growth in this country, that takes away these deductions—I have a tax return, a federal tax return, of 19,000 pages, 19,000. I mean that is crazy. The fact is, we need to simplify the Tax Code. We need to make it more agnostic.

Again, I talked about not picking winners and losers. You can pick any industry, and everybody has got, as Chairman Rangel said, an ox to gore here. But I think it all has to be on the table. What we need to have is a simplified tax system that taxes us the same way everybody else is taxed. And that way, as we compete globally, we are not at a disadvantage.

Mr. NUNES. Thank you. I thank the panel, and I yield back, Mr. Chairman.

Chairman CAMP. Thank you. Mr. Becerra is recognized.

Mr. BECERRA. Mr. Chairman, thank you. And to the four of you, thank you very much for your testimony. I think we all want to get to a point where we can get to some place where you all will come to us and say—at this stage—just try to help us find those new minds that are going to create those new inventions or come up with the latest type of technology and not have to deal with the Tax Code in 19,000 pages of a filing.

The good news is, from everything I have heard, you are all very normal. You come here, and you want your tax burden reduced. I have never seen a witness come before this committee and ask that his or her tax burden be increased. So you all are very, very normal.

The bad news is—actually, the only bad news is if you happen to be one of those people who believes that America's best days are behind it, that America is broke, and therefore, we are in chaos and we have to make some decisions that are going to hurt you and going to hurt the average American.

I don't think most people yet believe that about this country. I think most people still believe that, in the 21st century, we are still the country to model yourself after if you are an emerging nation, that America is still the place where you find innovation, where you find the kind of companies that can hire the best engineers and still help a guy like my father, who got to the sixth grade, get a chance to make a decent living and get to see his kids go on to college.

So, I sense that there is a lot of good news here. Not only are you very normal, but you are very successful. And I suspect that you will find that each and every member of this committee is looking for ways to make you even more successful, because the more wildly successful you are, the more people you are going to hire. And I think, if we take that perspective, we will have a better understanding of what is going on.

Let me give you some quick statistics. Because the prism looks very different from the eyes of differing Americans.

In 2009, pretty much when we were feeling the effects of this recession hardest, most American multinational corporations, folks like you here, decreased the size of your workforce by about 5.3 percent, 1.2 million Americans lost their jobs in your companies. At the same time, about 100,000 foreigners who worked for your companies, U.S. multinational corporations, lost their jobs, about 1.5 percent.

And so, the perspective of many Americans, including those 13 or so million Americans who are still not back at work is that we are not doing something right because too many Americans aren't working.

Another statistic. During the 1990s, U.S. multinational companies reduced their workforce by—I am sorry, you increased—strike that.

U.S. multinational companies cut their workforce by 2.9 million in this past decade, 2000 to 2010. At the same time, these multinational companies from the U.S. increased their employment overseas by 2.4 million. Now, that is a switch from the 1990s, when these same multinational companies added 4.4 million jobs in the U.S. and 2.7 million jobs abroad.

And so, from the perspective of a lot of Americans, the constituents that we hear from, we are not seeing the job growth in the U.S., and we are seeing a lot of very successful U.S. companies increase jobs abroad.

So, when we have to deal with policy, it is not just the nuts and bolts of a 19,000-page tax return. It is dealing with a guy who says,

“Wait a minute. I used to have a job that allowed me to send my kids to college. I am on the verge of losing that and my home.”

So, we have to deal with an issue that is very complex, and come up with a simple solution, not just for you, but for the guy who we see back home. And so there I have a—I would then pose a couple of questions. And I don’t know if you will have a chance to respond to it, but maybe later on, because I know, as Mr Rangel said, you will come back and talk to us.

If you want to see us move to, say, a territorial system that our OECD competitors have, are you interested in seeing the other aspects of their system: a VAT tax, a higher income tax, more regulatory structures over your operations? If you like one aspect of what they do, do you like the rest of what they do? And so that we don’t just cherry-pick what we like from all the rest of them and leave behind what we don’t.

The other—then the final point is—I hope you will consider giving us further advice and good counsel—is the issue of competitiveness. All things being equal, are you still hiring an American to do the job versus a foreigner with the same level of skill, the same title? And I think to the degree that you are coming back to us and saying, “Absolutely, all things being equal, it is the American we look for,” then guess what, we are going to be right there behind you, because at the end of the day it is that American who gets the job who is our constituent. So thank you very much.

Chairman CAMP. Thank you. Mr. Tiberi is recognized.

Mr. TIBERI. Thank you, Mr. Chairman. And thank you all for providing excellent testimony today.

Mr. Crines, the so-called lock-out effect, a combination of the deferral regime that you have talked about, and a relatively high corporate tax rate that we have in America, does it prevent you, as a CFO for a company that does business overseas, does it prevent you from making investments in the United States that you otherwise would make if it weren’t for that?

Mr. CRINES. Congressman, we, like many other U.S. multinationals, accumulate earnings and profits offshore. We have asserted that we intend to reinvest those earnings and profits offshore, understanding that if we were to return those earnings and profits back to the U.S., we would pay a significant toll tax to do that.

Mr. TIBERI. So, to go to Mr. Becerra’s point that he just made, the Tax Code is causing your company to make investments that it otherwise wouldn’t make overseas, it would make them here, because of the current Tax Code.

Mr. CRINES. Well, the Tax Code certainly is structured in a way where there is significant disincentive to bringing those earnings and profits back here to the U.S. So if we are looking to invest in the U.S., we have to find alternative sources of capital to make those investments.

Mr. TIBERI. But it would almost encourage you to make investments that you otherwise wouldn’t make overseas. Is that correct?

Mr. CRINES. I would agree with that, Congressman, yes.

Mr. TIBERI. Do others agree with that? Yes or no answer.

Mr. BUTHMAN. Yes.

Mr. RAPP. Yes.

Mr. HAYES. Yes.

Mr. TIBERI. Now, I am not going to ask you about your own companies, but—if you could give me a quick answer—talking to CFOs around the country, American CFOs who do business internationally—I assume you guys get together for a pop every once in a while and talk about the Tax Code—do you feel there is a risk that some of your CFOs and CEOs, not competitors in the United States, but peer companies who do business overseas, are talking about potentially, in the future, if we do nothing, if Rome continues to burn with respect to the Tax Code, that it would make sense for them to put their beer company in Belgium, for instance?

Mr. HAYES. I think that is actually the issue here, Congressman. I think the fact is we are at such a competitive disadvantage that a company in France can buy a company in the United States, and because of the tax arbitrage alone, pay for whatever premium is required to make that acquisition.

We saw it with InBev and Anheuser-Busch. And again, as UTC is a \$60 billion business, even we are worried about the fact that there are foreign companies out there that could take advantage of the tax arbitrage to pay for a takeover of a U.S. company. And, again, tough to do with a UTC, but there are a lot of other mid-market companies that are going to suffer from this.

Mr. TIBERI. And I would think you would agree with this statement, that the jobs that you provide around the world, the best paying jobs are at your headquarters? Is that true?

Mr. HAYES. Yes.

Mr. RAPP. The point you raise there is spot on. And if you take the combination of the tax arbitrage and a weak dollar, that risk has never been greater.

I talked earlier about the jobs that we generate because we've got our HR staff, our IT staff, our R&D staff all headquartered here. If you get acquired by a company from another country, where do you think those jobs go?

Mr. TIBERI. Well, in addition to that, then, let's say you were making diapers, and you are making diapers all over the world to sell diapers all over the world. Unfortunately, a lot of our constituents—Mr. Becerra made this point—believe that you are making diapers in China to sell to America. And I think your point is—all of your points are—you are growing jobs overseas, not at the detriment of the United States job market, but your growth is overseas. And if you don't grow overseas, somebody else from France or Germany or Belgium will grow overseas.

And let me ask you this, as it relates to that, starting with the gentleman from Texas. If you grow overseas, and you sell more diapers and more Depends, and all the other things that you sell in Europe and China and Africa and Asia, does that help your corporate headquarters? Does that help American jobs? And how does it?

Mr. BUTHMAN. Absolutely. And the fact is in our business, I think like in most businesses, you need to fish where the fish are. And the fact is, demand for our particular products are growing very rapidly overseas. And that is just going to be a natural evolution. The more competitive we can be overseas, the more successful we are going to be, the more successful our shareholders—

Mr. TIBERI. Final question—if you could, provide this in writing back to the committee, because my time is about to expire—if we go to a territorial system, which I am for going to—are there things that we need to avoid? Because different countries have different types of territorial systems.

Are there things that we should avoid if we go that way? And what are those things that we should try to avoid, to maximize the ability of U.S.—American companies that compete overseas to do better?

Thank you. I yield back.

Chairman CAMP. Thank you. Mr. Doggett is recognized.

Mr. DOGGETT. Thank you very much. Thank you for your testimony. I certainly agree with you, that we need tax policies that encourage growth of jobs here in America. But, as you know, I have a very different perspective about some of the particulars of how we get there.

And I am going to follow Mr. Tiberi's example, since there are four of you and five minutes, and ask you if you would, please, to—what will be narrow questions—respond with yes or no, or that you can't answer yes or no, and then if there is time I will come back around and get you to fill in some additional testimony, and certainly welcome, as he did, your supplementing your answers with written updates to our committee.

Let me begin with you, Mr. Hayes. Is it correct that you were quoted in Bloomberg recently as saying, "A one-time repatriation of profits is a bad idea. My fear is that we will have a repeat of 2004. If companies repatriate these profits and spend it on things like share buy-backs, they will create such negative connotations around tax reform with the public." Was that an accurate statement of your quote to them?

Mr. HAYES. Yes, it is.

Mr. DOGGETT. Mr. Rapp, do you agree with Mr. Hayes? And I think IBM took the same position.

Mr. RAPP. I agree with Mr. Hayes.

Mr. DOGGETT. Mr. Crines, do you agree with Mr. Rapp, Mr. Hayes, and IBM?

Mr. CRINES. I agree, as well.

Mr. DOGGETT. And Mr. Buthman?

Mr. BUTHMAN. I am in agreement.

Mr. DOGGETT. All of you agree that repatriation is a bad idea.

Mr. Rapp, let me ask you about the example that would apply to any United States company that moved jobs to China—it applies to others, as well, but it would apply to those companies—where you say that the Chinese tax rate is 25 percent. Am I correct that your testimony is that if an American company pays the Chinese \$.25 on the dollar, that you think it is unfair that they should, in addition to that, have to pay \$.10 on the dollar to the United States Treasury?

Mr. RAPP. Yes, I do.

Mr. DOGGETT. And, as I understand what you call a territorial system, the goal is to reduce the amount on earnings, on profits in China or elsewhere abroad, from \$.10 on the dollar to zero to the United States Treasury?

Mr. RAPP. Yes.

Mr. DOGGETT. And the goal here is to have in what you call a territorial system a permanent exemption from all U.S. taxes on all earnings abroad, all foreign earnings. Isn't that the goal of a territorial system?

Mr. RAPP. I think as we said earlier, you have got to do a benchmark of the territorial systems around the world. There is not one territorial system. What we are looking for—

Mr. DOGGETT. But the one you are advancing would consist of what you just said, of going from \$.10 to \$0 to the treasury. The goal is to not pay taxes, except where you are making the profits.

Mr. RAPP. In that example, absolutely, that we would pay the \$25 there.

Mr. DOGGETT. Mr. Crines, do you agree that the goal should be to pay zero dollars to the United States Treasury on earnings that you would have in China, if you paid the Chinese tax, that it should be zero here, that that is the goal of a territorial system?

Mr. CRINES. No, sir, I would not agree with that—

Mr. DOGGETT. Okay. And, Mr. Buthman, do you?

Mr. BUTHMAN. Yes, I would agree with that, and I would also add that I would love to have access to the excess capital that we have overseas.

Mr. DOGGETT. Overseas. I understand. And then, let me ask you, Mr. Rapp, you testified, especially in your written testimony, to the importance of the research and development credit to the active financing credit, which allows for extending credit abroad to operations without recognizing any earnings immediately from extending that credit.

Are you saying that if the corporate tax rate were reduced, the statutory rate were reduced to the mid-twenties, that you would be willing to forego both of those?

Mr. RAPP. As I said, if you get us to a statutory rate which includes states, that puts us competitive globally, everything is on the table.

Mr. DOGGETT. And that would be—several of you have talked about what that rate is, but that is somewhere around 25 percent?

Mr. RAPP. Including state.

Mr. DOGGETT. Including state taxes, as well.

Mr. RAPP. Right, right.

Mr. DOGGETT. So you—the federal rate you would be looking for is below 25 percent.

Mr. RAPP. Right.

Mr. DOGGETT. But if you got it below 25 percent, you would be willing, consistent with the testimony here about the need for simplification and the problems of having a 19,000-page tax return—

Mr. RAPP. Yes.

Mr. DOGGETT [continuing]. To eliminate the research and development credit. In fact, there are a long list of corporate deductions and exceptions and provisions that perhaps some of the team behind you have been successful in getting into our Tax Code in the past. And you would, for a flat rate of in the twenties, you would be willing to forego all of those?

Mr. RAPP. What we have said—and I said it in my comment up front—what we are looking for is a level playing field. So what I

want is a territorial system that lines up with the countries that we compete with around the world.

Chairman CAMP. All right.

Mr. DOGGETT. All right.

Chairman CAMP. Thank you. Time has expired. Mr. Reichert is recognized.

Mr. REICHERT. Thank you, Mr. Chairman. Well, first of all, Mr. Hayes, just a quick question. You mentioned 19,000 pages of tax returns that you have to fill out. Would you be more comfortable with a 10,000 to 15,000 page range, or—

Mr. HAYES. I was hoping—

Mr. HAYES. How about a one-pager?

Mr. REICHERT. A 1-pager, instead of the 19,000. Well, you know, this is really all about jobs in America. And I think all of us here in this committee recognize that. All of you on the panel recognize that. It is all about making the United States of America leaders in this global economy. That is where we all are headed, that is where we all want to go.

But I think part of the problem that we all have is that we hear from our constituents consistently—I mean they all agree—“Let’s sell American, sell American, sell American.” But I think most average Americans across this country believe that we can sell American within the United States borders, and I think some of us know and recognize that 95 percent of our market is outside of this country.

Let’s just say that I am one of your employees. What would you tell an employee who is thinking that, you know, I am working for one of these great companies, earning a great wage, but I see all the sudden this expansion around the globe, and jobs blooming up all over the world, but not so many jobs here, in the United States. How do you explain this global expansion to your average worker? Because I think that is where we hear the most complaints. And I would imagine that you probably hear some of the same.

Mr. RAPP. Congressman, I will start with that. I think you raise a great point. It is the responsibility of the business community to have that good discussion with our employees to explain it. And I will give you an example.

I was recently in our East Peoria plant, talking about the importance of global competitiveness. And I asked the open-ended question, “What do you think about free trade and some of the agreements that are out there? Do you think we should promote that kind of activity?” And I was disappointed in the fact that there wasn’t a stronger opinion from the group. And I commented that 8 out of the 10 tractors coming out of this factory go to export.

And what I took away from that was that is not a failure of you, it is a failure of us, as a business, to engage with our employees. So we are aggressively going after it. We have created a speakers bureau, which creates presentations on tax competitiveness, trade, and the other key elements of our business. We are pushing it down our organization and expecting our leaders to communicate it to their employees, because we have got to do a better job of educating our employees to support the changes you know you need to make.

Mr. REICHERT. There are some companies, too, that produce pieces of their product in other parts of the country, ship it back to the United States, and add it to the product to finish the product, which, of course, creates more concern for our employees here in the United States.

The rest of the witnesses, do you have similar programs to educate your employees?

Mr. HAYES. In fact, I would tell you, Congressman, at United Technologies we believe that lifelong education and furthering the education of all of our employees is of paramount importance. We spent nearly \$1 billion in the last 15 years on the UTC Employee Scholar program. More than 33,000 degrees have been earned by our employees.

Because globalization, as we tell everyone, is a reality. The jobs that we have today are not going to be the same jobs we have 10 years from now. We have to have a better educated workforce, we have to have people that have better skills. And we encourage that through paying for four-year college for people, we pay for books, we pay for fees. And we think that is the responsibility the corporations have to their employees, is to help them become better educated to deal with the globalization that is happening today.

Mr. REICHERT. Yes.

Mr. BUTHMAN. I would say we have the same emphasis on educating our workforce, but I also give them a lot of credit. In our industry, it is very competitive. We understand we have to drive efficiency. The best way to protect employment and growth is to drive efficiency and drive innovation. And our employees are actively engaged in that, and they are pretty aware. I am constantly amazed at how aware they are of the world around us—

Mr. REICHERT. My time has just about expired, but I want to make this point that what you see here are people that really want to work with you in solving this problem and making America great again and bringing confidence back into our economy.

Again, our constituents are the ones that drive us. And if you can help us with that, I think that would be one of the, I think, largest hurdles that we have to overcome in looking at restructuring the Tax Code, and also in looking at trade agreements that we have with other countries around this world.

Chairman CAMP. Okay.

Mr. REICHERT. And I yield back.

Chairman CAMP. Thank you. Mr. Thompson is recognized.

Mr. THOMPSON. Thank you, Mr. Chairman, and thank you for holding this hearing. I think it has been incredibly instructive and helpful for all of us in dealing with this issue. And thank you all for being here to provide the testimony.

I have a couple things I am not clear on that I would like to just have you help me out on. Am I to understand that you agree that whatever we do in regard to corporate tax reform should be revenue-neutral, we should not increase the debt, we should not increase the deficit? And we can do the yes or no thing; that is going to be popular—

Mr. HAYES. I think that is the reality of today, a fiscally responsible—

Mr. THOMPSON. So you are for that. Okay.

Mr. RAPP. Yes, fiscally responsible.

Mr. CRINES. Yes, sir we would support that.

Mr. THOMPSON. No, no, not fiscally responsible. Revenue neutral doesn't increase the debt, doesn't increase the deficit.

Mr. HAYES. Yes.

Mr. THOMPSON. Okay.

Mr. HAYES. That should be the goal.

Mr. RAPP. Agreed.

Mr. THOMPSON. Everybody is there? And then, on that, I think that Mr. Becerra started down this road, but on the issue of value added tax, let me be very, very clear. Many of us are either questionable of that, many of us are opposed to that. But just for the purpose of understanding the head nods when Mr. Becerra brought it up, are you saying that you would be in favor of a value-added tax in order to make up that difference that would come about because you—of the lower end of the corporate tax?

Mr. HAYES. I would just say that I think that a value-added tax is probably the most efficient way to raise revenue, because it taxes consumption and not investment. And any review of taxes on a holistic basis should include a review of the potential for a value-added tax.

Mr. RAPP. I would agree. I think that, to the degree that you can make this a comprehensive review of taxes, I think it makes it more valid. I think we have got to be realistic about how much you can bite off at one time.

Mr. CRINES. To the extent we are advocating in favor of simplicity, Congressman, I think introducing a new tax regime would add a lot of complexity. I would prefer reform that really is focused on the income tax regime.

Mr. BUTHMAN. And we would agree, that the essence is simplicity and really thinking through the administration that would be layered on through a VAT, which we see in, for example, in many countries in Europe, is something to be seriously considered.

Mr. THOMPSON. Well, and I just want to point out for the record and anybody who might be listening, that the idea of broadening the base and lowering the rate is great. And, bottom line, it is a math problem. But you can't get to where you all said we ought to be by just eliminating the expenditures. So something else would have to be added in if we were, in fact, going to stay at revenue neutral. And everything on the table is different than a—saying that everything is on the table is different than stating specific ways for us to get there.

A couple of other things. On Mr. Doggett's question on repatriation, I am not certain that I understood your position. You all think it is a bad idea, or you think the way that it was done last time was—shouldn't be duplicated?

Mr. HAYES. I think a one-time repatriation is a bad idea. I think, again, it derails the idea of a comprehensive tax reform. So I would advocate against a one-time repatriation.

Mr. RAPP. I would agree. We are encouraged by the type of debate that is happening here today, and we just don't want to give any relief valve to getting on with this.

Mr. CRINES. Done in isolation, I don't believe it accomplishes the objective of leveling the playing field.

Mr. BUTHMAN. Treats the symptom, and not the underlying issue.

Mr. THOMPSON. Okay. And then, if you will indulge me for just a second, there is a hidden tax. And it was—the Secretary of the Treasury pointed this out the other day. And that is in our failing infrastructure in this country. He has stated specifically that that equates to a tax on business.

And I am just curious if you, A, agree with that, and B, when you are looking at your investments in other countries, do you take into consideration their infrastructure and their plans for increasing efficiencies and infrastructure in your overall long-term business plans?

Mr. RAPP. Absolutely. You know, as I mentioned earlier, we exported about \$13 billion worth of product last year. And it is hard to do. I mean with the state of the U.S. infrastructure, the feeders into the ports, we definitely have seen a decline in infrastructure competitiveness in the U.S. versus other parts of the world. And as we invest around the world, infrastructure is one of the first things we look at.

Mr. THOMPSON. So you all agree with that?

Mr. CRINES. That is correct.

Mr. BUTHMAN. Yes, sir.

Mr. THOMPSON. And then, just lastly, you know, we are talking about this debt limit issue and how we are going to deal with that. And the experts tell us that if we don't do it, it will increase the interest rates. Would that, not increasing the debt limit, would that hurt or help you guys?

Chairman CAMP. I am afraid time has expired.

Mr. HAYES. That would hurt us.

Chairman CAMP. Dr. Boustany is recognized.

Dr. BOUSTANY. Thank you, Mr. Chairman. This is a great hearing, and I appreciate the panelists being here and providing testimony.

Given our current tax system, worldwide taxation with deferral, foreign tax credits, and the fact that we have seen the international marketplace change, you have gone to regional management structures, as opposed to country-by-country. We have some provisions in our Tax Code that have to be renewed annually, or maybe once every two years.

And one of those, Mr. Hayes, you mentioned, was the CFC look-through. And could you give us a little more background for the committee on why this is important, as you try to compete in this international environment?

Mr. HAYES. Yes, Congressman. As I mentioned in my opening statement, about 60 percent of our revenues are earned outside of the United States. And about 60 percent of the cash that is generated is also earned outside of the United States. The CFC look-through rules allow us to move that cash to the various pools where it is most efficiently put to use without having to pay a U.S. tax on the interest income earned in the jurisdiction that is potentially lending that money.

Again, I think this is simply a question of efficiency, and the CFC look-through rules provide a very efficient way for us to manage our foreign cash.

Dr. BOUSTANY. And so, when we have a tax provision like this that comes up for renewal once a year or maybe every two years, depending on the circumstances, this creates a significant problem for you to predict your future tax liability and make business decisions. Is that correct?

Mr. HAYES. That is correct.

Dr. BOUSTANY. Thank you. With regard to compliance, I want to ask everybody on the panel. And I think, Mr. Hayes, you mentioned that you have 19,000 pages in your tax return. Obviously, this is very complex. Talk to us a little bit about your interactions with the IRS. How difficult is this process? I understand there are ongoing audits. You probably have IRS folks embedded. Is that a process that works? What would you do differently?

Mr. HAYES. You know, I would tell you we have 12 full-time internal IRS agents that are on site at United Technologies in Hartford, Connecticut every single day. We have complete open books with the IRS. We share with them all of the information. As I mentioned, the 19,000-page tax return, that is just one year. We currently have five years open under examination. That is a lot of work.

Again, I think the attitude with the agency is cooperative, that we try and be open book. And we think—we take compliance very seriously. It is very important to us not to have to go to tax court. We want to be fair and open.

Mr. RAPP. I think the point you raise is why we have all talked about the need for simplicity. Because the high level of interaction we have is based on the complexity of the systems that we have to deal with.

And so, I would say the process today, painful would be the description that comes to mind.

Mr. CRINES. Congressman, it does take about six months for the company to prepare its consolidated tax return. It takes at least another six months for those returns to be audited by a team of auditors from the IRS that is larger in size than the size of our tax department. So I think that says it all.

Mr. BUTHMAN. Yes. You know, I would say we have a cooperative relationship. But the complexity of the Tax Code does mean you have to share a lot of information. You have to have very skilled people at understanding the Tax Code.

I feel a little bit better. Our tax return is only about 4,000 pages long. So I come away from this hearing a little bit encouraged.

Dr. BOUSTANY. It is my understanding that the IRS auditors rotate in and out as a team, and that there is some lack of continuity, and this creates some repetition and duplication of effort on your part. Is that a fair statement?

Mr. HAYES. That is correct. Every two years or so.

Mr. BUTHMAN. I think in any service organization, the quality of the individual is very important. And when we have good folks from the IRS working with us, it makes the process a lot easier.

Dr. BOUSTANY. Thank you. I see my time is about to expire, so I will yield back. Thank you.

Chairman CAMP. Mr. Larson is recognized.

Mr. LARSON. Thank you very much, Mr. Camp, for holding this hearing, and I want to thank all of our witnesses. And let me start

with a point that Mr. Hayes had made, and I hope all of you can answer that. It centers around the idea and concept of benchmarking.

And in as much as this is a global economy, what, in your opinion, if your companies are benchmarking, and I assume all of them are, who would be the top benchmark in the world right now? What system in the world would you say would best advantage American companies if they were subscribing to it?

Mr. HAYES. Congressman Larson, let me start there. I think, again, as we look across the globe and the OECD, I think there is probably no one system that is perfect. And I would hate to hold out France as the paragon of efficiency, but the fact is I think the French territorial system probably has merits that should be considered as part of this benchmarking.

The fact is, under their territorial system, there is no expense disallowance, but there is a small toll tax of, I believe, five percent, as companies repatriate earnings back into France. But it is a very open system and, again, it does not focus on worldwide income, it focuses on income earned in France. And then French companies are simply taxed at a significantly lower rate than the statutory rate, as they bring earnings back.

But again, it is just one of many systems that is out there that I think is worth studying.

Mr. LARSON. Yes. Thank you. Mr. Hayes, you also realize—and I want to put this in the context—I understand you frame that in the context of both having sound economic fundamentals and also recognizing that benchmarking would have to go along with reform. This is not—I am just trying to get your sense so that, as we are looking at this—

Mr. HAYES. Yes.

Mr. LARSON [continuing]. We can point to those best practices, or try to benchmark to those as to what might enhance our capability, globally.

Mr. HAYES. Yes.

Mr. RAPP. Yes, and one I would add to it is I think the thing that is interesting that shows why this is so timely is the UK and Japan have just gone through this very same process. And they did an extensive amount of benchmarking, asking what does it take to be competitive, what type of system and structure that has to be out there. I think that is—would be another source to look at, in terms of how they walk through the process, how they determine to make the changes that they have made.

Mr. CRINES. And, Congressman, we believe the European territorial systems have made significant progress in simplifying their Tax Codes. And among those—and we have significant market share in Europe—would include the UK, Germany, and France.

Mr. BUTHMAN. I have nothing to add to the discussion. I do think a comprehensive review—I think that the process the UK and Japan just went through would be a great place to start.

Mr. LARSON. Following up on the line of questioning that a couple of my colleagues had, and Mr. Thompson, specifically, in knowing that the United States is currently—and this Congress is currently—dealing with raising the debt limit, what is your feeling on that?

Do you think that there should be a—what are the ramifications of not acting on this in a timely basis for your companies?

Mr. HAYES. You know, Congressman Larson, I think it would be devastating to the world economy, not just to the U.S. economy and not just to UTC, if the Congress failed to raise the debt limit. The full faith and credit of the U.S. Government is the basis upon which the entire world financial system revolves.

If we think that the problems back in 2008 with the Lehman crisis were devastating, a default by the U.S. Government would have repercussions beyond anything we saw in 2008 and 2009. So, we would encourage the Congress to raise the debt ceiling.

Mr. LARSON. This is in a process, then, from the perspective of business, of dealing with a credit card. This is a matter of default. That is how critical this is?

Mr. HAYES. That is correct.

Mr. RAPP. Yes. You know, for us, we are seeing improvements in our business around the world, but it is still a pretty fragile economy. The last thing we need now is another, if you would, shot across the bow that creates disruption, in terms of the global financial markets.

So, we are counting on the fact that Congress is going to come together and figure out the right thing to do here.

Mr. CRINES. I don't think I could say it any better than Mr. Hayes, Congressman. I would agree with his remarks.

Mr. BUTHMAN. Confidence in the quality of our U.S. Government debt and the U.S. dollar are critical to running our business and, really, are a worldwide issue. I agree.

Mr. LARSON. Thank you all for your expert testimony.

Chairman CAMP. Thank you. Mr. Buchanan is recognized.

Mr. BUCHANAN. Yes. Thank you, Mr. Chairman, for this important hearing. I appreciate the witnesses being here, and I applaud your companies because, at the end of the day, to me, it is about free enterprise. And the more we can help you be successful, it is in the best interest of the country, in terms of providing good jobs.

I would like to get your opinions, and I don't know if you have given much thought about this, but I am thinking down the road as someone that has been in business for 30 years. I think there is a mindset in Washington that they are seriously looking at lowering the tax rate, you know, and cutting out deductions, maybe 25 percent, 28. I have heard the President express that interest, you know, when he talks to CEO roundtables and others.

But help me understand. We are looking at one part of it. But as we look down the road, if we move down this road, you have a lot of competitors that might compete with your divisions or with other aspects of your business. They might not be the Fortune 500—in fact, they are not—the Fortune 500. But these are middle-market companies, these are small companies that compete with some of your divisions. They are called, as you know, pass-through entities. I am sure all of you are CPAs or work with a lot of accountants.

How do we cut your rate a third, ideally, and eliminate deductions—how do we—how do you do that without addressing the LLCs, the subchapter S corporations? I used to be a C corp, and you know, over the years they moved me to an S corp in the 1980s

and an LLC in the 1990s. How do you do that when you have a mentality with some people that, they want to tax the rich? Well, the rich are a lot of those job providers. They are people that make over \$250,000. A lot of them are my friends that have maybe 100 employees, 500 employees, but they happen to make \$2 million a year.

How can they give you a tax cut, which I would like to see go to 25 percent, but how do you do that and not address the LLCs and the other pass-throughs when you have got this political rhetoric that talks about taxing people over \$250,000 at a higher bracket?

And you might say, "Well, that is your problem," but I would like to get your thought on that. How do you deal—how do you propose that we consider something like that, as we move down the road?

And Mr. HAYES, I am going to put you on the spot.

Mr. HAYES. Okay. Well, again, I think, again, that the fact that there are many American companies, if not corporations, that don't pay tax is an issue that has to be dealt with. It is just a matter of law, the fact that if you are a company with less than 500 share owners you can be a pass-through entity, and you are not subject to corporate income tax, you are not subject to the same compliance rules, you are not subject to the 35 percent, and the income, in fact, is passed on to the individual owners of the business.

And so, how do you reconcile that with not wanting to raise taxes on America, and how do you deal with the fact that you do not want to kill job creation by small businesses?

I think, again, it goes back to, in our view, a holistic view of taxation in this country. What is the most efficient way to raise revenues? And, again, I think taxing capital, taxing investment is, at the end of the day, destructive to value creation, to job creation. And again, I know that the value-added tax is a very difficult—

Mr. BUCHANAN. My time is limited. Let me go back, though.

But can you imagine if we lowered your taxes to 35, corporate America, Fortune 1000, and then somehow the sub-S's and the LLCs either stayed at 35 or moved to 40? I don't see how that works. I mean am I missing something?

Mr. HAYES. Well, I think, again, it is the issue of double-taxation. Our share owners are taxed twice. They are taxed at the 35 percent statutory rate, and they are taxed again when we pay them dividends, whereas the pass-through entities are only taxed once.

Mr. BUCHANAN. Yes. That is why they are pass-through, as you know.

Mr. Rapp, do you have any thought on that?

Mr. RAPP. Yes. We have talked about VAT earlier that involves the consumers. Now we bring another one into it. And I think the reality of the situation is if we throw all these issues on the table at one time, we are probably not going to move forward on any of them.

The other thing I would say is, to the degree that we become more successful and more competitive, it has tremendous positive benefits to some of those very companies that you referenced. We are supported by about 4,900 small and medium-sized businesses in the U.S. who are suppliers to us, as an example.

Mr. BUCHANAN. And let me shift. I am going to shift gears, because my time is limited. On this territorial tax—I am not saying I agree or disagree with it, but, you know, I like less taxes. But the bottom line is if you are in a tax area—we said 25 percent, but let's say you are in a tax area that provides 10 percent. I was just talking to people from Hong Kong, they are at 16. Then you have a 20 percent tax incentive to do business there, instead of in the States.

Chairman CAMP. Time has expired.

Mr. BUCHANAN. Thank you. I yield back.

Chairman CAMP. And what we will do is move to Mr. Smith.

Mr. SMITH. Thank you, Mr. Chairman, and thank you to our witnesses. We have heard a little bit about wage pressures here this morning. And I am intrigued by how diverse the panel is. And yet, when it comes to so many policies, whether it is energy policy or tax policy, I mean, there is so much interconnectivity. And, you know, with wage pressures around the world, those are very real issues.

I was wondering if you could elaborate, perhaps, the effect of tax policy on wage pressures, or wage pressure the other way around. So, if any of you could, elaborate.

Mr. BUTHMAN. Let me take a crack at it. You know, I am not sure that the two interact. As we look at an investment, where to set up a manufacturing plant, again, typically for our products you've got to be close to the consumer. And you consider tax policy, you consider wage rates, you consider infrastructure, you consider certainty, political and economic risk, I think, from our point of view, we don't see that interaction with tax policy driving wage rates lower or higher. It is just a fact of the local market.

I think with regard to the reference to China earlier, we are seeing how rapidly things change around the world. A low labor cost jurisdiction in a very rapid time can get to global averages with a lot of factors. So, we would say there are two separate and distinct factors that we would consider in making an investment decision.

Mr. CRINES. Congressman, the thing that we have to pay attention to with respect to our employee base is what is happening with disposable income and tax policy can certainly have an effect on that.

I would tell you that a more significant source of pressure with respect to our domestic employees has been health care, and the rising cost of health care over the last many years. And as we look at those pressures, and decisions around whether or not to locate in the U.S. or OUS, I wouldn't say we are seeing significant differences in tax policies that are causing us to choose OUS locations over U.S. locations.

Mr. RAPP. Yes, I would agree. I think the reality of the competitive world that we operate in today, you have got to be competitive in every part of your business. You have got to be competitive, relative to your tax structure. You have got to be competitive, relative to your wage rate. We have to build the best products, provided by the best services.

So, there is no free lunch in the competitive world we deal with. And so I wouldn't draw a direct cause and effect between the effec-

tive tax rate and our wages. I would say that we look at how are we going to be competitive across the full spectrum of our business.

Mr. HAYES. Yes, I would just add, as we look at long-term investment decisions, taxes is probably the biggest single cost, in terms of that investment decision. You know, direct labor, in our business, is less than 10 percent of our cost. So difference in wage rates really don't have a dramatic impact on investment decisions. It goes more to where are the customers, and where do the logistics costs—and then what are the tax costs associated with those investments.

Mr. SMITH. Okay. Now, when you mention your labor costs, Mr. Hayes, so you said 10 percent of your overall costs are labor costs?

Mr. HAYES. That is correct.

Mr. SMITH. So then it is quite obvious that you are not locating overseas to avoid wage pressures or anything.

Mr. HAYES. No, you locate in the markets where the customers are. And I think, again, you—I bring back the example of the Otis elevator. You cannot service an elevator in Shanghai from East Hartford, Connecticut. It is just not possible. You have to be in the markets where the customers are.

Mr. SMITH. Okay. Very well. Thank you, Mr. Chairman. I yield back.

Chairman CAMP. Thank you. Mr. Blumenauer.

Mr. BLUMENAUER. Thank you very much. I really appreciate the frank and clear testimony that you are giving us, in terms of some of the complexities that you are facing. I know I had similar feedback, but frankly, not as eloquently, from some of the businesses back home of late.

I also appreciated your clear and unequivocal statement about playing Russian roulette with the debt ceiling. I hope that—we have got all sorts of things we can argue about around here. We have got lots of leverage points that we can take hostages and push each other around. I hope that this is one that is not in that category. And your testimony, I think, helps add to the record that maybe will make that a little less likely, and I appreciate it.

I am—and I think you have made clear that you have got to deal with the reality—I think, Mr. Rapp, you talked about making investments based on what your—what the costs are going to be for you, not the aggregate, but what the costs will be, marginally, for the deal that you are looking at, posing problems.

One of the things that you have started to get at, and I would like you to elaborate on—because you have been clear, you are not interested in draining the treasury. You understand that there is investments, and several of your businesses would benefit, for example, if we were doing a better job of investing in infrastructure and some of the user fees that are—were—are worldwide, and we used to do here.

But you know, you look at the data. We are not a high-tax country, compared to the other developed countries around the world. All the information suggests we are at the bottom end. France, that you mentioned a moment ago, has much higher total taxes. We put aside for a second the personal income tax.

But, Mr. Hayes, I think you were starting to get into the value-added tax, which is a glaring omission. All our competitors have a

value-added tax. Hard to evade, reasonably simple to administer, people have figured it out. It is part of this level playing field. And, Mr. Rapp, I know you were starting—maybe if you two gentlemen would, just comment on where you would like to put that on the record, in terms of our deliberation of deconstructing the Tax Code and putting it back together.

Mr. HAYES. Again, I think I would say, as we look at the structural deficits in this country, which are approaching \$1.5 trillion annually, the fact is we know we have to figure out a way to raise revenue, as well as to cut expenditures.

I think as we look at the OECD, we recognize that, you know, corporate taxes are perhaps not the most efficient place to raise revenue. And I think that is what we are talking about here today. Obviously, it should take a holistic view of how do we most efficiently raise revenue to meet the needs of the country. I think the value-added tax is one of those things that needs to be on the table. I think the deficit commission last year addressed this as a potential.

And I think you can't simply ignore the fact that it is an efficient way, it is very compliant. It is compliant because every step along the way everyone is incentivized to have compliance, because they have to get a refund from the taxes that they paid.

So, again, I am not saying it is the solution. I just think it has to be out there as a potential for us, as we have this debate on how do we deal with the structural deficits in the country.

Mr. BLUMENAUER. Yes, I appreciate your reference about the deficit commission that also talked about maybe a gas tax, a user fee.

Mr. Rapp, you have any thoughts?

Mr. RAPP. Yes. I just echo what Greg said. To me it really gets back to this issue of what do you want to be as a country. And you have really got to be careful of the unintended consequences.

I think a lot of the other OECD countries have decided that a good corporate, good manufacturing base is important, in terms of the long-term competitiveness, standard of living, and other things, and so they incent that type of behavior through their Tax Code. And they raise revenues through other mechanisms. Yes, I think it is clear.

The challenge, I think, before you is how much change can you take on at one point in time.

Mr. BLUMENAUER. Well, and I appreciate what our chairman has done, in terms of trying to lay a foundation for a broader conversation, having a variety of viewpoints. Because all those structural problems you talked about, actually it is the direction. We have got to bend the curve, we have got to send signals to business, to the bond market, to ourselves, as policy-makers. And I think you have given, I think, a very useful viewpoint about what we need to do to do that right. Thank you very much.

Thank you, Mr. Chairman.

Chairman CAMP. Thank you. Mr. Schock is recognized.

Mr. SCHOCK. Well, thank you for all of your great testimony and answers to some important questions. You know, a lot of the good questions have already been asked, a lot of the issues I was going to raise have already been addressed.

One thing I want to make clear, though, that some of my friends on the other side of the aisle continue to point to, and that is this issue of deficit neutrality.

I think it is important to point out—and I would be interested in your comment—to the degree we become more competitive as a country, you know, one of the things we struggle with when we talk about budget scoring is that our budget scores base it on a static business environment. In other words, based on current activity in the United States or in foreign countries.

Would a more competitive—and this is a softball, I think—would a more competitive rate warrant you to invest more in the United States, or less, or would it be static, in terms of the amount of investment you would make in the United States if we had a more competitive tax rate?

Mr. RAPP. On that one I would say as we talked throughout the discussion today, I think the four of us strongly support the principle that our global growth drives employment in the U.S. So the degree that you make us more competitive, it is going to lead to jobs and investment back here.

I think the thing on the scoring that you just have to keep in mind is the scoring would tell you that if we maintain status quo there is no change in revenue. Chairman Camp, I think you pointed out some interesting statistics earlier about the decline of U.S. competitiveness, and what it has meant in terms of share of global GDP, share of investment, all those things.

So, to assume that you can address the competitive issue and maintain a status quo may be a flawed assumption.

Mr. HAYES. I would also add as we think about the amount of cash that sits offshore with U.S. companies—over \$1 trillion, and at UTC that is over \$4 billion that is trapped overseas—a simplified tax system, one with a territorial system that would allow us to bring cash more freely back into this country, even if that cash is returned to share owners, those share owners have the opportunity to invest, as do we, back in this country.

And I think that is the key, is the free movement of capital here. And, right now, capital is stuck overseas, which forces us to make an investment overseas. To the extent that we have a territorial system, even one with a small toll tax, we will be encouraged to bring that cash back to make investments here, to give to our share owners, to invest in America.

Mr. CRINES. We have to compete, not only for customers, but also have to compete for capital. And to the extent that we have foreign-based competitors that have an opportunity to earn higher after-tax returns on the capital that they have entrusted to them, that puts us at a competitive disadvantage, clearly.

So, anything that can be done to reduce that disadvantage will put us in a position to invest more aggressively in innovation and grow our businesses on a global basis.

Mr. BUTHMAN. And I would agree. It is just like our business. When we are faced with a profit shortfall, as you are faced with dealing with a deficit, we can drive cost efficiency, we can raise revenue through pricing, or we can try to drive volume.

And, from our perspective, raising prices is sort of the last lever we pull, because we are in a competitive marketplace. And our con-

sumers shift very rapidly to competing products, even if we think we have the best performing, most attractive product on the shelf. And to me, this is about creating more competitiveness. If we are more competitive, we will drive more volume.

I think Greg makes a great point. There is a lot of capital trapped overseas that ought to be on shore, being deployed somehow, either through us, in research and capital, or deployed back to our shareholders to reinvest in other industries.

Mr. SCHOCK. Thank you all. I appreciate it.

Chairman CAMP. Thank you. Ms. Jenkins is recognized.

Ms. JENKINS. Thank you, Mr. Chair. Thank you for holding this hearing. And thank you all for being here. I think we probably have covered most everything. So if—maybe just comment briefly for me Because all of you do represent companies worldwide, and I have understood from the comments and your testimony this morning that for most of your companies, intellectual property and R&D takes place in the U.S.

So, I would just appreciate it if you might just reiterate for us the relationship between your domestic operations and your foreign operations, particularly how they support one another and how important your foreign earnings are to your domestic operations and our growth, here in the United States.

Mr. BUTHMAN. Yes, let me take a shot at that first. The vast majority of our R&D investment is done today in the United States. Increasingly in our markets, though, the pace of change and the amount of innovation around the world is an important source of ideas. So I see that shifting over time. We are going to have more ideas come to the U.S., we are going to bring them to these markets, we are going to be able to use those ideas to enhance the lives of our consumers.

But, by and large, and for the foreseeable future, the vast bulk of our technology and innovation investment is going to happen in the United States. The more capital we have to return here and deploy, the stronger that domestic base is, it strengthens our business here and around the world.

Mr. CRINES. Congresswoman, approximately 75 percent of our research and development employees are based in the U.S. Seventy percent of our foreign source revenues are sourced out of manufacturing operations that are U.S.-based.

So, as a consequence of being successful competing for business overseas, we have been able to increase U.S.-based employment over a 10-year period by 80 percent.

So, we continue to look for opportunities to expand our innovation programs, hire more engineers out of some of the terrific universities that we have here in this country.

Mr. RAPP. Yes, I would—Congresswoman, I would say our foreign operations have a tremendous impact on our domestic operations in a number of ways. One is—consistent here—is the R&D. We have got a tremendous investment on very complex sales systems and all that to test out the product that we have got to do. So a big part of it is R&D.

Another key driver is the corporate services. The amount of resources that we apply here—we are doing a global deployment of a new IT system right now worldwide led by the IT resources in

the U.S. We have got about a \$30 billion global portfolio on financing equipment for our customers headquartered treasury management, all out of the U.S. And the same goes for purchasing, IT. So those corporate services support our global operations, and it is really good for the U.S.

And then the last one of our foreign business really being a positive impact on the domestic aide is just the exports that we drive, about \$13 billion. You know, it is an interesting number. We have exported last year the equivalency of our total U.S. sales. And so people in our organization understand winning in China matters.

So those would be the places that it would have the most direct impact.

Mr. HAYES. Yes, Congresswoman, maybe just a couple of numbers here, because that is what we do every day. About 60 percent of our revenues come from outside of the U.S., and 60 percent of our profits. And so, last year we made about \$5 billion after tax at UTC. So \$3 billion of earnings came from our overseas operations. We spent \$3.7 billion on R&D last year. About a billion of that was overseas.

But for the overseas earnings, that \$3 billion that we were able to earn overseas, we wouldn't have been able to fund the \$2.7 billion that we invested in this country in R&D.

So, I look at this as, again, we are a global company. We serve global customers. But at the end of the day the big investments that we are making in R&D are coming in this country, and that is what creates the intellectual property that allows us to be successful around the world.

Ms. JENKINS. Thank you all. Mr. Chairman, I will yield back.

Chairman CAMP. Thank you. Mr. Pascrell is recognized. I think, under the rule of presence at the gavel, Mr. Pascrell is recognized.

Mr. PASCRELL. Thank you, Mr. Chairman. Listened very, very carefully to this discussion this morning. I don't know of a person that sits in the Congress that doesn't want tax fairness. Of course that is perceived in different ways by different people. We understand that. And it would be foolish to take a position of anti-business, particularly in a time when so many of our own people are out of work throughout the nation—not in any one particular state, but throughout the nation.

There is a—we lose approximately \$100 billion in tax revenues every year, due to corporations and individuals moving money to offshore tax savings. Now, how do we make up for that lost revenue? Here is how we make up for the lost revenue. The average U.S. tax filer pays \$434 that he doesn't even know he is paying. So that is how we make up that slack. That will feed a family for about three weeks, by the way.

So that is a very serious problem in us trying to get equity. And, by the way, the thousands of pages that you complain about in the Tax Code were not written by the average guy on Main Street. Those pages—and every president in the past 30 years has promised us a simpler form and a shorter amount of pages, every president—but most of those pages are written by your lawyers. And you know it, and I know it. But the people of New Jersey better know that they are paying, each individual, \$752 more in taxes because of what corporations do to us day in and day out.

You have hundreds of lawyers. GE has 1,000 lawyers doing tax stuff. The average American has no one to turn to, usually, and is a victim. So let's get it straight. Who are the victims, and who are the perpetrators?

Mr. Crines, I have waited a long time—it was quite by accident, I didn't even know you guys were going to testify today—Zimmer Holdings. You are here to advise us on tax policy. Your company, your corporation, was accused of Medicare fraud in 2007. In fact, your company paid \$310 million in a fine. It has become part of how we do business nowadays.

Let's talk about competitive advantage. Here is what your corporation was, in terms of corporate advantage: bribing doctors in hospitals to use your device. In fact, the person who was appointed the federal moderator of that case was the former attorney general, Ashcroft, who got a \$52 million contract to oversee you to get you to fly straight to keep you from going to court in—not you, personally—so nobody would go to jail. So you made the agreement.

I want to know one thing, first of all, is how much was your fine, as stated in that settlement? Did you engage in a monitoring agreement with Mr. Ashcroft, Mr. Crines, your company?

Mr. CRINES. The company entered into a deferred prosecution agreement with the U.S. attorney's office. It was effective from September of 2007, expired in March of 2009, after the company had successfully complied with all the terms of that agreement, sir.

Mr. PASCRELL. Were you able to deduct your tax liability from your—were you able to deduct that from your tax liability, the cost of the monitoring agreement which you made with the Federal Government?

Mr. CRINES. As a result of a submission to the IRS requesting a ruling as to how we should handle the fine on our tax return, we were able to deduct one-half of the fine that we paid.

Chairman CAMP. Time has expired. Mr. Paulsen is recognized.

Mr. PASCRELL. May I ask one more question, Mr. Chairman?

Chairman CAMP. I am afraid, Mr. Pascrell, time has expired. I have treated everyone the same way in the hearing today, and it is Mr. Paulsen's time.

Mr. PASCRELL. Okay, thank you.

Mr. PAULSEN. Thank you, Mr. Chairman, and thank you for—all of you—for taking the time to be here today. And we certainly heard some common messages in terms of competitiveness and what you have to do to create jobs here in the United States.

I want to ask one quick question, too, of Mr. Crines, and then I will open it up. You know, one of the issues that I really do have a strong concern with that we have touched on in a couple of hearings is this new medical device tax that is going to be a tax on innovation, a tax on R&D. You talked about 75 percent of the R&D in your company is here, in the United States.

Can you just maybe reflect how this is going to—this new tax, which starts in about a year-and-a-half, this new excise tax, doesn't matter if you are profitable or not—how is that going to affect your competitiveness in general, and will that come out of R&D?

Mr. CRINES. Well, as a matter of fact, Congressman, the company announced at the beginning of this year a restructuring, in part, to get the company in a position to be able to afford the in-

creased tax and still continue to produce returns on the capital that we have invested that are aligned with what our peers both our U.S. multinational peers, as well as our foreign-based multinational peers, can earn for their investors.

So, the—as I said, the excise tax, which, for Zimmer, will result in additional expense of somewhere in the neighborhood of \$50 million to \$60 million, beginning in 2013, has forced us to take steps to—that have resulted in the reduction of about 450 management and staff jobs at the company.

And again, those reductions are taking place over the course of this year, and will put us in a position such that we can afford that tax. And those reductions did include, in some cases, research and development positions that are U.S.-based.

Mr. PAULSEN. Thank you for that. Without a doubt, I have heard this similar story from other medical technology device companies, that this industry has been very successful. It is an American success story, got a strong presence in Minnesota. It is in New Jersey, it is in Boston, it is in California. And we want to keep it in the United States. And there are definitely threats that this is moving towards Europe. And the tax is just one component of that.

But I think all of the witnesses here today also have just, really given a message that it is better to have a simpler system that you can all focus on with certainty, because you are allocating capital 10, 25 years out.

And one of my observations with Congress is Congress's long-term thinking is six months or two years. And so, you know, we have the R&D tax credit, are we going to extend it for another year, are we going to extend it for six months. And you are thinking 10, 25 years out. So if you are going to create jobs, you have to be thinking down the long term.

And wouldn't it be better to have that certainty and that predictability in your tax department, so you don't have to have 50 people, 100 people, 100 lawyers, 100 attorneys working for you, how to comply with the Tax Code or find deductions or loopholes, et cetera, and really put those people's knowledge and expertise to start their own company, to create their own jobs, to really harness that energy?

I mean, feel free to just walk that line, share any thoughts.

Mr. RAPP. I would just say yes. I think a lot of times I get the question, "What does it take to get the U.S. growth engine moving," and I think you touched on the key issue, and that is certainty.

And if you look at our company and the customers we serve, major contractors in the U.S., with absolutely no line of sight to are we going to get a highway bill or not, are not going to make the decision to make the investment to buy the equipment that generates the jobs.

As we make decisions about the opportunities in terms of the export markets, but yet while we are encouraged by the recent progress, we have tremendous uncertainty relative to what is going on in trade. And then, of course, the debate we are having here today, with taxes.

Business is all about confidence. And when you have confidence in a system that is going to yield a good investment, you are will-

ing to put the money on the table. I think today, the uncertainty that exists makes that really difficult.

Mr. PAULSEN. Mr. Hayes.

Mr. HAYES. Yes. I would just add I think certainty is really the issue here. And the fact that we passed an R&D tax credit that was retroactive to the beginning of 2010 in December of 2010, while it was a nice Christmas gift, as I have told my people, "It is hard to plan, waiting for Santa Claus."

And I think what we need here is long-term certainty that either the R&D tax credit is going to be here or it is not, so that we can make decisions, long-term, that are the best for the share owners and best for our employees. And that is all we are really talking about here, is simplicity, fairness, and competitiveness.

Mr. PAULSEN. Mr. Buthman, final comments before my time runs out?

Mr. BUTHMAN. Yes. I would say, as we look overseas, the degree of uncertainty, political and economic instability, is a key part of our cost of capital. And I think that is an advantage that the United States has. To the extent we can reduce it, maintain that advantage, it is to all our benefit.

Mr. PAULSEN. Thank you.

Chairman CAMP. Ms. Berkley has the time.

Ms. BERKLEY. Thank you, Mr. Chairman. I appreciate this hearing very much. The longer I stay on this committee, the more I realize I don't know as much about these issues as I should.

Mr. Buthman, it gives me—as I go further from Huggies and closer to Depends, it gives me great comfort to know that I am going to be a lifetime customer of your company.

[Laughter.]

Mr. BUTHMAN. We want to take care of you, cradle to grave.

Ms. BERKLEY. Womb to tomb, yes. I represent Las Vegas. And up until very recently, we didn't have any multinational corporations doing business overseas, just very local. And because of the gaming laws, most of my companies—and I have one major industry in my state—they couldn't even do business in another state, and retain their gaming license. Now, of course, gaming is located in almost all 50 states, and we are doing heavy-duty business overseas, particularly in the Asian market. So, all of a sudden this is a very important issue for me.

This is my question. I have a number of gaming companies, but I am going to highlight two without naming names. One of them pays over 30 percent corporate tax. The other pays eight percent.

Now, if I go over to the corporation doing business overseas that is paying over 30 percent corporate tax rate, and tell them, "In the interest of simplicity and certainty, we are going to lower the corporate tax rate to 26 percent," let's say, argument's sake, but they will have to lose whatever deductions and credits, they will probably think I am brilliant and beautiful, and wise to boot. But if I walk across the street and go over to the company that is only paying eight percent corporate tax, and I tell them in the interest of simplicity and certainty, that we are going to have a 26 percent tax rate and they will lose all of their deductions in the interest of revenue neutrality, they are going to think I am Satan on a horse and I am a moron, to boot.

Now, how would you counsel me to address that corporation doing business overseas that I am going to be voting to—for stability and certainty and simplicity, and I am going to jack up their corporate tax rate like crazy? I would love some counsel from you.

Mr. HAYES. Well, let me start. First of all, I think there are really two different discussions here. One is around the effective tax rate, which you are referring to might be 8 percent for one company and 30 percent for the other, versus the statutory tax rate, which is really what we are after here.

And I think the fact is that, by leveling the playing field, and eliminating some of the preference items that are in the Tax Code, everybody is on the same basis, whether you were paying 30 percent or whether you were paying 8 percent or no tax, or 35 percent. The fact is what we are trying to do is to advocate for a system that is globally competitive for everyone.

And, yes, there will be winners, there will be losers. I think all of us, as we sit here today, understand that we are going to have to give up things like accelerated depreciation. We are going to have to perhaps go to capitalizing some R&D, or capitalizing advertising costs to make this bill revenue neutral. And I think all of us understand that there is a shared sacrifice amongst corporations in the short run, to make a globally competitive system which will help drive jobs back to this country, and free up capital to come back to this country.

So, again, I think we have to divorce ourselves from effective tax rates, which is really just an accounting question. And effective tax rates vary quarter to quarter, year to year, and circumstances by circumstances. But, really, we are talking about statutory tax rates and long-term competitiveness here.

Ms. BERKLEY. Do you think my gaming company that pays eight percent is going to be happy with that answer?

Mr. HAYES. I suspect not.

[Laughter.]

Mr. RAPP. And I would add trust me, within Caterpillar not all decisions we make make all of our employees happy. Tough decisions in tough times, and I think that is exactly where we are at.

U.S. competitiveness, I think, is in question. Our share of global GDP has gone from close to 50 percent down to somewhere in the neighborhood of 20 over the last 50 years. And we have got a choice. We make those tough decisions, get ourselves competitive, compete and win globally. I think if you do that, you will have more people coming to Las Vegas.

Ms. BERKLEY. That is my goal. Well, thank you very much. I appreciate it.

Chairman CAMP. Thank you. Mr. Marchant is recognized.

Mr. MARCHANT. Thank you, Mr. Chairman. You have all testified earlier that you would be willing to have a lowered tax rate, and it could be revenue neutral.

But, in fact, wouldn't that put you in a position to ultimately make a higher profit, and ultimately pay more money into the treasury than you are paying now? I mean, isn't lowering the tax rate ultimately—doesn't it have a dynamic effect, because it will allow you to make more profit and then, ultimately, over the years,

the treasury will actually net more money because of the lower tax rate?

Mr. RAPP. We would welcome the opportunity, through having a simpler system and globally competitive, to grow our company, to grow our profits, and, as a result of that, send more money to the treasury. And we think that is one of the opportunities that exists.

U.S. companies and their ability, their ingenuity, their entrepreneurial spirit, we are absolutely convinced we can compete and win around the world. And to the degree we do that, I think you are absolutely right, you have the opportunity to increase your revenue.

Mr. HAYES. I really think it is one of the fallacies of the static scoring system we have today is the fact that it doesn't take into consideration the impact of repatriation into this country when you have a simplified tax system, when you have a territorial tax system and the free movement of capital that will drive job creation here in the United States, that will drive investment here in the United States.

And, unfortunately, as the Congressional Budget Office scores tax reform, I think we miss that piece of the economic growth that is going to result from tax reform and simplification.

Mr. CRINES. I mentioned earlier that Zimmer has grown as a consequence of being able to expand its operations overseas. And it was able to do that, in part, by taking advantage of deferral rules. That is what enabled the company to prevail in a competitive bid for a European-based manufacturer.

Several years later our company is four times larger, the amount of pre-tax earnings that we earn is four times larger. I mentioned that our effective tax rate is 30.6 percent as a consequence of paying about 40 percent in the U.S. in federal and state taxes on half our earnings and 15 percent on our foreign earnings.

So, in fact, we are paying more money into the U.S. treasury, as a consequence of being able to compete in that particular situation.

Mr. BUTHMAN. And I would say for Kimberly-Clark—and I suspect most or all of the companies on the panel, and business in general, we welcome the opportunity to compete on the basis of having the best product in the marketplace at a fair price every day. The less noise, the less uncertainty, the less leakage we have, in terms of the resources we deploy toward innovation, toward manufacturing, toward driving efficiency and productivity, I think the better off we are.

The more competitive we are, the more volume we drive, the more profit we generate. And that gives us the opportunity to generate—we are happy to pay more taxes for every incremental dollar of profit that we generate.

Mr. MARCHANT. Your compliance cost is significant, I assume. A simpler system—a lower rate with a less complex code—it would lower your compliance cost, of course. How about your cost to minimize your tax? Every company incurs additional cost, simply to minimize their actual tax, because the rate is too high.

Mr. HAYES. Well, I think that is clearly—all of us have tax departments, we have very talented people that understand the tax rules, not just in the U.S., but around the world. And I would tell

you, at the end of the day, while it is a value to our share owners today to do this type of tax planning, it is not truly value added to the economy to do this type of tax planning.

And I think we would all welcome the opportunity, with a simplified Tax Code—again, 19,000 pages will never go to 1. But to the extent that we can reduce complexity, reduce compliance costs, reduce the cost associated with trying to plan around what is a prohibitively high tax rate, is going to be a benefit to the economy.

Mr. MARCHANT. Thank you very much.

Chairman CAMP. Thank you. Mr. Lewis is recognized.

Mr. LEWIS. Thank you very much, Mr. Chairman, for holding this hearing. I want to thank each of you for being here today.

At our first hearing on tax reform, a CEO testified on behalf of the Business Roundtable, and said that corporate tax reform does not need to be revenue neutral. In other words, we do not need to pay for this, we should just add it on to the deficit, and shift the burden to American families, working families.

For the past 10 years or so, we have seen an increased willingness to shift the burden of government on to the middle class and the working poor. This give me great concern. And, in my estimation, it is not right, it is not fair, and it is not just.

Each of you represent corporation that do business in countries with lower corporate tax rates. Those countries compensate for those lower corporate tax rates by raising personal income taxes on families, and by adding a VAT tax on the things that they buy at the store.

Now, tell me. I want each one of you to tell me, and tell Members of the Committee, what do you say to American families struggling to make ends meet who hear that their taxes are going up, to go up so multinational corporation can get a tax break? Why should they give more? Why should the middle class, why should working families, why should the poor, those at the bottom, give more so you can get less?

Mr. HAYES. Congressman, just let me start. I think, as—

Mr. LEWIS. So that you can give less.

Mr. HAYES. I think the panel has all testified, and we would all agree that, you know, revenue neutrality is ultimately the goal of corporate tax reform. And while we talk about fiscal responsibility—and I think, as you heard from the Business Roundtable, we are looking for, originally, corporate tax reform that was fiscally responsible. But we would tell you that we understand the need for revenue neutrality with corporate tax reform.

What I would tell you, and what I think we should tell the American people, is corporate tax reform is not a giveaway. We are not here looking for a gift from the government. We are not looking for a gift from the American taxpayers. What we are looking for is the ability to be competitive, globally, so that we can drive investment to this country and drive job growth into this country.

And I think that is the way we need to frame this debate. It is not about taking away from the middle class, it is not about giving to corporate America—

Mr. LEWIS. There is a perception abroad in America that the average taxpayer, middle class, working poor, they pay more than

their fair share, and corporate America are not paying enough. So I want you to respond to that.

Mr. HAYES. Again, I think as we sit here today, we look at the corporate taxes that we pay, the 35 percent statutory rate, what we are talking about is how do we drive job growth into this country. And we would tell you that the corporate tax structure that we have today is anti-competitive and anti-jobs.

At the end of the day we can argue about what is the right rate for everyone to pay across the economic spectrum, and the fact is we are not advocating for a giveaway. We think we need to have a fair and reasonable corporate tax rate, but one that is globally competitive. Because, at the end of the day, capital is mobile. Capital will move to where it is most efficiently put to use. And that means if we cannot put it to use here in a tax-efficient manner, jobs will be created overseas. And I think that is all we are advocating for here today, Congressman.

Mr. LEWIS. Thank you.

Mr. RAPP. And my argument would be that it is not a question of transferring from one pocket to another. It is a question of how do you grow the economy. And I am absolutely convinced of that. We have done it since 1925. We can compete and win against people from all over the world. And to the degree we get a level playing field, we are able to do that.

As we have talked throughout this discussion this morning, it generates jobs back here. And I think that is really what this country wants to do. They don't want to debate the issue of do I transfer tax from one pocket to the other. They want to debate how do we generate jobs here.

Mr. LEWIS. Thank you.

Mr. CRINES. Congressman, as I indicated earlier, the company accrues and pays taxes at a rate of about 40 percent on our U.S. earnings and profits. That includes both federal and state income tax. To increase that burden, I do believe, would put the company at a competitive disadvantage, relative to our foreign-based competitors.

We are advocating as we have indicated, in favor of reform that would be revenue neutral, and believe that can be accomplished by lowering the rate and eliminating some of the deductions, as we have discussed.

Chairman CAMP. All right. Time has expired. Mr. Berg is recognized.

Mr. BERG. Thank you, Mr. Chairman. And thank you for being here today. A long hearing, but this has been very fruitful for me.

I come from a state where, a few years ago, we lowered income tax and we lowered corporate income tax, and revenue came up, went higher. So, last month we did the same thing. We lowered corporate tax, we lowered income tax, and actually lowered property tax. You know, I think it is trying to find that sweet spot.

And—as I sit here, I think about what really strikes me is when at one time 17 out of 20, or 85 percent of the top 20 companies in the world, were U.S.-based, and today it is less than 30 percent. And when we look at historical corporate tax, at one time we were kind of middle of the road, globally, and now we are, highest.

And so, it seems to me if we want to grow business here and create jobs, that we have to figure out a way for companies to grow within America or acquire companies and do that expansion.

And so, we kind of talked about repatriation a little bit, and I think the position that I have heard is if we bring our corporate rate down to 25 percent, it is clean. That will kind of serve as repatriation of funds as we go forward.

So, could each of you just respond to that just a minute?

Mr. HAYES. Yes, I think that is exactly the idea here, with—there is no need for a one-time special repatriation if we have a territorial system which gives us some certainty. And, again, assuming there would be some toll tax associated with repatriating, at least we would have certainty around that. It is not a once every third or fourth congress that we do that.

Mr. RAPP. And just one point on the 25 percent. As I said earlier, we look at the 25 percent benchmark relative to the other parts of the world as being a combination of federal and state. And I just wanted—

Mr. BERG. I was very clear on that. I heard that.

Mr. RAPP. I just wanted to make sure we were clear, no miscommunication here.

And to me, it really gets down to what does it take to be competitive over the long haul. And that is why a one time only bring back just doesn't give the vision, long term, on where we are going to be at. And we would prefer to see this tough discussion through. We are very encouraged by the dialogue you are debating here today. Let's flog through this.

Outside the United States today there are a lot of economies that are growing. And it is a tremendous opportunity for American companies to go compete and win in that. So I think the timing of what you are putting on the table is good, and we just want to see it through.

Mr. BERG. Okay, thanks.

Mr. CRINES. There are significant disincentives today towards bringing the earnings and profits that are being earned offshore back into the U.S. and deploying that capital here in the U.S.

I do believe any reform that allows us to deploy capital more efficiently will ultimately lead to growth, growth in jobs here in the U.S., growth in employment, and growth in our businesses, globally.

Mr. BUTHMAN. Yes, and I would echo the other panelists' comments. And just to be clear, in fact, in our accounting, in our financial statements, in our tax returns, we actually have to commit that we do not intend to return that cash home. Otherwise, we have to provide tax on it at some point.

So, there is actually—it is very clear, the encouragement to leave that cash overseas, unless we can find a vehicle to bring it home. And there is no doubt in my mind that, if we can solve this problem, it is a huge source of capital for the U.S. economy that ultimately is going to make its way into our local market to drive technology, to drive manufacturing, to drive job creation.

You are faced with a very difficult challenge. We have a fiscal deficit that we have got to tackle. Tax policy is an important part of that. Fiscal reform is an important part of that. So, again, I

would echo the other panel members. I am happy to participate here, and I am very glad to see you tackling this issue, collectively.

Mr. BERG. Well, thank you. Just one other quick issue, and that is when you acquire a property, or acquire a company, or a company competing with another company, how, again, there is a tax disadvantage, because you are working on two different levels.

And I am just wondering if you had any examples of—public examples of where a foreign company was able to acquire something that an American company was not, because of that disparity in the corporate tax.

Mr. BUTHMAN. I don't have a specific example, but I do have a number of examples of companies that we compete with around the world in, again, an increasingly global marketplace.

As we look at a geography to buy a diaper business or a tissue business, to the extent we are competing in that, either with a local company or, let's just say, a European-based company—we have a number of competitors in Europe and northern Europe—there is a clear advantage, in terms of the cost of the capital that they are able to deploy, in terms of their after-tax cost of that acquisition.

We hope we can overcome that in terms of efficiencies, our market power, et cetera, and in other ways, but there is a clear structural advantage when we are competing for acquisitions on a global basis.

Chairman CAMP. Thank you. Mr. Kind is recognized.

Mr. KIND. Thank you, Mr. Chairman. I want to thank our panelists for your testimony and your presence here today. One of the advantages to being one of the last ones to ask questions, you get to hear a lot of testimony, which I think has been very candid and very helpful today. You also get to cross off a lot of items on your own sheet with good questions that have been asked beforehand.

But at the risk of being the skunk at the picnic here, let me just illuminate the discussion a little bit further. We have been fortunate enough, with the chairman's leadership, to have some closed door, bipartisan sessions, talking about this, getting various options in front of us, exploring the complexity of the Tax Code.

And the truth is—and I think there is wide agreement—that the goal ought to be trying to lower the rates, broaden the base, through the eyes of international competitiveness issues, something you have all been talking eloquently about today, the importance of that, domestically. But most of the tax expenditures aren't on the corporate side, they are on the individual side. In fact, only 8 percent of the total tax expenditures that exist in the code today are on the corporate side; 92 percent are on the individual or pass-through side.

Now, if we were to get rid of all of them on the corporate side, every tax expenditure that exists from accelerated depreciation to R&D to everything else, we would be able to lower the rate down to 28 percent. Getting rid of all of them. And if we get rid of all of them except for accelerated depreciation, that is 31 percent. And yet, all of you are testifying today that we ought to do this in a deficit neutral fashion, which I appreciate and I agree with.

But getting at that mid-20—or, Mr. Rapp, in your eyes, the lower 20 percent range, it means we are going to have to look elsewhere. And I guess that is the question I would pose to you is, where else

can we look to make up the revenue shortfall, as far as paying for a lowering of the rate, overall?

And you get into the individual side, the pass-through side, and Mr. Buchanan was talking about it a little bit earlier. The majority of the businesses right now in the United States are pass-through entities. They are not going to be too happy if we are going to be after them, and reducing their expenditures that they are currently enjoying in order to lower the overall corporate tax rate here.

And, Mr. Hayes, I appreciate your candidness, too, about having the VAT as a part of the overall discussion. But, to be honest, given the political dynamics, and especially my friends on the other side, that is a non-starter. They are not going to want to talk about a VAT on top of or in addition to any kind of corporate tax structure that we have in our country today. That is just a non-starter, as far as a conversation.

This is where it gets difficult. This is where it gets real complicated. And the fact that, as some of my other colleagues pointed out, there are going to be some clear winners, some clear losers in anything that we do.

And maybe you can help me. You don't have to cite specifically what—your effective tax rate, but I think I am correct in my assumption that all of you are paying an effective tax rate that is north of 25 percent right now, is that right?

Mr. HAYES. That is right.

Mr. RAPP. That is correct.

Mr. CRINES. That's correct.

Mr. BUTHMAN. That is correct.

Mr. KIND. You are all agreeing with that. Well, I think we might hear a little different testimony from some representative from GE today, in light of the news that they have just garnered in the last month or so. And that is really the point of this exercise.

You talk about the statutory tax rate. We are high, 35 percent. The effective tax rate, we are about average, as far as the rest of the developed world is concerned. The marginal rate on new investment in this country, we are slightly above average. So your perspective, and the testimony that you might bring to this issue is certainly going to depend on what seat you are viewing this issue from. And that is going to be very wide, and it is going to get very complicated and very difficult for us, then, to have to navigate through that.

But if you have thoughts on where we can go, as far as additional offsets, in order to lower the rate down to the levels that you all are testifying about, mid to low 20 percent, obviously we are all going to be—have a lot of ears for that.

But this, I think, is what is going to be very difficult with the exercise that we have before our committee, and your guidance on this issue will be crucial.

Mr. Rapp, let me also just quickly congratulate you in recognizing that your leadership in the corporate world, as it relates to the workers, will be important with these trade agreements. I got a company in Lacrosse, Wisconsin, 60 percent of what they are making there is exported overseas. The machinist union there is some of the fierce critics of any type of trade agreement. And your help, as far as educating the workers, will be important.

And let me just leave you with this thought. And I was hoping to get testimony, but our time has limited. But something else is bothering me with our economy today. And if you have any ideas, we would be—we would welcome that.

But in typical recoveries, you get an increase in worker productivity, and it has been true the last couple of years. About a 6.8 percent jump. But in the typical recovery, a majority of that increase in worker productivity goes back in the form of wages to workers. That is not happening. We have had wage stagnation in this country for the last 10 years. And in this last couple of years, of that 6.8 percent, roughly—a little less than 10 percent of that growth is going back into wage increase. And when the U.S. economy is 70 percent consumer-driven, we got a problem, and we get the economy that we have here today.

I don't know what, policy-wise, we can do to incent companies—and I am not citing you specifically—to recognize the key role that wages play in our economically domestically, too, but we are kind of stuck right now. And I think the reason why Wisconsin has received so much attention, it wasn't just about pensions and health care, I think it is the middle income, working-class families feeling that no one is looking out for them. And they are working harder and running faster just to keep up, and they are not keeping up.

Chairman CAMP. Thank you.

Mr. KIND. And that is the frustration that so many people feel today. Thank you for your—

Chairman CAMP. Thank you. Ms. Black is recognized.

Mrs. BLACK. Thank you, Mr. Chairman, and thank all of you for being here today. It has been very enlightening.

All of you have talked about having your operations worldwide. And Mr. Hayes in particular, your one statement, "capital is mobile," is certainly a truth here that we have to recognize as we are dealing with this very important issue.

And one of the pieces that I liked hearing is that most of your companies have your intellectual property and your research and development right here in the United States. Because, obviously, the United States has always been known for being the innovator of so much that is bought around the world.

And so, can you briefly explain the relationship between your domestic operations and your foreign operations, in particular, how they support one another? And then, how important are these foreign earnings to our domestic operations and your growth in the United States?

So, Mr. Hayes, if you could, speak to that.

Mr. HAYES. Certainly. Yes. As I mentioned earlier, as we were speaking, I think it is important to understand that UTC is a global company. Most of our research and development is spent right here, in the United States.

So, as we think about developing the next generation of jet engine, that is work that is being done in East Hartford, Connecticut. That work will support export sales to Airbus in Toulouse and in Frankfurt. It will support export sales to Japan for the Mitsubishi regional jet, to Russia, as well as to Canada, for the Bombardier C series.

And again, I think it is critically important to understand that, as we keep R&D in this country, those are the types of jobs and the type of growth that will ultimately bring prosperity back to this country. Those are the great jobs. We are going to hire about 300 engineers this year in East Hartford, Connecticut, as we ramp up the spending on R&D.

And again, most of the R&D, as I mentioned before, happens here in the U.S. And we use that to support development of products around the world and introductions of products around the world.

Mrs. BLACK. And could I also draw the conclusion, then, that what you then sell around the world also helps to bring money back to the United States, so that we can have more research and development, and continue to be the leader in innovation in this country?

Mr. HAYES. It certainly brings earnings, if not cash. Again, the cash, as we have said earlier, is still trapped overseas.

Mrs. BLACK. Sure.

Mr. HAYES. But the earnings, from an accounting standpoint, certainly supports the R&D efforts that we have in this country.

Mr. RAPP. Yes. Congresswoman Black, let me give you an example of that. If you look at our business, the industries we serve in the U.S. market is still about 50 percent of what it was at the end of first quarter 2006. However, this year we will have an all-time record high spend in R&D, the majority of that coming into the United States. That is not because of the strength of the U.S. economy or what is going on here. It is based on the strength of our businesses around the world.

So, I think it is a great example of the point you are poking at. Our success, winning in China, Brazil, Latin America—the other parts of the world we compete in—definitely, positively impacts what goes on here, in the U.S.

Mrs. BLACK. Mr. Crines.

Mr. CRINES. Congresswoman, 45 percent of our revenues are coming from our foreign markets. And, as I said earlier, 70 percent of the revenues are sourced out of our U.S.-based manufacturing facilities. Three-quarters of our research and development efforts are based in our U.S.-based facilities.

So, clearly, very similar to the other companies represented here, we have been able to grow employment here in the U.S., on the basis of our success in competing for business overseas.

And it is the case that much of that growth now is taking place in places like China, Brazil, Russia, India, Eastern Europe, because those economies are growing at a faster clip than the more developed economies of the world, because those governments are investing in a pretty significant way in building out infrastructure—in our case, health care infrastructure that is giving access to health care to their citizens that they have not in the past had access to.

Mr. BUTHMAN. And we are similar. We export not only technology, but brands. So you can find a Kleenex box, a Kleenex facial tissue around the world. And every box of facial tissue that is sold in a country around the world, we get a royalty as a result of that. We pay income tax on that today. So it is—to your point, Congresswoman, it is a source of income and cash, in our perspective.

I think there is a reality that, as the economy gets increasingly global, we are going to build our R&D footprint here, which is almost exclusively U.S., I think more and more we are going to keep that base, we are going to grow that base. We are also going to bring ideas in from around the world, which will benefit U.S. consumers, if not just the cash flow that comes back—

Chairman CAMP. Thank you. Mr. McDermott is recognized.

Mr. MCDERMOTT. Thank you, Mr. Chairman. Let me thank you for having this hearing, because hearings are always interesting to learn from.

Before I came to the Congress, I was a state legislator and was Ways and Means chairman in the state senate for five years, ran a state budget. And then I got here in 1988. Old, wise guy in the State of Washington said to me one time, "Business doesn't give a damn what the rate is, as long as they can count on it. They want certainty. They want to know how long it is going to last." And I hear some of that from you, Mr. Hayes.

I look out in this audience, there is a lot of empty seats. But I know there are a lot of people sitting in their offices, watching this on television. And when I got here in 1988, just after tax reform had passed in 1986, my office in 1989 was loaded with folks coming in, telling me they wanted to make a little adjustment in the tax reform. And I have had a steady stream of those people for the 23 years that I have been in the state legislature—or in this—in the Congress.

Now, my question to you is, how long a moratorium do you think we could put into the law that says we have done tax reform, and nobody is going to get a change for—six months? A year? Two years? How long would you sign up for, if we gave you this new rate?

Mr. RAPP. I would probably sign up for a moratorium with a quid pro quo that we won't come ask for any special exceptions, if you don't come and ask for more, in terms of the tax rate.

I think the key issue is how do we maintain competitiveness. And to the degree you give us that competitive rate, then it turns over to our responsibility to compete and win against our global competitors. And so, I think if we get that right, then it is up to us. I think you hold the rate, I think we hold off on asking for the exceptions.

Mr. MCDERMOTT. You think the whole business community would be willing to accept that? Because, you see, in 1986 we did that once, right? We made all these careful compromises between reinvestment trusts and, oh God, real estate industry, and everybody. And all that was done—bingo, as soon as it was passed—

Mr. RAPP. But what I would say about the business community in that regard is you are engaging the business community in this debate. We had a request earlier, in terms of continuing the discussion after this session. I think we all realize that this has gone far enough, and it is in the long-term interest of the business community, as well as the country, that we get this issue on the table, find a solution that gets us to a competitive playing field around the world, and then we get on with what this country is best at, and that is competing and winning.

Mr. MCDERMOTT. Could I ask one question further, then? We talk about competitiveness. Because this is like a spider web. We are talking about one little piece of the spider web, and there is all kinds of things related to your competitiveness. Your decisions aren't made simply on tax rates. They are made on a whole lot of other things.

Do you support, as a group, the President's Affordable Care Act, as passed by the Congress? Mr. Hayes.

Mr. HAYES. I think the need for health care reform is paramount in this country, because health care costs are one of the things that will bankrupt the economy sooner than anything else. And we certainly support the effort, if not the specifics, of everything that is in the health care bill.

Mr. RAPP. We support the effort, but we think private enterprise is a good place to solve the solutions.

I mean if you look at, from 2002 to 2010, as a company, our health care costs have tracked below CPI.

Mr. MCDERMOTT. So you think leaving it in the private insurance industry, as the President's bill does, and including more people into the private insurance industry, is competitive? That is a good way to go to control costs?

Mr. RAPP. As Greg said, we need absolute reform. And I think private enterprise is a better place to solve that.

Mr. MCDERMOTT. You mean the government should get out and let you on your own?

Mr. RAPP. As we said earlier, I think there is some reform that is required. But, in terms of private enterprise, addressing the issue, that is where we found the best result.

Mr. MCDERMOTT. So I can't tell whether you would be for a repeal or not. How about you?

Mr. CRINES. The company supported the health care reform efforts, certainly support providing access to health insurance to what was 46 million Americans, now 50 million uninsured Americans. We did, however, object to the way that it is being paid for, in particular—

Mr. MCDERMOTT. The 2.3 percent—

Mr. CRINES [continuing]. 2.3 percent excise tax that is being imposed on the company.

Mr. MCDERMOTT. Okay.

Mr. BUTHMAN. I am not convinced—I am all for health care reform. I am not convinced we really solved the underlying issue of rising costs.

Chairman CAMP. All right, thank you.

Mr. MCDERMOTT. So you think repeal would be a good—that would make you more competitive?

Chairman CAMP. I have to tell the gentleman his time has expired. And I want to thank this panel for their participation this morning. Your testimony today has been very helpful as we consider these critical issues, and I want to thank you all for listening to every Member who wanted to talk to you today, and trying to answer their questions. And I hope we will be able, as others have said, to continue this discussion as it unfolds.

And Members may wish to submit some additional questions to you, in writing, and I hope you would respond, so we could include those in the formal record, if that were to occur.

Again, let me thank you for being here.

And I now invite our second panel to come forward to the witness table.

Thanks again.

[Brief Recess.]

Chairman CAMP. Thank you. We are pleased to welcome our second panel which features three experts in the field of international tax law. All three witnesses on our second panel have previously testified before the Ways and Means Committee, and we welcome you all back today.

First, I would like to welcome and introduce a fellow Michigander, Jim Hines. Mr. Hines is the L. Hart Wright Collegiate Professor of Law at the University of Michigan Law School, and a research associate of the National Bureau of Economic Research.

Second, we will hear from Dirk Suringa, a partner at Covington & Burling, specializing in international tax law here, in Washington, D.C. Mr. Suringa previously served in the Department of the Treasury's office of international tax counsel from 2000 to 2003. And finally, we will hear from Jane Gravelle, a senior specialist in economic policy from the Congressional Research Service.

Thank you all again for your time today. The committee has received each of your written statements, and they will be made part of the formal hearing record. Each of you will be recognized for five minutes for your oral remarks. And Mr. Hines, we will begin with you, and you are recognized for five minutes. Thank you for being here.

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

Mr. HINES. Thank you, Chairman Camp, Representative Levin, and Members of the Committee. As you know, the United States has a different tax system than any other major capital exporting country and any other G7 nation. The consequence of our tax system is that it distorts business activity around the world, it distorts asset ownership, and it erodes the productivity of American businesses.

It is an interesting fact that 50 years ago the prevailing theory was that the United States should have a tax system like the one we do now. But what has happened in the intervening 50 years is we have come to realize it is a mistake. Countries around the world that used to have tax systems like the United States have abandoned them. The United States is, as I mentioned, the only remaining major capital exporter that taxes the active foreign income of its residents' businesses.

As a consequence of this system, American firms are less productive than they otherwise would be. And that feeds back to the American labor market. In order for American workers to get high wages and have good jobs that produce good lifestyles, they have to be productive. And in order for them to be productive, they have to work for companies that make them productive. The way for

companies to make workers productive is for the companies to be efficient and effective in deploying their labor and other productive assets. And the tax system has the opportunity to help companies do that, or, unfortunately, the tax system can get in the way.

Now, this is a challenging time for labor markets in high-income countries like the United States. If you think about what the impact of moving to a territorial tax system would be, if it makes American labor more productive, then it will increase employment opportunities in the United States, and it will increase wages in the United States.

There are two separate effects that territoriality and offshore business activity would have on American labor. One is substitution. And that is a concern of people. It is an appropriate concern. The concern is that American firms—or for that matter, German firms or other foreign firms—would employ labor in other countries, rather than the United States, and, as a result erode the employment opportunities of Americans.

There is a separate effect, and that is what you heard from some of the witnesses this morning about, which is the productivity effect of offshore business activities. If offshore business activities enhance the productivity of American workers, then it increases demand for them, and increases the wages that they earn.

There are examples of cases where foreign business activities substitute for domestic business activities. And, as a result, there is less demand for American workers. That happens. What also happens is that there are many cases in which foreign business activities enhance the productivity of American workers. The question, I think, for Congress is: What happens mostly in the American economy?

If we look at the business sector, the American economy as a whole, what is the predominant effect? Is it this substitution, or is it the productivity effect? The statistical evidence that we have, not just from the United States, but from around the world, suggests very strongly that the productivity effect is more potent than the substitution effect, that the foreign business activities of American firms enhance the productivity of their domestic operations, and thereby increase demand for American labor.

The evidence that we have for the United States is that, for multinational firms, 10 percent expansions of foreign employment are associated with 3.7 percent expansions of domestic employment by the same firms at the same time. Now, that is an average effect. It doesn't apply in every single case.

However, if the question is, for the American economy, is foreign business activity productive from the standpoint of generating demand for American labor, the answer is yes.

We know that these productivity effects are important. If they were unimportant, one might entertain the possibility of passing a law that would make it illegal for American companies to employ workers abroad. Nobody contemplates such a law. But why don't we contemplate that law? Because we know it would not be good for the American economy, and ultimately, would not be good for American workers. American workers benefit when their work is productive. And their work is productive when American companies

help them make it productive. And so, that is why we need a tax system that doesn't distort the activities of American companies.

The United States has a serious budgetary problem. There are things that we need to do about it. Mr. Becerra this morning said that he never heard a witness testify that their tax burden should be increased. Mr. Chairman, you should increase my tax burden. And I think you should increase the tax burdens of others, too, because we are not on a fiscally sustainable path right now.

Let me quickly add we also need spending reduction.

But when we think about our fiscal problems, taxing the foreign incomes of American business is not a good way to address them. [The prepared statement of Mr. Hines follows:]

Testimony before the Committee on Ways and Means,
United States House of Representatives
Washington, DC
May 12, 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 Richard A. Musgrave Collegiate Professor of Economics in the department of economics, L. Hart Wright Collegiate Professor of Law in the law school, and Research Director of the business school's Office of Tax Policy Research. I am also a Research Associate of the National Bureau of Economic Research, Research Director of the International Tax Policy Forum, and Co-Editor of the Journal of Public Economics.

The United States faces significant economic challenges, but Congress has the opportunity to improve the performance of the U.S. economy, and the economic prospects of American workers, through changes to our tax system. The current U.S. system of taxing the worldwide incomes of American firms impairs their ability to compete for business in global markets, and distorts the ownership of productive assets in the United States and abroad, thereby undermining the vitality of the American economy. Changing the taxation of American businesses in a way that makes it more consistent with the tax systems of other major economies would permit Americans to compete on an equal basis with foreign firms, improve the efficiency of resource allocation in the United States, and strengthen demand for the services of American workers.

The United States is currently unique among major capital exporting countries in taxing foreign income as heavily as we do. The United States subjects active foreign business income to domestic taxation, and in a manner that strictly limits the ability of taxpayers to claim foreign tax credits and to avoid current U.S. taxation of unrepatriated foreign income. There are aspects of the U.S. tax system that limit burdens on foreign income: in particular, taxpayers are generally entitled to claim credits for foreign income tax payments, and there are many circumstances in which U.S. taxation is deferred until income is repatriated. But every other major capital exporting country exempts active foreign business income from taxation, and even among the countries that do tax foreign income, their rules for claiming foreign tax credits and deferring home country taxation of foreign income are far less draconian than those of the United States.

What are the consequences of taxing foreign income so much more heavily than does any other major capital exporting country? American firms are put at competitive disadvantages relative to firms from Britain, Germany, Canada, Japan and elsewhere in competing for business opportunities in global markets. Most of foreign direct investment represents acquisitions of existing companies, whose assets and activities the new acquirer can then deploy to good advantage. An example would be an American firm with intellectual property and business know-how developed in the United States that seeks to acquire a firm in Spain – whose operations, the potential acquirer believes, would be enhanced by adopting some of its own practices and technologies. If the price is right, the acquisition would go through, and should be expected subsequently to encourage even greater business activity in the United States, since the return to the development of new product lines and business practices by the U.S. parent company would then be enhanced by their potential exploitation by the Spanish affiliate. The difficulty is that, since the U.S. tax system imposes a cost that the German tax system does not,

potential German acquirers may be able to outbid Americans simply on the basis of tax differences. As a result, the Spanish firm may wind up with German ownership even though the more efficient owner would be an American company. The inefficiency thereby created depresses the return to business activity in the United States, a cost that is borne largely by American workers in the form of lower wages and reduced employment prospects.

The U.S. tax system generally discourages foreign investment by imposing a tax on repatriated active business income. In addition, the United States taxes certain forms of unrepatriated income, limits the ability of U.S. taxpayers to claim foreign tax credits if they have certain domestic expense deductions, and discourages firms from repatriating income to the United States. The impact of the U.S. rules is to change the business practices of American taxpayers in a manner that is inconsistent with the practices of firms from other countries with which they compete, and inconsistent with practices that would otherwise maximize pretax profits. It is certainly unwise to have a tax system that distorts and depresses American business activity, and it is curious to have a tax system that looks so very different from the tax systems of other major capital exporting nations, indeed, a system that most countries have chosen to abandon.

A seductive, but ultimately misleading, and perhaps even tragic, logic lies behind the U.S. system of taxing the worldwide incomes of American businesses. This logic holds that it is appropriate for the U.S. tax system to subject all income to taxation at the same rate. This proposition is inconsistent with economic efficiency and with the realities of global competition. Despite these inconsistencies, it serves as the basis of the 1960s notion of capital export neutrality that remarkably still influences the thinking of some who advocate in favor of taxing the worldwide incomes of American firms. In fact, the capital export neutrality logic goes quite

a bit further than that, in that it implies that the United States acting on its own behalf should not permit taxpayers to defer U.S. taxation of unrepatriated foreign profits, and also implies that taxpayers should not be entitled to claim foreign tax credits for foreign tax payments. By this way of thinking, the problem with the current U.S. tax system is that we do not tax foreign income heavily enough. It is irrelevant, so this argument goes, that we already tax foreign income more heavily than do other countries – because the theory is constructed in a way that ignores the impact of foreign tax systems and the activities of foreign companies.

The capital export neutrality paradigm has been decisively rejected by modern scholars, whose models and evidence incorporate the actions of other countries and the operation of the global marketplace, and by governments around the world, who do not seek to tax the active foreign incomes of their resident companies. It is now generally understood that efforts to tax active foreign income reduce the efficiency of a country's tax system, and thereby reduce the returns earned by a country's productive factors. Unfortunately, capital export neutrality lives on in Washington DC, in the form of the U.S. income tax.

To those who accept the logic of capital export neutrality, who believe that it is important to continue to tax the foreign incomes of American businesses, or worse, to stiffen the taxation of foreign income by further limiting the ability of American taxpayers to defer U.S. taxation of unrepatriated profits, it is worth asking why the U.S. tax system should restrict itself to such limited moves. The logic of capital import neutrality implies that the United States, acting on its own behalf, would benefit from repealing the foreign tax credit, permitting taxpayers only to deduct foreign income tax payments. Furthermore, the logic implies that the United States should give global scope not only to its income tax, but also to its excise, property, sales, and other taxes.

What would happen if the U.S. federal government were to levy a \$2 tax on each gallon of gasoline sold in the United States and sold abroad by persons resident in the United States? Suppose that this system permitted American taxpayers to claim foreign tax credits for excise taxes paid to foreign governments, so that a U.S. firm selling gasoline in a country whose excise tax rate exceeds \$2 per gallon would owe no additional tax to the United States, whereas a firm selling gasoline in a country with a \$1.25 per gallon tax would owe \$0.75 per gallon to the United States. One could imagine permitting worldwide averaging, thereby permitting taxpayers to use excess excise tax credits from sales in jurisdictions with excise taxes exceeding \$2 per gallon to claim credits to offset taxes due on sales in jurisdictions with excise taxes less than \$2 per gallon.

What would be the impact of such an excise tax regime? Firms selling in countries with excise taxes exceeding the U.S. rate would have excess foreign tax credits and therefore no U.S. tax obligations, so the tax regime would not affect them. Firms without excess foreign tax credits would face U.S. excise taxes on foreign sales that vary with local excise tax rates. Odd though such a system would be, it might not spell the end of foreign gasoline sales by American companies in all low-tax jurisdictions, though that is a distinct possibility. American companies would persist in selling gasoline in those foreign markets in which they are both profitable and unable to earn even more by selling their operations to foreign petroleum companies not subject to the U.S. tax regime; otherwise, they would be likely to disappear from those markets, to be replaced by foreign petroleum companies.

The economic costs of a residence-based excise tax regime are simple to identify. American firms lose the opportunity to earn profits in foreign markets from which they are driven by U.S. excise taxes, and this, in turn, reduces the rate of return to domestic activities that

make foreign operations otherwise profitable. Since there is every reason to believe that a worldwide excise tax regime would have very significant effects on the participation of American firms in foreign markets, the associated economic costs are potentially enormous. The tax crediting mechanism creates an odd pattern of U.S. excise taxes on foreign operations, with zero and even (in some cases) negative excise taxes on foreign sales in some countries, whereas in other countries the U.S. system imposes positive tax rates that vary with local excises. Even in circumstances in which American firms sell in foreign markets despite the imposition of significant U.S. excise taxes on such sales, the volume of foreign activity will be reduced, and distorted among countries, as a result of such taxes.

What possible justification could be offered for a home-country excise tax regime such as that just described? Many, if not all, of the same arguments commonly advanced in favor of worldwide income taxation would apply with equal force to worldwide excise taxation. From the standpoint of the world as a whole, the benefits of selling an additional gallon of gasoline equals the benefit to consumers, which in turn is measured by the (tax-inclusive) price that consumers pay for the gasoline. Since sellers receive only the tax-exclusive price of gasoline, their incentives do not correspond to global efficiency except in the unlikely event that excise tax rates are the same everywhere. In the absence of residence-based worldwide excise taxation, too few gallons of gasoline will be consumed in countries with high excise tax rates, and (relatively) too many in countries with low excise tax rates. Domestic excise taxation might be said to encourage American firms to move their sales offshore. A system of residence-based taxation in effect harmonizes excise taxes around the world from the standpoint of domestic producers.

An analogous argument would apply to domestic welfare, which, by the standard logic, is maximized by a worldwide excise tax regime even less generous than that under consideration.

Domestic welfare, the thinking would go, is maximized by subjecting foreign sales to domestic excise taxation without provision of foreign tax credits. The reason is that, from the standpoint of the United States, the value of selling a marginal gallon of gasoline in a foreign market equals the profit that it generates, whereas the value of selling a marginal gallon of gasoline in the United States equals the profit it generates plus the associated excise tax revenue. Equating these two requires that the United States impose equal excise taxes on foreign and domestic sales.

One simple and entirely reasonable objection to subjecting foreign sales to home country excise taxation is that excise taxes tend to be incorporated in sales prices, so that, for example, increasing a (commonly used today; destination-based) excise tax on gasoline by \$0.10 per gallon tends to be associated with roughly \$0.10 per gallon higher gasoline prices. Of course, this incidence is unlikely to be exact, and indeed, both theoretical and empirical studies of sales tax incidence find that prices can move by less than, or in some cases more than, changes in excise tax rates. But the efficiency argument is valid on its own terms regardless of the incidence of the tax. That is, the argument is unchanged whether or not gasoline taxes are incorporated fully in consumer prices. Furthermore, and this is the underlying point, the same argument that consumer prices incorporate excise taxes applies to corporate income taxes, and for the same reason: both excise taxes and corporate income taxes increase the cost of doing business, and market forces translate higher costs into higher consumer prices.

The same argument applies with equal force beyond excise taxes to worldwide residence-based taxation of state property and sales taxes. How are taxpayers likely to respond to the introduction such residence-based taxation? The obvious reaction is to shed, or avoid in the first place, ownership of activities in jurisdictions where it would trigger significant tax liabilities. Again, it does not follow that American firms would maintain no foreign operations; it is almost

certain that they would continue at least some operations, despite the tax cost. But the distortion to ownership, investment, and productivity would be enormous.

The older efficiency norms that underlie capital export neutrality and related concepts would evaluate residence-based worldwide excise, property, and sales taxation favorably. Policies that allocate economic activity around the world based on pretax returns maximize world welfare, so the capital export neutrality logic implies that total (host country plus home country) tax rates should be the same everywhere. In the absence of worldwide tax harmonization, this can only be achieved by home country tax regimes that offset any differences between domestic and foreign taxation. Home-country welfare would be maximized by a different regime, in which after-foreign-tax returns are subject to home country taxation at the normal rate, so by this reasoning maximizing home welfare implies that taxpayers should not be entitled to foreign tax credits.

No country attempts to tax sales or property on a residence basis, doubtless deterred by some of the considerations that are apparent from the preceding discussion. The reason to analyze worldwide sales or property taxation is not because they might realistically be adopted by the United States or some other government in the near future, or because they contain desirable features, but instead for the light that they shed on residence-based systems of taxing corporate income earned in other countries. To put the matter directly: why is it that residence-based excise, sales, and property taxation are clearly undesirable policies, while residence-based income taxation has not enjoyed the same unpopularity in the United States?

Residence-based taxation of foreign income has the same ownership effects as would residence-based excise, sales, or property taxation, with the same (negative) impact on economic

welfare. The economic consequences of income taxation seem subtler than those of, say, excise taxation, but this is merely an illusion, since a \$10 million tax liability associated with American ownership will discourage U.S. ownership of foreign business assets to the same extent whether the \$10 million is called an income tax or an excise tax.

It is this distortion to ownership 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.

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, specifically including land but primarily labor, and thereby increase the returns that they would earn. Studies, including some of my own recent statistical work with Mihir Desai and Fritz Foley, generally find that 70 percent or more of the corporate income tax burden is borne by labor in the form of lower wages. This is likely to be at least as true of international corporate tax provisions as it is of corporate taxes generally.

What would be the domestic consequences of reducing the taxation of foreign income and thereby rationalizing the demand for foreign assets by American firms? One of the concerns that naturally arises is the possibility that reduced taxes would encourage greater foreign activity on the part of American firms, who would then substitute foreign for domestic employment, to

the detriment of American workers. In evaluating this concern it is important first to note that the actions of British, German, and other foreign firms themselves potentially influenced by what American firms do, so that if American firms were to contract their U.S. operations then foreign firms are likely to replace them by expanding their U.S. operations, and if this reallocation of activity is efficient, then it should be accompanied by even greater demand for American labor. The second point, however, is that it is far from clear that greater foreign activity by American firms comes at the cost of their domestic activities.

There are examples of instances in which American firms have substituted foreign for domestic labor input; but there are also many examples of instances in which the ability to exploit business opportunities abroad enhances the value of, and the demand for, American labor. In many modern industries it is impossible for a large firm to maintain a high level of domestic productivity without also engaging in business activities around the world. From the standpoint of their demand for American labor, foreign expansions by American firms entail what are often countervailing substitution and productivity effects: foreign employment is a substitute for American employment, but foreign business operations also enhance the productivity of American business operations, thereby stimulating greater demand for American employment. The same logic applies to capital investment, so levels of capital investment in the United States might be positively or negatively affected by foreign investment by American firms. The statistical question is whether the substitution or the productivity effect dominates for the typical American firm.

There is a flurry of recent statistical evidence suggesting that greater outbound foreign direct investment does not reduce the size of the domestic capital stock, but instead increases 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. In a recent firm-level study of my own with Mihir Desai and Fritz Foley, we 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 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.

One of the striking aspects of viewing international income taxation through the lens of its impact on asset ownership is that this perspective offers important implications for the treatment of domestic expenses by firms with foreign income. Businesses engaging in worldwide production typically incur significant costs that are difficult to attribute directly to income produced in certain locations. Important examples of such expenses include those for interest payments and general administrative overhead. There is a very important question of how these expenses should be treated for tax purposes. 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 exempt foreign income from taxation based on the same capital ownership considerations that make the United States prefer not to impose worldwide excise taxes, 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 traced to their uses, as most countries other than the United States currently treat interest expense. To put the same matter differently, tax systems should permit taxpayers to allocate general expenses that cannot be directly attributed to identifiable uses in such a way that they are fully deductible in the country

in which they are incurred (this assumes that governments will not permit deductions for general expenses incurred in other countries, as is indeed the universal practice).

In order to understand the logic behind permitting the full deductibility of domestic expenses, it is helpful to start by noting that any other system of expense allocation will have the effect of distorting ownership by changing the cost of foreign investment. Consider the case of a firm with both foreign and domestic income, and 150 of expenses incurred domestically in the course of activities that help the firm generally, and thereby arguably contribute both to domestic and foreign income production. One sensible-looking rule would be to allocate the 150 of expenses according to income production, so that if the firm earns half of its income abroad and half at home, with the foreign half exempt from domestic taxation, then the firm would be entitled to deduct only 75 of its expenses against its domestic taxable income. For a firm with a given level of general domestic expenses, greater foreign investment would then be associated with reduced domestic deductions, and therefore greater domestic taxes. Hence the home country would in fact impose a tax on foreign income, in the sense of discouraging foreign investment and triggering additional domestic tax collections for every additional dollar of foreign investment. 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.

The same point can be considered from the standpoint of the taxpayer. An American multinational firm with domestic and foreign operations should be indifferent, at the margin, between investing an additional dollar at home or abroad; if not, the firm is not maximizing profits. Hence when the firm borrows an additional dollar to invest abroad, it might as well invest at home, since the two produce equivalent after-tax returns – and it is clear that if a purely domestic firm borrows to undertake a domestic investment, it is entitled to deductions for its interest expenses.

Part of the confusion that surrounds the treatment of interest expenses (and other general expenses that firms incur and that are difficult to assign to particular lines of business) is that,

from a tax standpoint, the marginal source of investment finance matters greatly. That said, the marginal source of investment finance is extremely difficult to pinpoint. Debt finance is generally preferred to equity finance on the basis of tax considerations, since in a classical corporate income tax system such as that practiced by the United States, interest expenses are tax deductible whereas dividend payments to shareholders are not. Hence debt finance might be thought of as a worst case scenario from the standpoint of raising corporate tax revenue; with appropriate income measurement, marginal debt-financed domestic investments generate no tax revenue, and with inappropriate income measurement, these investments might generate positive or negative tax revenue.

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. Using a system of expense tracing that in practice often entails 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 tracing for 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 question to ask going forward is what is the alternative to exempting foreign income from taxation? The alternative is one in which American businesses continue to face inefficient incentives for asset ownership, incentives that their competitors from most of the rest of the world do not face. The inefficiencies for which these incentives are responsible continue to erode American living standards, not acutely, but gradually and relentlessly, thereby contributing to an economic situation in the United States that is not as promising as it might otherwise be. If worldwide taxation of active business income is a good idea, then is it not also just as good an idea to subject the foreign operations of American firms to U.S. excise taxation, sales taxation, and property taxation? And if not, what does that tell us about worldwide income taxation?

Exempting foreign income from taxation, and permitting full deductibility of domestic expenses, would promote efficient ownership of productive assets, domestic and foreign, by American businesses and foreign investors in the United States. Such a policy would 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, would have the unfortunate effect of reducing the

productivity of U.S. business operations, thereby reducing the welfare of U.S. residents, again primarily affecting American workers. There has never been a time when the United States would benefit from inefficient tax policies, and now is certainly not the time. The alternative of exempting foreign income and permitting domestic expense deductions is hardly a bold step, given that every G-7 nation other than the United States has already taken it, and it is one from which our economy would substantially benefit.

Chairman CAMP. All right, thank you.

Mr. Suringa, you have five minutes, as well. And your written statement is part of the record, as well.

STATEMENT OF DIRK J.J. SURINGA, PARTNER, COVINGTON & BURLING LLP, WASHINGTON, D.C.

Mr. SURINGA. Thank you, Mr. Chairman. Chairman Camp, Ranking Member Levin, and Members of the Committee, my name is Dirk Suringa. I am a partner with the law firm of Covington & Burling. From 2000 to 2003 I was an attorney advisor in the office of international tax counsel at the Treasury Department. I appreciate very much the opportunity to testify before the committee today. I appear before you today on my own behalf, and not on behalf of my firm or any firm client.

I would like to make three basic points today, and I make these points as a practitioner who advises clients on a daily basis about how to work with and how to comply with the existing U.S. foreign tax credit rules.

First, those rules are widely—and I think correctly—regarded as highly complex and unstable. We started in the early days of the Internal Revenue Code with a very simple principle, that the United States should provide a credit for foreign taxes paid by U.S. businesses on their overseas operations. That simple principle has become, over the last 90 years, a thicket of rules and restrictions that now occupies about 35 pages of the Internal Revenue Code, and almost 190 pages of Treasury regulations.

What is more, this highly complex set of rules is a moving target. Virtually every major piece of international tax legislation in the history of the code has changed the foreign tax credit rules. The most recent examples are the enactment just last year of new code sections 909, 901(m), 960(c), and 904(d)(6). This instability not only creates a significant compliance burden, but also makes it difficult for U.S. companies to engage in the type of long-term business planning that is necessary for them to compete internationally.

Second, the main cause for this complexity, from at least a tax practitioner's perspective, is what could be called the continual pursuit of technical perfection. Now, trying to ensure that the rules on the books operate as intended is, of course, a worthy and important goal. But in the case of the foreign tax credit, it has led, over time, to a system that makes comprehensive compliance and administration nearly impossible.

What we have, in effect, is a feedback loop that has been in place over many decades. Each change to the rules raises difficult interpretative questions, including how that particular change interacts with existing rules, what specific transactions were meant to be covered, and what specific structures were meant to be impacted. Those types of questions often lead to another round of fixes, or even wholesale revisions, which, in turn, raise their own sets of questions. The result, over time, is a tangle of rules and regulations that are full of traps for the unwary.

Therefore, third and finally, as you consider international tax reform, I urge you to keep in mind simplicity, stability, and, not least, support for U.S. businesses trying to compete abroad. International tax reform offers the opportunity to clear away the thicket of rules we now have to live with. But in the design of any new system, there will arise many choices about how to structure the rules. In dealing with such questions, we can learn a great deal about the very recent experience from some of our major trading partners, like Canada and the UK. These countries have been very up front about the importance of making their systems competitive, simpler, and stabler. We can learn from their example.

Now, it is something of a statement against self interest to say it, but I think our rules really should be simpler. There should be less economic opportunity for people like me, who practice in this area, and more economic opportunity for working Americans who are trying to bring home a living. We can, I think, in order to achieve that objective, resist the impulse to let the technically perfect system become the enemy of the perfectly good system.

So, with the objectives of simplicity and stability, and with a frank analysis of what our system needs to be competitive with the systems of other countries and our major trading partners, I think we can create a system of international taxation that supports U.S. business and attracts capital to our markets.

Once again, I would like to thank the committee for the opportunity to testify today, and I look forward to your questions.

[The prepared statement of Mr. Suringa follows:]

STATEMENT OF DIRK J.J. SURINGA
BEFORE THE COMMITTEE ON WAYS & MEANS
OF THE
U.S. HOUSE OF REPRESENTATIVES
ON THE NEED FOR COMPREHENSIVE TAX REFORM TO HELP AMERICAN COMPANIES COMPETE
IN THE GLOBAL MARKET AND CREATE JOBS FOR AMERICAN WORKERS

MAY 12, 2011

Chairman Camp, Ranking Member Levin, and Members of the Committee:

My name is Dirk Suringa. I am a partner with the law firm of Covington and Burling LLP. From 2000 to 2003, I was an Attorney-Advisor in the Office of International Tax Counsel at the Treasury Department. I appreciate very much the opportunity to testify today before the Committee. I appear before you today on my own behalf and not on behalf of my firm or any firm client.

My testimony today is that of a practitioner who works daily with the existing U.S. foreign tax credit rules. The theme of my testimony is that if the United States does decide to pursue comprehensive tax reform, including the adoption of an exemption system for the relief of international double taxation, the United States should avoid letting the technically perfect system become the enemy of a perfectly good system. In this regard, the complexity of the current foreign tax credit rules offers a cautionary tale.

The United States uses the foreign tax credit as its primary method of relieving double taxation and has done so almost since the inception of the Internal Revenue Code.¹ As one might expect from a system that has been in place for over 90 years, the foreign tax credit rules have been repeatedly revised and have become exceedingly complex. The sources of complexity are varied, but their common denominator in my view can best be described as *the continual pursuit of technical perfection*. Trying to make sure that the rules operate as intended is of course a worthy goal for any set of tax rules, but in the case of the foreign tax credit, it has led over time to a system that makes comprehensive compliance and administration nearly impossible.

The operation of the foreign tax credit limitation, just one set of rules under the credit, offers many examples of this phenomenon. By way of background, the foreign tax credit limitation generally limits the amount of the foreign tax credit to the potential U.S. tax on a taxpayer's foreign-source income. The purpose of the limitation is to prevent the foreign tax credit from relieving a taxpayer of the U.S. tax that would otherwise be payable on U.S.-source income.

During the 1970s, Congress became concerned about the potentially distortive effect of capital gain and loss on the computation of the foreign tax credit limitation. If a taxpayer had foreign-source capital gain but U.S.-source capital loss, for example, then the taxpayer's foreign-source income would be increased, for purposes of computing the limitation,

¹ Pub. L. No. 65-254, 40 Stat. 1057 (1919).

without a commensurate increase in U.S. tax liability. A rule was therefore added to require taxpayers first to offset foreign-source capital gain against foreign-source capital loss. The remaining net foreign-source capital gain would be taken into account in the limitation only to the extent of the taxpayer's overall net capital gain.²

Congress also was concerned that foreign-source capital gains and losses were being taken into account for limitation purposes at their actual dollar amount, even though they bore a rate of tax less than that of ordinary income. Thus, if a U.S. taxpayer earned U.S.-source ordinary income and a foreign-source long-term capital gain, its foreign tax credit limitation could be artificially increased. Correspondingly, if a taxpayer incurred a foreign-source capital loss that offset U.S. capital gain, its limitation could be artificially reduced. Rules were therefore added to adjust the foreign tax credit limitation to account for the rate differential between capital gain and ordinary income.³

These rules, directed at enhancing the technical accuracy of the foreign tax credit limitation, also added an almost impenetrable thicket of rules and regulations, including separate definitions for terms such as "foreign source capital gain net income," "foreign source net capital gain," "capital gain rate differential," and "rate differential portion."⁴ Thirty-five years later, unresolved interpretive questions remain and are unlikely to be resolved any time soon. And these rules represent only one very small example of the complexity that U.S. businesses must contend with on a daily basis.

A related consequence of the continual pursuit of technical perfection is instability in the foreign tax credit rules, which impedes long-term business planning. The history of the separate limitation rules again illustrates this phenomenon. At present, the foreign tax credit limitation is computed twice, once for so-called "passive category" income and again for all other income. This separate computation is intended to limit excessive cross-crediting. Cross-crediting is the practice of averaging high and low rates of foreign tax together to make the overall rate of foreign tax equal to or less than the U.S. tax rate, ensuring full utilization of available credits.⁵

The separate limitation rules have constantly changed over the history of the foreign tax credit: from no limitation (1918-1921), to a single "overall" limitation (1921-1932), to an overall limitation and a limitation applied separately to each country (a "per-country" limitation) (1932-1954), to a per-country limitation only (1954-1960), to an election to use either one (1960-1962), to an election plus a separate limitation for non-business interest income (1962-1976), to an overall limitation plus a single separate limitation for passive income (1976-1986), to an overall limitation plus multiple separate limitations (1986-2004), to its current status of an overall limitation with two separate limitations.

² See I.R.C. § 904(b)(2)(A).

³ See I.R.C. § 904(b)(2)(B).

⁴ See I.R.C. § 904(b)(3); see also Treas. Reg. § 1.904(b)-1.

⁵ See Joint Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986, at 862-63 (Comm. Print 1987). Foreign tax credits in excess of the limitation for a given year may be carried back one year and carried forward ten years, after which they expire.

This constant iteration is emblematic of the rest of the foreign tax credit system. Virtually every major piece of international tax legislation in the history of the Code has changed the foreign tax credit rules, including the enactment just last year of new Code sections 909, 901(m), 960(c), and 904(d)(6). Changes to the foreign tax credit rules, from ad hoc tweaks to wholesale revision, make long-term business planning difficult for U.S. businesses, relative to their foreign competitors.

The complexity and instability of the U.S. foreign tax credit rules impose a material, ongoing administrative burden on taxpayers and the government.⁶ Comprehensive tax reform, such as the adoption of an exemption system for the relief of double taxation, offers the opportunity to clear away the detritus of past policy battles and to start anew with a simple and stable set of rules. Simply replacing one Byzantine system with another, however, will not help American companies compete in the global market or create jobs for American workers.

The oft-stated purpose of the foreign tax credit is to relieve international double taxation of income.⁷ There is, however, another purpose for the foreign tax credit: to help U.S. businesses compete internationally. This purpose was openly acknowledged in earlier times. For example, in 1960 Congress authorized taxpayers to elect either the per-country limitation or the overall limitation for computing the credit, reasoning as follows:

In most cases American firms operating abroad think of their foreign business as a single operation and in fact it is understood that many of them set up their organizations on this basis. It appears appropriate in such cases to permit the taxpayer to treat his domestic business as one operation and all of his foreign business as another and to average together the high and low taxes of the various countries in which he may be operating by using the overall limitation.⁸

In other words, American firms should be allowed to maximize their foreign tax credit through cross-crediting because that helps them to be competitive abroad.

Fast-forwarding to the present, U.S. taxpayers that buy foreign businesses now must contend with Code section 901(m), enacted in 2010. This provision denies the portion of the taxpayer's foreign tax credit attributable to foreign taxes imposed on the amount of foreign income that is not offset annually by the increased U.S. cost recovery deductions arising from differences in the treatment of the acquisition for U.S. and foreign tax purposes. In this case, as in many others before it, the pursuit of technical perfection has come at the cost of administrability—and, on a certain level, at the cost of encouraging U.S. businesses to buy foreign businesses, instead of the other way around. From one practitioner's perspective, simplicity, stability, and encouragement of U.S. businesses trying to compete with foreign businesses are critical design criteria in any system for the relief of double taxation.

⁶ See National Foreign Trade Council (NFTC), *1 International Tax Policy for the 21st Century* 16 (2001); ABA Section on Taxation, *Tax Simplification Recommendations* 10 (2001).

⁷ *Associated Tel. & Tel. Co. v. United States*, 306 F.2d 824, 832 (2d Cir. 1962); *Theo. H. Davies & Co., v. Commissioner*, 75 T.C. 443, 450 (1980), *aff'd per curiam*, 678 F.2d 1367 (9th Cir. 1982).

⁸ S. Rep. No. 86-1393, at 4 (1960).

Chairman CAMP. Thank you.

Ms. Gravelle, you are recognized for five minutes, and your written statement is also part of the record.

STATEMENT OF JANE G. GRAVELLE, SENIOR SPECIALIST IN ECONOMIC POLICY, CONGRESSIONAL RESEARCH SERVICE, WASHINGTON, D.C.

Ms. GRAVELLE. Thank you, Chairman. Many proposals for tax revision argue that our corporate tax system should be revised to improve our “international competitiveness” by moving from the current deferral regime to an exemption of foreign source income

or a territorial tax. Related policies we have heard discussed today include another repatriation holiday or corporate rate cut.

International tax policy could also move in the opposite direction, by eliminating or restricting deferral, as the President has proposed. Deferral means that the U.S. system has territorial elements. It encourages firms to conduct activities and retain earnings abroad. A territorial tax would further encourage firms to operate abroad. But both a territorial tax and eliminating deferral would remove the retention incentive.

Although competitiveness has been invoked in this debate, it is not countries that are competitive, it is companies that are. A country's firms cannot be competitive in all areas. Even if firms in our country are more productive than firms in all other countries, a country would still produce those goods in which its relative advantage is greatest, and trade with other countries for other goods. The other countries need to produce goods with their resources, as well.

So, competitiveness, in economic terms, is not a very helpful concept here. When you do economic analysis of international tax policy, the issues are really of either efficient tax policy or optimal tax policy. Efficiency refers to allocating capital to uses around the world with the highest pre-tax or social yield. And it maximizes world welfare. Optimal policy maximizes U.S. welfare.

Concepts that relate to these two goals are a term called capital export neutrality and a term called national neutrality. Capital export neutrality is efficient, and requires a country to apply the same tax rate to its firm's investments, regardless of where they are located. It is embodied in a residence-based system. National neutrality requires only allowing a deduction for foreign taxes paid.

A third concept, called capital import neutrality is achieved with territorial taxation. This approach will cause a misallocation of capital to low-tax countries, lowering the wages of workers in high-tax countries, and raising them in low-tax countries.

Although capital import neutrality appears to be fair, a level playing field, it is not efficient because firms make choices based not on the options facing each country's firm, but their own returns to investments in different locations.

Although this discussion focuses on the allocation of investment, another consequence, an important consequence of the choice of tax regime, is the ability to shift profits artificially from high-tax to low-tax countries, which occurs with deferral, and would likely increase with a territorial tax.

Now, arguments have been made that these concepts are outmoded because they assume that U.S. firms are constrained by U.S. rules. The firms can shift their nationality, or if investors can shift their portfolios to foreign firms, capital export neutrality cannot be achieved. Evidence indicates, however, that these options are not available or important, and they could also be further restricted.

Our anti-inversion rules seem to be working very effectively. Recent research suggests that headquarters locations are not very sensitive to tax, and that new firms rarely incorporate abroad—new U.S. firms. The increasing portfolio investment by U.S. citi-

zens in foreign firms appears motivated by portfolio diversification, and not tax issues.

While moving to a territorial tax would reduce any existing incentive to headquarter abroad, it is not clear that this issue would be important enough, considering revenues, to—compared with the increase incentive for profit shifting. That is, I think it is a lot easier to shift profits than to shift headquarters.

Another proposal that has been made is to cut the corporate tax rate. I don't have a lot of time to talk about that, although I mention it in my testimony. It would be opposite from the effect of a territorial tax. My own research finds that cutting the corporate tax rate by 10 percentage points would increase output on a 1-time basis by only $\frac{2}{10}$ of 1 percent of income, and will increase national income, the income we own, by only $\frac{2}{100}$ of 1 percent of income. So it is important to growth, but certainly not important to things like getting the deficit under control. Thank you.

[The prepared statement of Ms. Gravelle follows:]

Statement of Jane G. Gravelle
Senior Specialist in Economic Policy
Congressional Research Service
Before
The Committee on Ways and Means
United States House of Representatives
May 12, 2011
on
International Tax Issues

Mr. Chairman and Members of the Committee, I am Jane Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss international tax issues..

A striking feature of the modern U.S. economy is its growing openness—its increased integration with the rest of the world. The attention of tax policymakers has recently been focused on the growing participation of U.S. firms in the international economy.

Many proposals for tax revision argue that our corporate tax system should be revised to improve our “international competitiveness.” Among proposals advanced for this purpose is moving to a territorial, or source-based, tax, which would exempt foreign source income of U.S. firms. Arguments for this revision are sometimes accompanied with an appeal to a concept termed “capital import neutrality.” Related proposals include enacting another repatriation holiday and cutting the corporate tax rate, possibly with accompanying base broadening.

Proposals for a Territorial Tax System¹

The current U.S. system for taxing international business is a hybrid of worldwide and territorial principles. In part the system is based on a residence principle, applying U.S. taxes on a worldwide basis to U.S. firms while granting foreign tax credits, to alleviate double taxation. The system, however, also permits U.S. firms to defer the tax on profits earned by foreign subsidiaries until dividends are paid to the U.S. parent. Foreign tax credits are limited to the U.S. tax imposed on foreign source income. This limit is applied on an overall basis and permits cross-crediting, where unused foreign taxes generated in one country or on one kind of investment can offset U.S. tax due on income from low-tax countries. Deferral means that the U.S. system, while generally residence-based, has elements of a territorial system. It also encourages firms to conduct activities and retain earnings abroad.

Although the particular details could vary with different proposals, a territorial tax would exempt the earnings of foreign subsidiaries from U.S. tax. International tax policy could move in the direction of a worldwide tax as well, by eliminating deferral. The President's FY2012 budget proposals would move in this direction. These proposals would not fully eliminate deferral but would disallow some parent company deductions to the extent taxes on foreign source income are deferred, and restrict foreign tax credits related to deferred income. Both a territorial tax and eliminating deferral would eliminate the incentive to retain earnings abroad.

Concepts of Competitiveness, Efficiency and Optimality

Although the term competitiveness has been invoked in the debate about U.S. policy in a global economy, it is not *countries* that are competitive, it is *companies* that are. A company generally thinks of itself as competitive if it can produce at the same cost as, or a lower cost than, other firms. But a country's firms cannot be competitive in all areas. Indeed, even if firms in a

¹ The issues discussed in this section and the following two sections are discussed in more detail in CRS Report RL31145, Reform of U.S. International Taxation: Alternatives, by Jane G. Gravelle.

country are more productive than firms in all other countries in every respect, a country would still tend to produce those goods in which its relative advantage is greatest and trade with other countries for the goods they do not have a relative advantage in productivity. The other countries need to produce goods with their resources as well. This notion is called comparative advantage, and it is an important concept in economic theory, dating from the early 19th century.

In sum, companies compete, and countries trade. In the economic analysis of tax policy, including tax policy and its effect on the international allocation of capital, the issues are generally framed around concepts of efficiency, neutrality, and optimal policies rather than notions of competitiveness. These terms can mean the same thing, or they can be slightly different. Neutrality generally refers to provisions that do not alter the allocation of investment from that which would occur without taxes. Efficiency refers to the allocating capital to those uses that yield the highest social (or pre-tax) return, and it maximizes world welfare. When markets are operating competitively, a neutral tax policy will also be an efficient policy, since it will maintain the efficient allocation that would occur without taxes. Moreover, even when there are market imperfections, neutrality may still be the policy most likely to be efficient, given the difficulty in identifying and measuring market imperfections.

Optimal policy differs from efficiency in that it usually refers to a particular agent or actor choosing a policy that maximizes his or her own welfare. A country can also choose a policy that leads to the greatest welfare for its own citizens, even if that policy distorts the allocation of capital (is not neutral) and leads to less efficient worldwide production. The optimal policy from the perspective of a country, in other words, may not be the most efficient in terms of the worldwide allocation of capital, and may not be the optimal policy from the perspective of world economic welfare.

Concepts, or guidelines, are discussed in the formulation of international policy. Two concepts that relate to these goals of efficiency or optimality are capital export neutrality and national neutrality. Capital export neutrality requires a country to apply the same tax rate to its

firms' investments, regardless of where they are located, and is embodied in a residence-based tax system. National neutrality requires that the nation's total return on investment, including both that nation's taxes and its firms' profits, is equal in each jurisdiction, foreign and domestic. This form of neutrality is obtained by taxing foreign-source income and allowing a deduction for foreign taxes. There is also an optimizing rule for choosing the tax rate on inbound investment, which depends on how responsive that investment inflow is to the return.

A third concept, capital import neutrality, is achieved with source-based or territorial taxation. This approach, however, will result in higher returns in low-tax countries. As a result, capital will flow out of the high-tax country, raising its return and lowering the wages of the workers in that country and into the low-tax country, lowering its return and raising the wages of the workers in that country. Although capital import neutrality appears to be fair by imposing the same taxes on firms operating in a particular country, it is not neutral because firms make choices based not on the options facing other country's firms but on their own returns to investment in different locations. Hence, a territorial tax is not neutral or efficient.

In sum, according to these longstanding measures of neutrality and efficiency, capital export neutrality is appropriate for maximizing world output, national neutrality is appropriate for maximizing a nation's welfare, and capital import "neutrality" is not neutral at all.

Although this discussion focuses on the allocation of capital, another consequence of the choice of tax regime is the ability to artificially shift profits (without necessarily altering economic activities) from high-tax to low-tax countries, which reduces tax revenues in the high-tax country. Profit shifting can occur in territorial tax systems, depending on the ability of the tax authorities to police it, and it can occur in the U.S. system because of deferral. Considerable evidence exists to indicate profit shifting occurs.²

² This evidence is discussed in CRS Report R4063, *Tax Havens: International Tax Evasion and Avoidance*, by Jane G. Gravelle.

Is Capital Export Neutrality Obsolete?

Recently, arguments have been made that these concepts are outmoded because firms can alter their nationality. That is, these concepts are based on the notion that U.S. firms are constrained by U.S. tax rules. If firms can shift their nationality or if investors can shift their portfolios to foreign firms, capital export neutrality cannot be achieved by a country.

Firms could potentially change their nationality by moving their headquarters abroad (termed “inverting”), by merging with foreign firms, or by originally incorporating abroad. In 2004, however, Congress enacted anti-inversion rules which continue to treat these firms as U.S. firms and this approach seems to be working effectively.³ Inverted firms, such as Transocean, owner of the Deepwater Horizon drilling operation in the Gulf of Mexico, generally inverted prior to 2004. Other stricter rules could also be devised, including a facts and circumstances determination of management control. Thus, existing or potential provisions can be used to prevent this action even if further movement towards a residence-based tax (such as eliminating or restricting deferral) occurred. Recent evidence has also suggested that firm’s headquarters choices are not affected significantly by taxes.⁴

International mergers seem less of a concern because there are many serious consequences to a merger that may outweigh tax considerations. It is also, however, possible to devise rules that prevent or limit tax motivated mergers and rules of this nature (limiting certain tax benefits for a firm if there is at least 60% continuing ownership for ten years) were adopted in 2004 as well.

New start-up firms are not likely to be an important avenue for shifting nationality. The challenges that a new U.S. firm face are significant and success is more likely in a familiar

³ The American Jobs Creation Act of 2004, P. L. 108-357.

⁴ Kimberly Clausing, “Should Tax Policy Target Multinational Firm’s Headquarters?” *National Tax Journal*, Vol. 63, No. 4, Part 2, December 2010.

environment. Moreover, at the point when the firm has an initial public offering, it would likely be more successful with stock offered in a U.S. firm governed by U.S. rules and regulations.

Preliminary research (whose specific results are not yet available to be cited) has also suggested that foreign IPOs for U.S. entrepreneurs are rare.⁵

Rather than U.S. firms or potential U.S. firms incorporating abroad, another avenue that is sometimes cited as a concern for achieving capital export neutrality, is that U.S. citizens can invest directly in foreign firms. This argument appeared to gain currency in recent years as U.S. portfolio investment abroad increased, although there is a significant home bias, with about 80% of U.S. portfolios invested in U.S. firms. Although portfolio investment has increased significantly, it is probably related to the greater ease with which foreign stocks can be purchased. Supporting the view that the major motive for this expansion of portfolio investment is portfolio diversification, most stocks held in foreign firms are in firms in developed countries with similar tax rates to those of the U.S., not firms in low tax countries. Since portfolio investors are concerned with the overall return (governed by overall tax rules) and not the details of a country's foreign tax regime, this behavior is unlikely to reflect a desire to avoid U.S. tax on foreign source income.

Policy makers might need to remain vigilant about the possibility of shifting the location of firms, if a movement further towards a residential tax system is contemplated. While moving to a territorial tax would reduce any existing incentives to headquarter abroad, however, it is not clear that this issue would be important enough, with respect to revenues, to overcome the increased incentive for profit shifting, since it is likely easier for firms to shift profits than to shift headquarters.

⁵Eric Allen (Ph.D. Candidate, UC-Berkeley) & Susan Morse (UC-Hastings), Firm Incorporation Outside the U.S.: No Exodus Yet, This paper was referred to on a well known tax professor blog and presented at a recent tax conference. See http://taxprof.typepad.com/taxprof_blog/conferences/.

Repatriation and a Repatriation Holiday⁶

One aspect of our deferral system is that it encourages firms to retain profits abroad if they are in circumstances where adequate foreign tax credits do not exist to offset U.S. tax. This incentive is somewhat constrained because if firms pay taxes in the future they will pay them with interest and because funds may be needed to pay dividends. This incentive could, however, be eliminated either through a territorial tax or through a repeal of deferral.

In 2004, firms were allowed a repatriation holiday that permitted them to repatriate while excluding 85% of dividends from the tax.⁷ The purpose of this holiday was to make funds available for investment and to hire workers. Most evidence, however, suggested that funds were used to pay shareholders; evidence also suggested that the holiday increased the tendency of firms to retain profits abroad in later years, possibly in anticipation of another holiday.

There has been some discussion of another holiday to provide funds to increase investment and hiring of workers, although the arguments are perhaps less compelling currently because of the large amount of liquid funds already held by corporations. Granting another holiday might also reinforce firms' beliefs that they will periodically be allowed to repatriate at a low tax cost, and might further encourage future retentions abroad. It is not clear, in any case, how important the repatriation is to financing investment given the fungibility of money. If another repatriation holiday is considered, it might be more effective if the benefit is tied to increases in economic activity such as investment, hiring workers, or research expenditures.

⁶ Issues discussed in this section are discussed in further detail in CRS Report R40178, *Tax Cuts on Repatriation Earnings as an Economic Stimulus: An Economic Analysis*, by Donald J. Marples and Jane G. Gravelle.

⁷ The American Jobs Creation Act of 2004, P. L. 108-357.

Reducing Corporate Tax Rates⁸

Advocates of cutting corporate tax rates frequently make their argument based on the higher statutory rate in the United States as compared with the rest of the world; they argue that cutting corporate taxes would induce large investment flows into the United States, which would create jobs or expand the taxable income base enough to raise revenue. Some proposals for rate reductions support a revenue neutral tax reduction which also expands the tax base, given the current pressures on the deficit. Others have urged on one hand, a revenue raising reform, and, on the other, setting deficit concerns aside.

Is the U.S. tax rate higher than the rest of the world, and what does that difference imply for tax policy? The answer depends, in part, on which tax rates are being compared. Although the U.S. statutory tax rate is higher, the average effective rate is about the same, and the marginal rate on new investment is only slightly higher than corresponding rates in other countries. The statutory rate differential is relevant for international profit shifting; effective rates are more relevant for firms' investment levels. The differential in statutory rates is reduced when tax rates in the rest of the world are weighted to reflect the size of countries' economies and further reduced when the production activities deduction is included.

For outbound capital (capital owned by U.S. firms but invested abroad), a corporate rate cut acts in the opposite direction from a territorial tax, because it discourages the flow of capital abroad, while a territorial tax encourages the flow of capital out of the United States. A corporate rate cut would increase inbound capital, although the gains to revenue would be uncertain since a rate cut, while collecting taxes on induced inflows, reduces taxes collected on existing investments.

Regardless of tax differentials, could a U.S. rate cut lead to significant economic gains and revenue feedbacks? Because of the factors that constrain capital flows, estimates for a rate cut

⁸ This section summarizes research contained in CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by Jane G. Gravelle.

from 35% to 25% suggest a modest positive effect on wages and output: an eventual one-time increase of less than two-tenths of 1% of output. Most of this output gain is not an increase in national income, because returns to capital imported from abroad belong to foreigners and the returns to U.S. investment abroad that comes back to the United States are already owned by U.S. firms. The gain in income is estimated at about a tenth of the output gain, 2/100 of 1%.

The revenue cost of such a rate cut, with no base broadening, is estimated at between \$1.2 trillion and \$1.5 trillion over the next 10 years. Revenue feedback effects from increased investment inflows are estimated to reduce those revenue costs by 5%-6%. Reductions in profit shifting could have larger effects, but even if profit shifting disappeared entirely, it would not likely offset revenue losses. In any case, it seems unlikely that a rate cut to 25% would significantly reduce profit shifting given these transactions are relatively costless, largely constrained only by enforcement, and significant tax differentials would remain.⁹

These results also suggest that the gains to output in the United States from ending deferral and the losses from moving to a territorial tax would be small as well, since these policies have smaller effects than the corporate rate cut. They might have more important consequences for profit shifting.

Both output gains and revenue offsets would be reduced if other countries responded to a U.S. rate cut by reducing their own taxes. Evidence suggests that the U.S. rate cut in the Tax Reform Act of 1986 might have triggered rate cuts in other countries. Output gains might also be reduced since tax rate reductions increase the cost of debt finance which is likely more mobile.

It is difficult, although not impossible, to design a reform to lower the corporate tax rate by 10 percentage points that is revenue neutral in the long run. Standard tax expenditures do not appear adequate for this purpose. Eliminating one of the largest provisions, accelerated

⁹ A recent news story explained how Google not only shifted its European operations to Ireland, but also took measures to shift profits out of Ireland, with a 12.5% rate, to Bermuda, with a 0% rate. Jesse Drucker, "Google 2.4% Rate Shows How \$60 Billion Lost to Tax Loopholes," *Bloomberg*, Oct. 21, 2010, posted at <http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html>.

depreciation, gains much more revenue in the short run than in the long run, and a revenue-neutral change would increase the cost of capital. The other major source of broadening is increasing the taxation of foreign source income by ending deferral and restricting foreign tax credits, and limiting interest deductibility. The former moves in opposite direction to a territorial tax, and the latter could cause reductions in capital flows into the United States if debt is significantly more mobile than equity. Rate cuts could also be financed by increasing shareholder level taxes on dividends and capital gains.

Chairman CAMP. Thank you very much. Thank you all for your testimony. We have heard that there are different territorial systems, and we know there are. But let me ask you, Mr. Suringa, if there was a properly designed territorial system. What advantages to the U.S. economy would there be from adopting such a system? And I realize we are talking in a generality here, and there are specifics, but—

Mr. SURINGA. Yes, I think that is right. The main advantage of territoriality, is as a way to end the lock-out effect on capital that is abroad, the earnings and profits that are now, in essence, trapped in foreign subsidiaries.

The notion is that if a company is looking for how to use its capital or its earnings in a foreign jurisdiction, its choice about bringing those back to the United States is handicapped by the hurdle rate that is imposed by the tax on repatriation.

So, let's assume you get a foreign tax credit to offset the U.S. tax on some piece of a distribution to the United States. You are still talking about playing with, you know, \$.65, \$.75 on the dollar if you bring the money back home. And if you are looking at what kind of investment do I make, do I make the investment abroad, where I am starting with 100 cents on the dollar, do I make the investment in the United States, when I am talking about \$.65, \$.75 on the dollar? That is just a very basic sort of dollars and cents problem that territoriality helps to address by, essentially, taking away the tax cost of bringing the money back home. I think that is the main advantage of a territorial system, relative to the current system.

In addition, I think a properly designed territorial system gives the opportunity to reduce a lot of the complexity associated with our current rules, in particular, the foreign tax credit limitation, which is incredibly complex, and has pages and pages of rules. I mean it is fun for people like me, but it is not fun for American businesses. And these types of rules are much less significant if you move to a territorial system.

Chairman CAMP. And, Mr. Hines, what are the important—some of the most important decisions that policy makers should consider when trying to design a territorial system?

Mr. HINES. One of the big issues is how you think about expense deductions associated with a territorial system, because American firms will have general expenses like interest expense in the United States or general and administrative expense. And the question is whether you want to permit those expenses to be fully deductible if the foreign income earned by those companies is not taxed by the U.S.

It seems intuitive that if a company is doing 20 percent of its business abroad and has administrative expenses in the United States that cover both its domestic and foreign activities, then perhaps only 80 percent of those administrative expenses should be deductible in the United States.

However, that is not really the right answer to that question. This expense deductibility question is a very important one. If you look at what other countries do—like the example of France was given earlier today generally do permit full domestic deductibility of the associated expenses, and that is the right way to run a territorial system. If you don't, then you are implicitly taxing the foreign income again, and that is a mistake.

Chairman CAMP. Okay. Mr. Suringa, do you have anything to add to that?

Mr. SURINGA. Well, I think also on the deductibility of interest expense and other costs, I would agree with Professor Hines. One of the things to think about is if you are disallowing a portion of the interest and other expenses that are allocable to foreign source income, and you make an investment in the U.S.—let's say you borrow to build a factory in the U.S.—if you have just a general expense allocation rule that allocates a piece of that to foreign source

income, you are going to actually lose your interest expense deduction for borrowing to build something in the U.S.

I think that a lot of the complexity that people talk about in existing territorial systems is related to expense allocation. And that is why, in countries like Canada and the UK and France, as well, they have basically said, "We are not going to get into that game," just for competitiveness reasons.

Chairman CAMP. All right, thank you. Mr. Levin is recognized.

Mr. LEVIN. You know, in a way, one should hesitate to ask questions because the answers often aren't what we want.

[Laughter.]

Mr. LEVIN. I think we found that out today with a repatriation holiday because the witnesses who were here before very much articulated the reasons why we should not do it on a one-year basis, or a periodic basis. And I am not sure, Professor Hines, that my colleagues to my right here like your answer, in terms of raising taxes on individuals.

So, maybe there should be some hesitation to ask questions, but I will anyway.

Chairman CAMP. I would just say the committee doesn't normally do rifle shots, but we might make an exception in his case.

[Laughter.]

Mr. LEVIN. I remember how previous chairs—myself, for a period of time, and those before us—talked rather negatively about rifle shots. But anyway, I can just look on the wall, and hear Dan Rostenkowski talking about rifle shots.

But let's have some discussion back and forth among the three of you, because you don't agree, I don't think. And I think the more discussion we have, the better. Your response on interest allocation, I think we need to spend some time on it. Because with territorial, you can very much escape taxation by an unfair allocation. And to simply say, "Let anybody do whatever they want," is an open door to abuse of the tax system. And so, if you avoid complexity, you may increase undermining the integrity of a Tax Code.

So, let me ask you, Ms. Gravelle, to bring you into this discussion, your view of the adoption of a territorial tax system and what impact it would have on wage income, labor income, what is your judgement there?

Ms. GRAVELLE. I think it would cause—although we have got a lot—we are very close to a territorial system already, but it would make foreign investment more attractive. That would cause investment to flow abroad, and that would reduce the capital with which workers in the United States have, so it should reduce wages. A capital flow reduces wages in the United States, increases wages abroad.

Mr. LEVIN. Okay, because on page eight of your testimony you say that a territorial tax encourages the flow of capital out of the U.S.

Ms. GRAVELLE. That is right.

Mr. LEVIN. Why don't you elaborate on that? And then, because, Mr. Chairman, we need to have some discussion here—this is not an easy issue—

Ms. GRAVELLE. Well—

Mr. LEVIN [continuing]. Maybe those who disagree with Ms. Gravelle, who has a long history with these issues, chime in if I have the time. Ms. Gravelle?

Ms. GRAVELLE. Well, I mean, basically, if you lower the tax, either the perceived tax, because of eliminating, you know, any prospect of tax, with a territorial system, you will increase the after-tax rate of return that firms see abroad, so they will want to move their investments—they would want to make investments abroad, instead of the United States.

I mean it is a very straightforward idea. And the more capital abroad, the less capital in the United States, that is going to lower wages in the United States. So that is just a very standard notion of where investment flows, and capital output—capital stock versus worker ratios in different countries.

Mr. LEVIN. I—

Ms. GRAVELLE. I also think, though, an equally important issue is profit shifting. I think profit shifting is a problem that you have to be concerned about that is going to grow with territorial tax.

Mr. LEVIN. Professor.

Mr. HINES. I have been disagreeing with Dr. Gravelle for 25 years, and I disagree with her right now.

Mr. LEVIN. You are not old enough to have disagreed with her for 25 years.

Mr. HINES. Oh, I guess you are right about that.

[Laughter.]

Mr. HINES. A territorial system would encourage business activity abroad, and that would stimulate greater and more productive business activity in the United States. The mistake in Dr. Gravelle's logic is the assumption that there is one piece of capital, and it can either go to the United States or it can go abroad.

The fact is, in the world there is lots of capital. And if business is more productive abroad, they can also be more productive and expand at home.

Mr. LEVIN. All right.

Chairman CAMP. Thank you. Dr. Boustany is recognized.

Dr. BOUSTANY. Thank you, Mr. Chairman. Thank you all for appearing before the committee today.

Mr. Suringa, in your testimony you warned us against the pursuit of perfection as we go about looking at this. And if we go to a territorial system, and we move to exempt active foreign income, we will only need the foreign tax credit for passive income. Is that correct?

So would this allow us to really simplify the use of foreign tax credits? You mentioned the complexity in the code and in the regulations. Could you elaborate on that?

Mr. SURINGA. Sure. I think it would certainly reduce the pressure on the foreign tax credit rules. It depends a lot on what type of system you go to. So, for example, if you choose a system like the Netherlands, which exempts both dividends and also branch income, then you are really not talking about much scope for application for the foreign tax credit rules, because double taxation is being relieved through the exemption system across the board.

If you, on the other hand, go to a system like the UK has gone to, where you exempt dividend income but do not exempt branch

income, you rely on treaties for whatever exemption you are going to get in that context, then the foreign tax credit rules would still play a role.

So I think it really depends a lot on the type of system you adopt. And I think that that type of dialogue about whether to adopt that system wholesale or piecemeal, that is sort of an ongoing dialogue that those countries are having internally.

For example, there has been discussion in the UK and in Canada about going from a participation exemption system for dividends only to a system in which they also exempt branch income as well. And I think the motivation for that is, in part, simplicity of application, and not having to deal with the foreign tax credit rules very much at all.

Dr. BOUSTANY. Thank you. Mr. Tiberi asked the first panel earlier, "What pitfalls should we look for, as we move forward?" And let's say we go forward with a territorial system.

So, Mr. Hines, I know we talked a little bit about the expense allocation issue just a moment ago. I don't know if there is any—if you want to add more to that. But could you also talk a little bit about pitfall, just in general terms? I know it is beyond the scope of the time we have here, but give us some guidelines.

Mr. HINES. Well, certainly, expense allocation is a pitfall, because it is very easy to talk yourself into propositions about limiting deductibility that would be mistakes in a territorial system.

A second issue is you have to think about the tax treaties that we have. I realize that is not the House's responsibility, but we have a lot of treaties, and they are based on the tax system we currently have. And so we would need to think about a number of our treaty arrangements. *Dr. Boustany. Thank you. Mr. Suringa, you want to comment there?

Mr. SURINGA. There are various sorts of design elements. So an example is in Canada. Their participation exemption is an exemption for what is referred to as "exempt surplus". Exempt surplus is a portion of the earnings that are basically active earnings that are earned in jurisdiction with which Canada has a treaty or a tax information exchange agreement, and that has certain other similarities to the Canadian tax system.

If you have active earnings in a jurisdiction that is outside that set of parameters, it is called "taxable surplus". And so when a Canadian company brings home a dividend, they have to figure out, okay, is this out of the taxable surplus account or the exempt surplus account, or is it under the foreign accrual property income regime, which is their anti-deferral regime. And you have to maintain all these sorts of complex accounts for how to deal with that.

Because of the distinction between taxable and exempt surplus, you get discontinuities. For example, they have a treaty with the Bahamas. So you can earn active income in the Bahamas in Canada that is going to be treated as exempt surplus. They don't have a treaty with Hong Kong. So you have an active manufacturing operation in Hong Kong. That is all taxable surplus.

You get these sort of odd discontinuities, in terms of where you would expect to see an exemption apply, versus where you would expect to see residual taxation apply. For that reason, I think they are leaning towards trying to adopt a reform in which they would

not make those types of distinctions, that they would treat all active foreign business income as exempt surplus. And I think those are the types of design criteria that the U.S. should think about if we are going to move to a territorial system.

Dr. BOUSTANY. Thank you. I yield back, Mr. Chairman.

Chairman CAMP. Thank you. Mr. Rangel is recognized.

Mr. RANGEL. Thank you, Mr. Chairman. Assuming that we all agree that our foreign tax system is overly complicated, and it has to be simplified, your mission today is to make certain that we provide whatever incentives is necessary to encourage our multinationals to invest in the United States of America without doing violence to their competitive position, as relates to transportation and other reasons that encourage them to do business and invest abroad.

But your jobs, collectively, is to tell us what we can do with the existing code so that, at the end of the day, you know, as tax writers, that we did the best we could to encourage foreign—strike that—multinationals to bring that money and invest it—invest it, not just give it out in dividends—into American business, expansion of business opportunities to create more jobs in the USA.

If you three can find some area of agreement, we will be way ahead with our problem. Mr. Hines.

Mr. HINES. Well, I don't know about agreement, but I will start with what I think the answer is, which is American companies will invest in the United States if it is profitable to do so, and if it is feasible to do so.

Mr. RANGEL. What can we do?

Mr. HINES. To make it profitable, I think we should exempt foreign business income from U.S. taxation, and allow companies to structure their businesses in the most profitable way.

If it is in their interest to invest in the United States, they will do it. And the current tax system puts impediments in the way to the most productive business structuring.

Mr. RANGEL. Suppose it is in their interest just to pay off debts and to increase dividends and to do things that are not directly related to creating jobs here.

Mr. HINES. But we need to have confidence in the American economy. This is a great economy, we just need to get the tax system out of the way of the economy. And that has been our history, and there is no reason—

Mr. RANGEL [continuing]. Depend on them to do the job creating thing here by improving the economy generally?

Mr. HINES. Yes.

Mr. RANGEL. Okay. Mr. Suringa.

Mr. SURINGA. Well, I think my perspective is one of as a practitioner, and this may be a little bit above my pay grade. But I think where I would start with is the rules that create complexity in the existing code. And, you know, I would probably start, you know, with last year's bill and work backwards. I mean I just—

Mr. RANGEL. There is no question that is a done deal. We promise you that we will simplify the system, based on your recommendations.

Now, what can we do to get that investment money here to create jobs here?

Mr. SURINGA. Well, I think moving to a participation exemption is going to simplify things and improve the ability of U.S. businesses to bring their money back home. So I think it is just a question of—

Mr. RANGEL. Bringing it back home is not the issue. Getting them to invest here and create jobs is the problem.

Mr. SURINGA. Well, that is a very difficult problem. I think it really ultimately ends up being a matter of faith, as the—

Mr. RANGEL. Faith?

Mr. SURINGA [continuing]. As Professor Hines has said, in the sense that—

Mr. RANGEL. Faith in the economists and multinationals is at an all-time low.

Mr. SURINGA. Well, that is—I understand. The issue is that if you—the extent to which you put restrictions on their ability to use the money when they come back home, that is either going to discourage them from bringing the money back home, or they are going to bring it back home and use it in the right way, or they are going to bring it back home and try to figure out a way to work around those rules. So—

Mr. RANGEL. Thank you for your contribution.

Mr. SURINGA. Well, that—

Mr. RANGEL. Ms. Gravelle.

Ms. GRAVELLE. Well, I think the answer to moving that direction is simple. We could have a tax reform that increases the tax on foreign source income and reduces the tax rate in the United States. One example of that is in the Wyden-Gregg Bill, which was introduced last year. It is now the Wyden-Coats Bill.

But basically, I don't see that cutting taxes abroad is going to help bring capital here. I think it will do the opposite. And I do think we have a fixed pot of capital that belongs to U.S. companies. And if you move it one place it can't be another place. So I think that is a very straightforward answer.

But I think we should think about efficiency, and we should think about tax administration, too. I actually think a system that ends deferral would be easier to administer, because there wouldn't be all these incentives to have profit shifting.

Mr. RANGEL. Thank you. Mr. Chairman, what is your idea?

Chairman CAMP. Well, I think my idea, if you are yielding back your time, is to recognize Ms. Black for five minutes.

[Laughter.]

Mrs. BLACK. Thank you, Mr. Chairman. And thank you for being here today, panel.

I want to go back to something that was talked about in our first panel. I think you may have all been in the audience at that point in time, but let me just go back and remind you what was said. I think it actually was my colleague, Mr. Berg, who made the observation that in 1960, 17 of the 20 largest companies were headquartered here in the United States. And we are now down in 2010 to just 6 of those top 20 businesses being headquartered here, in the United States.

And given the fact that both on this panel and also the previous panel it was noted that capital is mobile, and in our world of increasingly mobile capital, how do these very high corporate taxes

make business investment and job creation in the United States attractive? Or, in the other case, not attractive?

Mr. HINES. So the question is how do high tax rates make investment attractive?

Mrs. BLACK. Well, I am trying to see can if we draw a conclusion about these businesses being headquartered and going to another country where the tax rate is, frankly, just more attractive. Would you draw that conclusion? And if so, what makes that happen?

Mr. HINES. Oh, there is ample evidence that investment is attracted to lower tax locations. That is clear, and virtually every statistical study shows that. Furthermore, if taxes discourage certain kinds of industries, then you get fewer of those industries.

There have been, in the past, expatriations, where companies actually pick up and move their headquarters, move their site of incorporation outside of their home country if the home country imposes a punishing tax burden.

The United States had a spate of expatriations in the late 1990s, although subsequent legislation made it very difficult for companies to do that. Part of what motivated Great Britain's recent tax reform move to a territorial system was concern about expatriating British companies that were moving elsewhere in Europe.

So, expatriation is not itself quantitatively a large problem, but it is a little bit the canary in the coal mine, in that it illustrates the problem that your tax system has, that it makes your companies less competitive and discourages investment which, alas, is what we have had.

Mrs. BLACK. Mr. Suringa.

Mr. SURINGA. Yes. I think in the planning context you see this very much in what are referred to as sandwich structures, where you have got a foreign parent above a U.S. parent above a foreign subsidiary. And in that circumstance, the U.S. company ends up becoming a significant tax driver for that series of corporations. It leads to a lot of incentives on the part of the foreign company to actually move those operations out of the U.S. and align them under the foreign group, because the top tier foreign group can benefit from an exemption system, from concessions that are offered in its jurisdiction of incorporation.

That is an example in which you see a direct incentive, in terms of business planning, for moving operations out of the U.S. And, obviously, to the extent that we can create a much more attractive environment for corporations to be headquartered in the U.S., you would expect to see that to stop. People would want to put operations underneath the U.S., because they are expecting to be able to get exempt dividends back up to their U.S. operations, and then to be able to redeploy them into our market, and into other markets, as well.

Ms. GRAVELLE. Well, I think that most of the expatriations that occurred before 2004, and I think our legislation there pretty much took care of that problem. Most people felt that was the purpose of moving abroad, so you could strip earnings out of the United States. In other words, you would move your headquarters abroad, and then you would engage in some sort of interactions

with your related companies in the United States, particularly leveraging for earnings stripping.

Every country has thin capitalization rules to prevent that, but ours are pretty weak. So, and that is what the evidence has showed, is the firms that inverted before 2004 moving mainly to places like Bermuda, used that as a way to reduce income that properly belongs in the United States, which is why you have this issue with allocation of deductions. That is another way you do earnings stripping.

Mrs. BLACK. So if we have a territorial system where we equalize the competitiveness, would it not seem, by just reasonable-thinking people, that if you have an American-owned company and you are apples-to-apples on the taxes that you would not want to be headquarters here in the United States, and grow your business here in the United States?

As I talk to those companies that I go to visit that do have operations offshore, and then they have them here, they tell me if they could just have a more equal footing, it would be more attractive for them to be here.

Chairman CAMP. Thank you. Mr. Doggett is recognized.

Mr. DOGGETT. Dr. Gravelle, if we move to a territorial system that eliminates taxes on foreign investment, or makes it nominal, won't that have the effect of incentivizing investment overseas, instead of investing here, in America?

Ms. GRAVELLE. I think that is pretty obvious.

Mr. DOGGETT. I think it is pretty obvious—

Ms. GRAVELLE. I mean if you lower the tax abroad, capital is going to go abroad. I don't know where the extra capital that Jim is talking about comes from. But, you know, unless we have a savings response, there is no reason to have more capital. So if you put capital in one place, it is not going to be in another place.

Mr. DOGGETT. I agree with you, that—

Ms. GRAVELLE. So that is just logic.

Mr. DOGGETT [continuing]. It is extremely obvious, despite all those who claim it is a panacea, that if you want to encourage economic growth overseas, adopt a territorial system. It is not aimed at creating jobs in America—

Ms. GRAVELLE. Absolutely.

Mr. DOGGETT. And, in fact, won't the economic effect of adopting a territorial system—over time, won't American workers actually see their wages go down?

Ms. GRAVELLE. That is what you would expect if you moved capital out of the United States elsewhere. You would expect wages to go down in the United States.

Mr. DOGGETT. So, American workers that are already struggling will pay a price if we adopt the Republican panacea approach. And let me discuss more specifically a matter that all of you have referred to, and those are these rules that few people on this committee, much less the American people, fully understand. And I will admit to being one of those.

As I understand moving to a territorial system, if you tell any of the corporations that were here today that they pay zero on their investments overseas, but they will pay—according to their standard—20, 25 percent on their income that they earn in the United

States, isn't there a rather dramatic incentive that that provides to characterize as much of your American income as foreign income as possible?

Ms. GRAVELLE. There is. In fact, there already is, under the—

Mr. DOGGETT. There is, because—

Ms. GRAVELLE [continuing]. Territorial elements of our system—

Mr. DOGGETT [continuing]. As you point out, in many ways a company like General Electric, that doesn't really believe in paying taxes, they practically have a territorial system now.

Ms. GRAVELLE. Yes.

Mr. DOGGETT. But the same rules that are a problem today are the same rules we would have to use in a territorial system. We would be saying to any of these corporations, "These are the rules that apply." And the problem referenced to some degree by all of the witnesses here, though clearly disagreeing on how severe it is, but the point is that the—those rules apply.

And we are not just talking about the income they earn in China, we are talking about the income that they earn in Detroit or in Hartford or in Austin, and that there is an incentive to categorize, under the rules that haven't worked very well in the past, to categorize as much of that American-earned income paid by American consumers as foreign income, because they won't have to pay any tax on that, whatsoever.

Ms. GRAVELLE. That is correct. And I think that problem becomes a little more serious. These guys wouldn't have been here before if they didn't think there was a value in a territorial tax. So I think it would—by removing any possibility of paying tax, it will increase the incentive—nobody knows how much—to engage in more of the schemes like you saw with Google and Forest Labs and GE—

Mr. DOGGETT. More tax-dodging, more cheating, more avoidance—

Ms. GRAVELLE. Right, there is a big incentive to shift paper profits.

Mr. DOGGETT. More not playing by the rules that would apply to the distributor of one of these companies down in Texas that may be paying near a full 35 percent. So you distort and disadvantage domestic companies versus these multinationals.

You mentioned, of course, the anti-inversion rules we have. But is it also your belief that, for a company like Transocean that didn't only drill for BP in the Gulf, but drilled the Tax Code by claiming that it was no longer—renouncing its American citizenship and claiming that it was a Swiss corporation, do you believe we should have a rule that if you are managed and controlled in the United States, as Transocean still is, it ought to pay taxes, just like every other American corporation, instead of dodging them in Zug, Switzerland?

Ms. GRAVELLE. Well, I think it would probably be helpful. I wouldn't abandon the anti-inversion rules, which work well.

Mr. DOGGETT. Of course not.

Ms. GRAVELLE. But I think it would be helpful to have a facts and circumstances approach to enforcing these tax rules, because why should just a piece of paper determine—

Mr. DOGGETT. Allow you, if you have management and control here—

Ms. GRAVELLE [continuing]. Determine all of this?

Mr. DOGGETT. And—

Ms. GRAVELLE. I know there is a concern that people would move their headquarters, but I have heard some recent research by Kimberly Clausing that suggested that the headquarters themselves are not very sensitive to taxes—

Mr. DOGGETT. But there is no merit to that job export—

Ms. GRAVELLE. Well, you know, there is always some effect.

Mr. DOGGETT. But no substantial merit—

Ms. GRAVELLE. But I don't think it would be a serious problem.

Mr. DOGGETT. And specifically, finally, on your point about even the—lowering the corporate tax rate, which may have some merit, but your feeling is lowering the corporate tax rate from 35 to, say, 25 percent, as has been advanced as a panacea, will have very modest impact on any type of economic growth. We would be much better to address the size of the deficits—

Ms. GRAVELLE. Yes.

Mr. DOGGETT [continuing]. And the national debt than focusing on that one aspect.

Ms. GRAVELLE. Yes. My estimates, and I am one of the people who have one of the only international corporate tax models in the country, with a colleague from Wharton—using those estimates, capital is just not all that mobile. It is constrained by all sorts of effects. And most of the income that comes in from abroad isn't going to belong to us.

Chairman CAMP. All right, thank you.

Ms. GRAVELLE. It is going to belong to foreigners.

Chairman CAMP. Time has expired.

Mr. DOGGETT. Thank you.

Chairman CAMP. I do think, though, that it is important to note that we are hearing about capital as if it is U.S.-based, and that is it. And if there is an investment opportunity around the world, the question isn't: "Is it just U.S. capital?" It is: "What capital is going to be taking advantage of that opportunity?"

And what we have been hearing from the other panel is we need to make sure that American-based companies are competitive when it comes to that investment. So will the U.S. and U.S. workers reap the benefit from that investment, or will it be a foreign entity, and foreign workers? And I think we just need to understand, it is not just this limited issue of: "Is it U.S. capital?"

But Mr. Pascrell is recognized.

Mr. PASCRELL. Yes. Thank you, Mr. Chairman. Mr. Hines, you aren't suggesting, are you, in reviewing the Tax Code that we are examining today, you aren't suggesting, when you said—your words were the tax system is in the way of these multi—you weren't suggesting that we—there not be any taxes on the deliberations between companies and between countries. You weren't suggesting—you were just suggesting that we need a new system.

Mr. HINES. That is right.

Mr. PASCARELL. Yes. Do we need a new system for middle class taxes, people on their income? Do we need a new system for that, too?

Mr. HINES. I think we could all agree that the tax system, as a whole, could be improved.

Mr. PASCARELL. Okay. We all agree that it could be improved. But how would you pay for the recommendations that you are making today, and how would you pay for what the consequences—because as soon as you change one part of that code, you are affecting a—many different parts of the code. Are we not?

Mr. HINES. That is right.

Mr. PASCARELL. Well, how would you pay for it?

Mr. HINES. There are many things that need to be paid for. I—

Mr. PASCARELL. No, how would you pay for your changes that you are recommending to us today?

Mr. HINES. The territorial system?

Mr. PASCARELL. Yes.

Mr. HINES. I think you have a couple of options of things that would be improvements, if we adopted a territorial system, and we eliminated the section 199—

Mr. PASCARELL. How would you pay for it?

Mr. HINES. You eliminate Section 199, you more than pay for it.

Mr. PASCARELL. And what would that do?

Mr. HINES. That is the domestic, you know, production activities deduction.

Mr. PASCARELL. All right.

Mr. HINES. And so you generate revenue that way. And it would increase the efficiency of businesses in America, and thereby increase the productivity of American workers.

Mr. PASCARELL. Well, that doesn't make sense to me. You know what else doesn't make sense to me? What we saw in the Republican budget this year. That budget gave—reduced the corporate tax 10 percent, did it not, over the next 10 years?

Mr. HINES. There was a reduction. I don't remember the amount.

Mr. PASCARELL. It was 10 percent. That was the rate reduction. And you know how it was paid for? You do agree that we have to pay for these things. You are not saying that we simply reduce the rates, reduce the taxes, and just move on. Because everything that will happen after that will produce, and therefore, will cover the gap that—we are missing revenue here.

Mr. HINES. The country has a serious problem with the deficit, as it is.

Mr. PASCARELL. Yes.

Mr. HINES. So, I agree, we don't want to be fiscally irresponsible.

Mr. PASCARELL. You want to pay for it.

Mr. HINES. Oh, yes.

Mr. PASCARELL. You know how we paid for it in the budget?

Mr. HINES. Please tell me.

Mr. PASCARELL. Well, we paid for it by ending Medicare and Medicaid as we know it. Want me to tell you how we did that? You got my idea? What is your response?

Mr. HINES. I think these are entirely separate issues, actually.

Mr. PASCARELL. They sure are. But one affects the other, don't they?

Mr. HINES. We need to put our fiscal house in order across the board.

Mr. PASCARELL. We all agree with that. I have heard that four million times and you have heard it five million.

Ms. Gravelle, let me ask you this question. The system is broken. Okay, we agree that we need some changes. In your opinion, what effect would a move to a pure territorial system have?

Ms. GRAVELLE. Well, as I said, I think it would cause capital flow out of the United States to abroad. That has consequences for wages in the United States falling, wages abroad rising.

I think it would also exacerbate our problems with profit-shifting, companies like Google or GE that we have all read about in the newspapers that managed to move their income abroad.

And I also think it is very important to not abandon the notion of allocating deductions, because debt—

Mr. PASCARELL. How much more revenue in wages could we lose under a territorial system in the United States of America?

Ms. GRAVELLE. I don't know. I mean I think it would be small, because I think all of these things are small. I mean I don't think it would be a big effect, because it is not a big—we don't collect very much tax already.

Mr. PASCARELL. Certainly not compared to the \$100 billion that we lose in revenue in offshoring most of our business dealings—

Ms. GRAVELLE. It would certainly be small compared to the revenue loss and the deficits. And in my corporate paper I show that the effects on growth from the deficit, if you cut the corporate tax rate or made any of these changes—

Mr. PASCARELL. Mr. Chairman, in—thank you, all three of you.

In conclusion, simply let me say this. The amount of business investment under three presidents, three prior presidents—President Carter, President Reagan—four actually—President Bush and President Clinton—is very eye-opening. The amount of business investment under President Clinton was 10.3 percent, under Ronald Reagan was 3.7 percent, under George Bush I was 3.8 percent.

Mr. RANGEL. Mr. Chairman.

Chairman CAMP. Yes.

Mr. PASCARELL. So all of the philosophical discussions that we have about private enterprise, and how we help business grow—let's look at the facts and the detail, rather than the myths.

Chairman CAMP. All right. And I do want to just say, as the witnesses have pointed out, it isn't clear that a territorial system would lose revenue. It depends how it is designed. It could very easily be designed in a way—

Mr. PASCARELL. That is correct.

Chairman Camp.—that it would not lose revenue. And I would just point out that the tax reform in our budget was revenue neutral, it did not lose revenue. But Mr. Becerra—

Mr. PASCARELL. Well, it did—you did it in cutting Medicaid and Medicare.

Chairman CAMP. No, the tax reform piece—

Mr. PASCARELL. Right.

Chairman Camp.—in and of itself, did not have a cost to it.

Mr. PASCARELL. Well, how did you pay for it, then? Tell me.

Chairman CAMP. Well, we designed it in a way that it was revenue neutral.

Mr. PASCARELL. Well, what did you design?

Chairman CAMP. Well, Mr. Becerra is recognized for five minutes.

Mr. BECERRA. Thank you, Mr. Chairman. And you obviously need to have more of these hearings, Mr. Chairman. They are stimulating.

Thank you all for your testimony. Actually, I would love to pick up on something the chairman just mentioned, the design of the system. It really is all in the design. You could make a system, whether territorial or worldwide, that collects a whole bunch of revenue, or not enough revenue. It is all in the design. And when we talk about the design, it is not just the design of the elements of the Tax Code or your revenue-collecting system, it is everything that impacts it, as well.

So, how do you treat your personal income tax issues in your—in that host country? What type of infrastructure do you have? What are the—what is the wage rate in your country? What level of exportation or importation do you have in your country? So all of those things come into play.

Dr. Gravelle, I was wondering if you could give me a sense. What—so many of the CFOs who testified were attracted to a territorial system, I think, because they saw a simplicity in it, in that it meant that they knew what would be taxed if it was domestically produced. And if it wasn't, then chances are they wouldn't have to worry so much about the U.S. Tax Code.

But there—as far as I know—and we have had several private sessions with experts on this within the committee, which I am very appreciative of, because they have been very learning experiences, is that no one has a purely territorial system.

And so, if you can, give us your sense of what you see goes into coming up with a system, whether territorial or not.

Ms. GRAVELLE. Well, there is several different elements, some we see in other countries, and some we could just do. I mean you have heard the talk about the haircut, the five percent tax. Or you could do more than that, if you wanted to.

France has a system where they don't extend their territorial treatment to tax haven countries with very low taxes, and I think some other countries might have that. But I know France does.

There is a proposal that—it is in the CBO budget options, actually—that has floated around for years that would allow a territorial tax with an allocation of deductions, of parent company deductions. Would actually raise revenue.

And I think one other feature of that proposal is to source, for purposes of the foreign tax credit—because you would still have the foreign tax credit, because you have flow-through income, you

would still have anti-abuse rules, like sub-part F—but one of the things that has been proposed.

And this was an idea that came from people at Treasury, is to resource royalties from things produced in the United States, consider that U.S. source income. Because right now, people can deduct royalties abroad and use the excess, and then shelter them from U.S. income with foreign tax credits—you don't ever pay any taxes on them. So that was an important proposal. That did split the multinational community.

Mr. BECERRA. My—

Ms. GRAVELLE. As to whether they wanted that system or not.

Mr. BECERRA. My sense is that when we speak of moving towards a different system, it is because that system that we speak of brings down our rates, whoever the definition of "our" is, my rates.

But if you take a look at the entire system—take France, for example, which does have a territorial system. Its social systems are far different than our social systems.

Ms. GRAVELLE. Right.

Mr. BECERRA. So that if their taxation system, along with their different systems towards manufacturing and so forth lead to high levels of export or import, they have in place an infrastructure that helps catch any French workers that might be impacted—

Ms. GRAVELLE. Right.

Mr. BECERRA [continuing]. Detrimentally by whatever industrial policy they have in place, far better than we do. We have a whole bunch of American workers who, right now, don't even get trade adjustment assistance, because Congress hasn't reauthorized the monies for American workers impacted negatively, losing their jobs, because of trade.

And so, if you are going to talk about a territorial system that you might like, whether it is France or any other countries, you have to also be willing to talk about the other things those countries do to be able to absorb that type of tax regime, instead of what we might have.

Because everybody, at the end of the day, still has to collect enough revenue to do all of the welfare activities—and by that I mean general welfare of your population, not a welfare program—the general welfare activities that are required of any sovereign nation.

And so, I am wondering, then. Have you found any particular country that fits the U.S. condition, circumstance today, that has a—or has an exclusively territorial system as it can get?

Ms. GRAVELLE. No.

Chairman CAMP. All right—

Ms. GRAVELLE. No.

Chairman CAMP. Thank you.

Mr. BECERRA. Thank you very much. Thank you, Mr. Chairman.

Chairman CAMP. Time has expired. I want to thank our panel of witnesses for being here, and thank you for responding to questions. And this hearing is now adjourned.

[Whereupon, at 1:04 p.m., the committee was adjourned.]

[Submissions for the Record follow:]

**Roger Conklin, Retired International
Sales and Marketing Executive, Statement**

Statement of Roger Conklin, Retired International Sales and Marketing Executive:
**The Negative Consequences of Citizenship-based Personal Taxation on the Competitiveness of
American Companies and the Resulting Destruction of Jobs for American Workers**

My name is Roger Conklin. I am 80 and fully retired after a lifetime of professional experience in the telecommunications industry. I have resided for 34 years in Palmetto Bay, FL. The last 45 years of my working career were as an international sales and marketing executive with several companies and, after retirement, as a self-employed consultant. I served as a member of the boards of directors of two U.S. corporations; Banfield (MI) Telephone Company and Northern Telecom (Caribbean Latin America) Corporation, and two foreign subsidiaries of U.S. corporations: Compañía Peruana de Teléfonos S.A. (Peruvian Telephone Company), Lima, Peru of which I was also executive vice president and deputy general manager, and Cook Electric Telecomunicações Ltda., Rio de Janeiro, Brazil. In Peru I testified at hearings conducted by the Peruvian Senate and was a regular participant in intelligence-gathering meetings conducted with U.S.-citizen CEOs and key executives of Peruvian subsidiaries of U.S. companies by U.S. Ambassador John Wesley White. I taught telecommunications courses part-time at Universidad Mayor de San Marcos. With my wife and 4 formative-age children I lived and worked abroad four years in Peru and seven years in Brazil. Over my lifetime I have marketed U.S. exports in 98 foreign countries.

Background: The Export Dilemma Confronting American Companies

For 100 years from 1876 to 1975 U.S. trade was balanced. Ninety-five of these were trade surplus years with miniscule deficits the other 5 years. The United States recorded trade surpluses every year during the 1929-1930s depression. The U.S. is still the largest manufacturing nation, producing 24% of the world's GDP, but the U.S. trade deficit accounts for 60% of the total trade deficits of the 130 trade deficit countries. The U.S. share of the 2010 export market is an anemic 8.5%.¹ The United States was the world's largest exporter until bypassed by Germany in 1999, ranking today as No. 3 behind China and Germany (whose 2010 trade surplus was 25% greater than that of China). The largest-ever U.S. trade surplus was \$12.4 billion in 1975. Our trade balance dropped abruptly in one year by \$18.5 billion to a 1976 deficit of \$6.1 billion. This was the kickoff of the downturn in the U.S. trade balance. Since 1975 the United States has never again recorded even one single trade surplus. The cumulative U.S. trade deficit for these past 34 years 1976-2010 exceeds \$8 trillion and in spite of the President's 2010 Export Initiative to double exports in 5 years, to date in 2011 through March the U.S. trade deficit continues its upward spiral by \$1.5 billion with each passing day.

Although there may be many causes of this sudden transformation of the United States from the world's largest and most successful exporting nation with a consistent job-creating balanced trade into the world's only industrialized nation with a perpetual and massive job-destroying trade deficit, representing 60% of the total trade deficit of the 130 trade-deficit nations in the world, the principal culprits of this massive and totally out-of-control U.S. trade deficit were two specific legislative Acts of the U.S. Congress.

President Kennedy, based on never-substantiated hearsay evidence, was convinced that movie stars and millionaires were living outside the United States to avoid taxation. Congress enacted the Revenue Act of 1962² subjecting non-resident U.S.-citizens to U.S. income tax on their foreign income, thus making the United States the only nation to institute extraterritorial "double taxation" of its bona fide foreign resident citizens who were already subject to residence-based territorial taxation on their worldwide income by their host countries. To this day the United States remains the sole nation that taxes its non-resident citizens. Recognizing the vital role of U.S. citizens living and working abroad in selling exports that create jobs and prosperity in the United States and to prevent undue difficulties that would discourage U.S. citizens from accepting employment abroad, this legislation wisely provided for a \$35,000 Foreign Earned Income Exclusion for citizens residing abroad 3 years or more and \$20,000 for those abroad less than 3 years. It allowed a foreign tax credit for foreign income taxes paid on foreign source income. Adjusted by the Consumer Price Index this 1962 amount of \$35,000 would be equivalent to \$258,985 in 2011 dollars.³ Inasmuch as \$35,000 in 1962 was nearly 6 times the \$6,000 U.S. median family income⁴ and given the generally lower-than-U.S. cost of living in foreign countries at that time, this exclusion operated to ensure that this new tax did not discourage middle class Americans from living abroad to sell U.S. exports, since only a few very wealthy expatriates owed any U.S. federal income tax.

The Tax Reform Act of 1976⁵, totally based on the false premise that U.S. citizens working abroad serve no useful purpose in selling U.S. exports, drastically increased their tax. It slashed the foreign earned income exclusion to the first \$15,000 "off the bottom" at the lowest marginal tax rate, established stacking by taxing non-excluded income at the higher marginal rate as if there were no exclusion and established new restrictions on the utilization of foreign tax credits to offset tax the U.S. tax obligation. Employer payments to foreign social security and pension funds; non-taxable to U.S. residents, became fully taxable. That same year the tax court ruled that employer reimbursements for extraordinary out-of-pocket expenses and non-cash "payment-in-kind" income incident to employment abroad (which remain to this day tax-free to diplomats and other Federal employees overseas) were taxable income to private citizens. This included tuition for children's education for English-language equivalent to free public schooling in the U.S., coach class air fare for periodic obligatory home leave, allowances for excessive foreign housing rentals, cost of living allowances, security costs in areas of high risk, etc. The tax court ruled that the taxable value of employer-provided housing was its inevitably higher rental value abroad rather than that of similar housing in the U.S.

Prior to enactment, the U.S. Treasury estimated this 1976 legislation would generate an additional \$44 million in tax revenue in 1976 and \$38 million in subsequent years. Tax returns for 1976 from citizens abroad disclosed their tax obligation had increased by \$351 million. Additionally the 1976 taxation of private U.S. citizens' out-of-pocket expense reimbursements tax revenue increase was \$65 million for a total revenue increase of \$383 million; 8.7 times greater than Treasury has projected.

The tax increase was so massive that hundreds of thousands of Americans living and working abroad, being taxed by two countries, could no longer afford to live and work abroad. They resigned and came home. U.S. companies with fixed price engineering and construction contracts employing significant numbers of U.S.-citizen professionals in the Middle East, in a market then totally dominated by U.S. companies which furnished American-made goods to implement these projects were driven into non-performance penalties. It resulted in breaches of contract and bankruptcies because these companies could neither afford to reimburse their employees' sudden massive tax increase nor pass such additional costs on to their customers. At the time they also found they could not easily replace them with qualified non-U.S. citizen not-subject-to-home-country-taxation professional workers. U.S. dominance of this market was destroyed as this Tax Act crippled the ability of firms employing U.S. citizens to price competitively in this overseas market.

Testimony presented before the House Ways Committee on this legislation in 1978⁶ by Mr. Robert M. Gants of the U.S. and Overseas Tax Committee, based on supporting data from the GAO and U.S. engineering and contracting trade associations whose members were impacted by this legislation, confirmed that the bottom-line effect of the 1976 legislation and tax court rulings was that 75% of these companies represented by Mr. Gants now had U.S.-citizen employees whose tax obligations exceeded their salaries, leaving them with less than zero cash upon which to live. Because of this legislation U.S. citizens were cost-wise no longer employable overseas on these kinds of turnkey projects.

My Personal Experience

I was a managing director of Telcon, S.A. a Brazilian-owned company in Rio de Janeiro selling and implementing turnkey telecommunications projects in that country, employing leading-edge U.S.-made telecommunications products; my specific area of expertise. I had been recruited to launch this company after 4 years as executive vice president and deputy general manager of the Peruvian Telephone Company and 4 years in telecommunications executive sales and marketing positions in Brazil employed by the U.S. companies International Telephone and Telegraph Corp. (ITT) and Continental Telephone Corporation. Starting from zero, in two years we had achieved \$10 million annual sales of U.S.-made products in Brazil. This resulted from intensive efforts in securing the adoption of U.S. telecommunications standards by the Brazilian government in competition with very active and determined European and Japanese competitors working around the clock to win the standards battle which would have favored their exports and excluded a broad range of U.S. telecommunications products. I established and maintained contacts at the highest levels and with the decision-makers in the Brazilian Ministry of Communications and Telecomunicaões

Brasileiras - Telebrás, the government holding company that controlled the telephone company monopolies in Brazil's 26 states and the Federal District in Brasilia. I was a frequently-invited speaker at Brazilian national and state telecommunications seminars, an active contributing participant in Brazil's professional standardization committees and was regularly invited to make presentations of both the U.S.-made products I represented as well as the merits of U.S. technical standards over those of European and Japanese competitors. Because of my wide range of experience and knowledge of worldwide telecommunications practices I was informally consulted for advice and recommendations based on my personal experience and obligingly supplied U.S. standards information which served as the basis for the preparation of Brazilian specifications in Portuguese that not only saved them valuable time during a period of accelerated expansion of the Brazilian telecommunications network but, most importantly, of major importance to the United States, my recommendations insured that these Brazilian specifications were based on U.S. standards that would facilitate successful penetration of that market by U.S. suppliers in general and not just those I represented. I made the arrangements and accompanied several high-level Brazilian delegations on fact-finding trips to the U.S. to attend telecommunications trade shows, technical society meetings and visits to telephone company laboratories and telephone operating companies whose practices and the U.S. products they employed served as models for adoption in Brazil.

All of these contacts and professional achievements were accomplished over extended periods of time by cultivating local contacts and friendships. It could not have been accomplished if I had not resided in Brazil be able to be in a Rio customer's office within 30 minutes or fly to and attend meetings in São Paulo and Brasilia with 2-3 hours notice.

When President Ford signed the Tax Reform Act of 1976 on Oct. 4 (made retroactive to Jan. 1) my combined Brazilian and U.S. tax obligation increased from its previous starting point of 10% more than any other non-American Brazilian resident with my exact same earnings and family status to 81% more. I shockingly discovered that I and my family could not survive this increase in my total tax obligations. Because of this tax increase and the radical differences between the U.S. and Brazilian tax systems, my compensation would need to be increased by a totally non-competitive 210% in order to net the after-tax income I needed just to survive. My Brazilian employer could not afford to give me such a raise. An identical dilemma faced many other U.S. citizens in Brazil (ranchers, newspaper publishers, university professors, restaurant owners, teachers, missionaries, airline pilots and those of every other profession. It made us all unemployable in Brazil. My wife taught high school math at the American School in Rio de Janeiro where 95% of the students were Americans at that time. In 2010, the percentage of American students, with so few left in Brazil, had dropped to 15%⁷ with an estimated 1/3 of these being dual U.S. - Brazilian citizens for reasons of place of birth or nationality of one of their parents.

U.S. tax laws require that taxes on foreign currency income be paid in U.S. dollars. Since my compensation was 100% in Brazilian currency, even if I had been able to afford this massive tax increase, which I could not, I could not legally convert my local currency income into dollars to pay the IRS. Reeling from the world petroleum crisis, Brazil at that time had strict controls on the exchange of its currency by residents for any foreign currency because of a massive shortage of dollars required to pay for the imported petroleum to keep the country running. Applications to the Brazilian Central Bank by U.S. citizens for dollars to exchange for local currency to remit to the IRS for this purpose were immediately rejected. Brazil considered it a violation of its sovereignty for the United States or any other foreign country to levy and collect taxes on income earned in Brazil by its residents. Dollars could be obtained on the black market at a significant premium, but such transactions were prohibited under Brazilian exchange control laws and persons violating these laws faced criminal prosecution for which the penalties included fines, imprisonment and confiscation of assets. The removal of dollars from Brazil for the unauthorized payment of taxes to a foreign government was categorized by Brazilian monetary authorities as illicit money laundering. Although IRS regulations allow the deferral of payment where foreign government exchange controls prohibit it and the taxpayer does not have funds outside of the controlled-currency country, these rules are unworkable for individuals residing in such countries since they define income to be "unblocked" when it is used in the same foreign country for any personal expenditure (e.g., food, clothing, rent, etc.) thus causing U.S. taxes to become immediately due and payable in U.S. dollars, even when there is no legal way for the person to obtain dollars to make such tax payments. U.S. citizens in controlled currency

countries are obligated by U.S. tax law to violate laws of their host country and, in effect, choose which country's prison system they believe they stand the best chance of surviving.

After exploring all alternatives, including traveling to Chicago where I meet with an IRS official about the effects of and compliance with this legislation; I concluded I had no choice but to resign my position and return to the United States to seek new employment. An interim managing director was appointed to close out existing contracts and shut down the business. News of my resignation traveled fast and a French company with no previous presence in Brazil moved in to take advantage of my work in opening this market. Its French managing director was subject only to Brazilian income tax, since France, like every other nation except the United States, does not subject its overseas citizens to home-country taxation.

Within eight years of my departure, that French company, building on the solid market foundation which I personally had laid, was responsible for \$1 billion per year in French exports to Brazil while U.S. exporters' share of this market dropped to almost zero. When I left Brazil to return to the United States an effective advocate and voice for U.S. products and standards in the then booming Brazilian market was lost. The task facing my Japanese and European competitors in insuring their success over American competitors was made a lot easier from the moment of my departure. Slowly but surely, the U.S. based standards which I'd convinced Brazil to adopt were changed through the efforts of European and Japanese competitors who no longer had to contend with any real American competition. Having Americans present in foreign markets is absolutely essential to capturing export sales.

Following voluminous complaints from U.S. citizens, both still abroad and those forced by this legislation to return to the U.S., as well as from their U.S. employers whose overseas turnkey projects, export product sales and customer support were negatively impacted as a direct consequence of the Tax Reform Act of 1976, the Tax Reduction and Simplification Act of 1977⁸ postponed the effective date of the sections 911 and 912 foreign earned income provisions to January 1, 1977. But this action occurred far too late. The irreversible damage had already been done because most U.S. citizens abroad whose jobs and careers had already been unmercifully and thoughtlessly destroyed by the 1976 legislation had thrown in the towel and returned home. By the time this delayed-effective-date legislation was enacted many overseas positions had already been either eliminated or filled by local or 3rd country nationals.

The General Accounting Office issued a report to Congress entitled "Impact of Changes in Taxation of U.S. citizens Employed Overseas" dated Feb. 22, 1978⁹ It concluded that the tax increase on U.S. citizens employed abroad would result in the return of many citizens to the U.S. which would seriously reduce the competitiveness of U.S. industry abroad. It stated that the tax changes could result in lost contracts and/or in the replacement of Americans with foreign nationals, with possible adverse effects on U.S. exports. The indirect costs of employer tax reimbursements to affected employees, where available, would be treated as taxable income by *both* the host governments and the United States. Concern was expressed with respect to the increased complexity and cost of preparing returns as well as "convulsion and apprehension" over how U.S. employees abroad would be treated from a U.S. tax standpoint. The inevitable effect, the full impact of which could not be objectively measured, would most certainly be a reduction of U.S. gross national product, U.S. exports and domestic employment. The GAO was absolutely correct in its predictions, but little did the GAO realize in 1978 just how seriously detrimental those effects would be to the competitiveness of U.S. exports in the world market. The \$29.8 billion merchandise trade deficit in 1978 had increased to \$847 billion by 2007.

On February 23 and 24, 1978, having returned home, I was one of 104 persons testifying before the House Ways and Means Committee at the hearing on "Proposals Relating to Sections 911 and 912 Of The Internal Revenue Code Dealing With Earned Income From Sources Outside The United States." At the conclusion of my testimony Rep. Joe D. Waggoner Jr. (D, LA) stated: "I just want to say, Mr. Conklin, it is admirable on your part, having lost your shirt, so to speak, as you did as a result of our inconsiderate action here in Congress, to come and try to tell U.S. what you have done firsthand, what your experience has been with just the hope that we will rectify it for others. You could not have said it better."

The then-president of the Bechtel Corporation George P. Shultz; (also formerly Secretary State, Secretary of Labor and Secretary of the Treasury), sat next to me at the same witness table and also testified. He

stated that the GAO February 22, 1978 report confirmed the case of one of Bechtel's engineers in Saudi Arabia with a \$40,000 salary who, under the Tax Reform Act of 1976, was subjected to a U.S. tax of \$51,000, and that this taxation "makes it very difficult for an individual American to be competitive"¹⁰."

Subsequent Developments

Congress subsequently voted for a complete elimination of the Foreign Earned Income Exclusion and replaced it with a series of deductions for U.S. citizens working abroad, under the Foreign Earned Income Act¹¹ of 1978. This replaced provisions of the Tax Reform Act of 1976 which, in effect, never went into effect.

In 1981, the Comptroller General of the United States issued a "Report to Congress of the United States – American Employment Abroad Discouraged by U.S. Income Tax Laws,"¹² which included the following summary:

"To adequately promote and service U.S. products and operations in foreign countries, U.S. companies employ a large force of U.S. citizens abroad. GAO surveyed a group of major U.S. companies which reported that U.S. tax provisions established by the Foreign Earned Income Act of 1978 are a major disincentive to employment of U.S. citizens overseas.

"GAO found that the Act did not meet its goal of relieving taxes on income reflecting excessive costs of living abroad for the employees of these companies. Further, tax returns are difficult and expensive to prepare under the Act's complex rules.

"Most of the companies surveyed reimburse U.S. employees abroad for excessive taxes, making them more costly than citizens of competing countries, who generally are not taxed by their home countries. The greater costs have led these companies to favor third-country nationals.

"GAO urges that Congress consider placing Americans working abroad on an income tax basis comparable to that of citizens of competitor countries."

The President's Export Council's unanimous Report to President Carter of December 10, 1979 stated:

"Work should begin immediately to encourage enactment of a new tax law to put Americans working overseas on the same tax footing as citizens from competing countries."

The membership of that President's Export Council included Sen. Jacob Javits (R, NY) and Adali Stevenson (D, IL); Congressman Bill Alexander (D, AR); Governor George Busbee (D, GA); Paul Hall, President of the Seafarer's International Union of North America, Ms. Herta Lande Seidman, Deputy Commissioner, New York State Department of Commerce along with the board chairmen and CEOs of five large American corporations. The Council chairman was Reginald Jones, Chairman and CEO of General Electric Co. It was an objective bi-partisan committee of legislators, labor and business leaders and government officials who clearly recognized and accurately diagnosed the Achilles Heel in U.S. tax law that had created a massive non-competitive situation for U.S. citizens abroad who play a key roll in U.S. exports and domestic job creation. Faced with a skyrocketing trade deficit resulting from legislation impacting the competitiveness of U.S. citizens and U.S. companies to whom these individuals' expertise and knowledge for overseas deployment was critical to their ability to compete. Both the Comptroller General's 1981 report and the 1979 President's Export Council clearly saw the handwriting on the wall which revealed that unless the U.S. changed its tax legislation to treat its citizens living and working abroad the same way that all of our major trade competitors treat theirs, the export sales for which these individuals were absolutely indispensable and upon which tens of millions of domestic jobs depend, were destined to deteriorate. Unfortunately both the GAO and President's Export Council reports were not only ignored by that Administration and Congress but by every Congress and Administration since. The longer they are ignored the worse our deficit gets. There have been a plethora of changes to the Tax Code with respect to the taxation of non-resident citizens over the intervening years, most focused on the false presumption that U.S. expatriates consist of wealthy tax evaders rather than the reality of hard-working

middle class citizens. None of these changes have addressed the fact that the double taxation of U.S. citizens abroad has destroyed the export competitiveness not only of U.S. companies, but also of U.S. citizens in foreign labor markets. This taxation of bona fide U.S. expatriates represents a massive trade barrier against U.S. exports created by our own government, not by China or any of our other trade competitors. Meanwhile the job-destroying U.S. trade deficit continues to grow unabated. Does anybody in Washington really care? It seems not.

Trade Competitiveness and Citizenship-Based Taxation

Congress needs only to compare how this citizenship-based tax policy has destroyed American jobs manufacturing for export while competing high-wage industrialized countries are experiencing record trade surpluses along with record low unemployment rates. Last year the United States recorded a \$646 billion trade deficit. Our current unemployment rate is 9%.

One of our largest competitors, Germany, with a population and an economy only about one-fifth the size of that of the United States, last year exported more than the United States and recorded a \$208 billion trade surplus; an 18.5% increase over 2009. In spite of the recent financial crisis it also experienced its lowest unemployment rate since the reunification of East and West Germany 18 years ago. On a per-capita basis Germany imported 2.2 times more than the United States, but its per-capita exports were 4.3 times greater than those of the United States. And although its per-capita imports from China were \$1,266 compared to \$1,204 for the United States, its per-capita exports to China were 7.9 times greater than those of the United States (\$882 as compared to \$112). And this occurred in spite of Germany's significant price disadvantage, with the Euro appreciating by 45% against the dollar over the past 8 years. Had U.S. per-capita exports to China equaled those of Germany, the U.S. 2010 \$273 billion trade deficit with China would have been reduced by 98.2% to a trivial \$5 billion.

Even tiny Switzerland, with an economy and population less than 1/10th the size of Germany, has a 3.1% unemployment rate, a 2010 trade surplus of \$20.8 billion and a trade surplus with China, in spite of the fact that the Swiss Franc appreciated 69% with respect to the dollar over those same 8 years. Switzerland is currently negotiating a free trade agreement with China which, when signed, will most assuredly further erode the meager U.S. share of China's import market.

Price is only one of many factors in capturing export markets. Except for some commodities, most products are not "bought." They have to be sold. And that takes feet on the ground accomplishing all of the many tasks that it takes to capture sales in the export market, most importantly of which includes developing personal relationships and business networks. All of our trade competitor nations encourage this activity for their citizens. But the United States has deliberately chosen a tax policy that stifles such activity and keeps our citizens, employed or not, at home.

It should not pass unnoticed that the recent successful taking-out of Osama Bin Laden was accomplished by the U.S., not using foreign mercenaries or friendly foreign military forces, but by U.S. Navy Seals under the command of U.S. citizen Naval officers. Just as military success requires "boots on the ground," successful U.S. exports do too. Until Congress removes the tax barrier it has erected against our own citizens that have decisively tipped the international market playing field against our businesses and citizens by making them uncompetitive for employment abroad selling U.S. products and capturing foreign markets that create American jobs manufacturing for export, this trade deficit problem will remain unresolved.

Purpose of citizenship-based taxation

By no stretch of the imagination can this unique-to-the-U.S. citizenship-based taxation be described as for the purpose of increasing U.S. tax revenues, for the following reasons:

1. It is Not to Enhance Tax Revenue

Every U.S. citizen resident abroad whose total gross income is equivalent \$9,350 or more must file a U.S. tax return. This includes non-English speaking dual-citizens born abroad to a U.S.-citizen parent who have never held a U.S. passport, never visited the U.S. and who are likely unaware of their U.S. citizenship and tax obligations.

If the U.S. citizen lives in a country whose tax system mirrors that of the U.S. and its tax rates are as high as those of the U.S. then the taxes paid to that country provide foreign tax credits that totally offset and fully satisfy the person's U.S. tax obligation. The overseas citizen is required to establish and maintain much more detailed records (including foreign currency income and asset values converted to dollars at constantly-changing exchange rates) than a U.S. resident and file complex tax returns, even though, after foreign tax credits, he may owe zero U.S. tax. High cost professional tax assistance is necessary to accurately prepare the several unbelievably complex forms, even to substantiate that no U.S. tax is due. **The revenue produced for the U.S. Treasury in these cases is zero.** So by no stretch of the imagination can this be defined as a tax to enhance revenue of the U.S. Treasury.

2. The Short End of the Stick With Very Different Foreign Tax Systems

The tax systems of most other countries are very different from the U.S. system. Certain income taxed by the U.S. is not taxed by other countries and vice versa. Some countries do not levy or have low income tax rates. They raise their tax revenue through high consumption and other types of taxes that do not exist in the United States. Many countries do not tax capital gains, but instead levy an annual wealth tax on the value of the person's assets. The U.S. citizen abroad gets hit by both. Except for real estate taxes these non-income based taxes, although often higher than an income tax would have been, are neither deductible nor creditable in the United States. So the U.S. citizen in such countries is fiscally punished by U.S. tax law for the act of living in a country with a tax system different from that of the United States. U.S. citizenship-based taxation destroys the ability of U.S. persons to be competitive for employment outside of the U.S. unless they choose to accept a much lower standard of living than their co-workers. It also arguably deprives U.S. citizens of the right guaranteed in Article 13 of the UN Universal Declaration of Human Rights to insure that everyone has the right to leave any country, including his own.

3. A Tax That Destroys Far More Tax Revenue Than it Generates

Citizenship-based taxation has not only resulted in the destruction of tens of millions of American jobs manufacturing for export, but it also destroys far more tax revenue than it generates. Using the oft-cited Commerce Department rule of thumb that each \$1 billion of U.S. exports creates 10,000 to 15,000 American jobs,^{13,14} last year's \$646 billion merchandise trade deficit, and was equivalent to the destruction of, as a minimum, some 6 million U.S. jobs. The annual tax revenue collected by the IRS from U.S. citizens and non-citizen permanent residents living abroad totals approximately \$5 billion per year. However, the domestic tax revenue that failed to be generated by the \$646 trade deficit, at 18% of GDP, was \$116 billion; for a net tax revenue loss of \$111 billion directly resulting from the double-taxation of U.S. citizens which renders them non-competitive for overseas employment promoting U.S. exports.

4. A Tax That Bars Small U.S. Businesses from Competing In the Export Market

U.S. small businesses are often formed as flow-through entities or sole proprietorships. Such businesses employ far more persons in total than do large corporations. However, U.S. tax laws act as an effective deterrent to such non-corporate businesses to export and expand abroad. To set up an export sales business abroad they must establish an accounting system in local currency in compliance with local legal and tax regulations. Few can afford to gross-up the salaries of U.S. citizen employees who they might wish to send overseas to open a new export market sufficient to compensate them for the additional cost of this double taxation by the U.S. In addition, the income tax and information-reporting complexities involved in attempts to expand abroad carry a costly tax and compliance price tag, often negating any profit margin such businesses might have

expected from foreign expansion opportunities. Add to all this the now onerously enforced foreign bank account provisions and new withholding-related provisions that have now made it nearly impossible for a U.S. small business owner or U.S. citizen to open a bank account in a foreign country, without which no business or person can pay for local expenses and operations.

Being owned more than 10% by a U.S. person U.S. tax laws require that they must set up and maintain a second accounting system in equivalent U.S. dollars in accordance with U.S. generally accepted accounting principles (GAAP) and a third system under U.S. tax principals, for all other purposes under the U.S. Tax Code. Foreign currency values must be translated into U.S. dollars in accordance with extremely complex rules, and in addition to paying foreign taxes they must file U.S. tax returns and pay taxes U.S. on the same already-taxed-once income by the foreign country even though no profits are remitted back to the U.S. These are tasks that require highly competent professional accountants affordable only to large corporations in order avoid fines and IRS penalties for even the most insignificant inadvertent errors. And they may, at great expense, be required to translate into English and travel with their complete accounting documentation to the U.S. for IRS audits.

Contrast this with the situation of the foreign small business entrepreneur selling his home-country products in either the U.S. or in a foreign country. Since other countries employ territorial tax rather than citizenship-based taxation systems, he is never taxed on his foreign business income. He is also able to deploy an army of sales personnel to live in a new potential market for years to develop contacts and business networks for selling his home-country produced products without the additional financial burden of having to gross-up salaries to compensate double taxation by his home country or that his sales personnel will have to accept a lower after-tax standard of living in their new country of residence. He has no trouble opening foreign bank accounts. The playing field is tipped, not by foreign laws or regulations, by our own tax and other laws so steeply as to totally discourage small U.S. businesses from even thinking about the export market.

Recommendation to the House Ways and Means Committee

Based on this testimony and the evidence herein presented I recommend that the Committee commission the GAO to update the Comptroller General's Report to Congress "American Employment Abroad Discouraged by U.S. Income Tax Laws" ID-81-29 dated February 27, 1981, and that Congress act to adopt residence-based taxation and rescind citizenship-based taxation of income of nonresident individuals enacted by The Revenue Act of 1962 in order to level the competitive playing field for the business income of individuals, regardless of whether that income consists of wages and salaries or product sales. Nonresident citizens should be taxed by the U.S. in the same manner as nonresident aliens. This is how other nations treat their citizens living abroad, even when, unlike the United States, they provide uncompensated foreign emergency evacuation assistance or other government services. The U.S. must enhance their ability to compete in world markets. Failure to enact this change will leave U.S. citizens and companies shackled with a non-competitive job-destroying ball and chain that neither the citizens of any other country nor their businesses have to bear. It makes more sense to put Americans back to work doing the jobs for which they are already trained making products being sold abroad than it does to spend large sums of money to retrain them to for a new job and have them joined the ranks of the already-trained for that new job, but who remain unemployed because there are no job openings.

¹ Central Intelligence Agency, The World Fact Book, <https://www.cia.gov/library/publications/the-world-factbook/index.html>.

² PL 87-834

³ <http://data.bls.gov/cgi-bin/epicalc.pl>

⁴ <http://www.schamenek.com/charlie/opinions/incomes.html>

⁵ PL 94-455 Tax Reform Act of 1976, Oct. 4, 1976

⁶ Transcript of Hearings Before The Committee on Ways and Means, House of Representatives, 95th Congress, Second Session on Proposals Relating to Sections 911 and 912 Of The Internal Revenue Code Dealing With Earned Income from Sources Outside the United States, Feb. 23-24, 1978 - Serial 95-68, pg. 34.

⁷ Escola Americana do Rio de Janeiro, 2010 Annual Report
⁸ Tax Reduction and Simplification Act of 1977, PL 95-30, Sec. 302, 91 Stat. 126 (1977)
⁹ GAO Report ID-78-13, February 21, 1978
¹⁰ Transcript of Hearings Before The Committee on Ways and Means, House of Representatives, 95th Congress, Second Session on Proposals Relating to Sections 911 and 912 Of The Internal Revenue Code Dealing With Earned Income from Sources Outside the United States, Feb. 23-24, 1978 - Serial 95-68, pg. 232
¹¹ Foreign Earned Income Act of 1978, PL-95-615, November 8, 1978
¹² GAO Report ID-81-29, February 27, 1981
¹³ Testimony before the House Subcommittee on International Monetary Policy
http://commdocs.house.gov/committees/bank/hba92336.000/hba92336_0f.htm.
¹⁴ Patric Hale, *It's The Economy Stupid.* Capital Markets LLC, Greenwich, CT 2008, pg. 32

**Brian Garst, Director of Government Affairs,
Center for Freedom and Prosperity, Statement**

Testimony Submitted by Brian Garst
Director of Government Affairs
Center for Freedom and Prosperity

To the House Ways and Means Committee Hearing on
“The Need for Comprehensive Tax Reform to Help American Companies Compete in the Global
Market and Create Jobs for American Workers”
May 12, 2011

Submitted on May 26, 2011

Thank you for the opportunity to share my views with you. My name is Brian Garst, and I am the Director of Government Affairs at the Center for Freedom and Prosperity, an Alexandria, Virginia based, 501(c)(4) citizen organization that lobbies Congress and the Administration on tax competition, financial privacy and fiscal sovereignty.

The Committee is examining how the tax code burdens U.S. corporations and leaves them uncompetitive in the global market. The tax code as constructed often taxes the same capital two, three or even four times, which severely impacts savings and investment. Reforming the tax code to instead promote savings and investment would help improve competitiveness of U.S. corporations, boost economic growth, and create American jobs.

My testimony will focus on two fundamental flaws in the current approach to taxation, as well as identify several future problem areas based on current or pending laws and regulations.

More information on the following is also available at our website: <http://freedomandprosperity.org>.

High Corporate Tax Rate

High corporate rates are a burden on investors, consumers and workers, and furthermore discourage U.S. corporations from creating American jobs. Following the Tax Reform Act of 1986, the U.S. for a time had a low corporate tax rate compared to other developed nations. But other nations quickly caught on to the fact that low corporate tax rates are necessary for economic growth, and have since been cutting their rates. The U.S. has simply failed to keep up.

Today, the U.S., when combining state and federal taxes, has the second highest statutory corporate tax rate among OECD nations.¹ The highest rate is held by Japan, which has pledged to reduce their rate by 5%², thus leaving the U.S. soon to hold the dubious distinction of having the highest level of destructive corporate taxation. Although this is bad news, the statutory rate does not tell the entire picture. Effective marginal tax rates take into account rules for depreciation and additional features of the tax code that influence where corporations choose to invest. When comparing effective marginal

¹ OECD Tax Database, Table II.1 – Basic (non-targeted) corporate income tax rates.
http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_00.html#C_CorporateCapital

² “Japan Will Cut Corporate Income Tax Rate,” New York Times, December 13, 2010.
<http://www.nytimes.com/2010/12/14/business/global/14yen.html>

tax rates, international trends again leave U.S. corporations increasingly uncompetitive.³

The obvious consequence of comparatively high rates is that many corporations choose to forgo investing and expanding in the U.S. in favor of more hospitable jurisdictions. But high corporate rates also negatively impact the economy irrespective of international rates, especially when combined with other taxes on capital – such as the capital gains, dividends and estate taxes. These taxes reduce investment by raising the cost of capital, and thus the amount of return that must be seen before justifying new investments. Lower investment means fewer jobs and smaller paychecks for American workers.

For more, see CF&P's video on corporate taxes:

The Need to Cut the Corporate Income Tax to Make America More Competitive

<http://freedomandprosperity.org/2007/videos/cut-the-corporate-income-tax/>

Worldwide taxation

The U.S. taxes income earned in other jurisdictions. If U.S. corporations are taxed by a local jurisdiction at less than the federal statutory rate of 35%, the U.S. expects to receive the difference. Foreign companies competing in the same jurisdictions are not similarly hobbled, leaving American companies at a severe disadvantage. The U.S. is one of only a handful of countries that use a worldwide tax system.

The worldwide tax system also adds considerable complexity to the tax code, and accounts for a large share of corporate compliance costs. Deferral of U.S. taxes until profits are repatriated provides some temporary relief – though there is talk from the Administration of doing away with even that – but it has the exact opposite effect of what good tax policy ought to promote, which is greater investment in the U.S. Rather than encourage corporations to reinvest in the U.S., it rewards them for keeping profits overseas. The net impact of this system is that many corporations have simply chosen to relocate their headquarters to other nations, and multi-national corporations are less likely to be created in the U.S. The next Microsoft is now more likely to be created overseas than within American borders.

It's worth pointing out that the worldwide tax system is not simply a burden on business. It also applies to labor, and so harms Americans who work overseas and who, because they face double taxation on their labor beyond a certain exemption known as the Section 911 exclusion, cannot compete for top level executive positions. Yet some quixotically want to end this exemption, which would result in a brain drain as many talented American workers would simply choose to abandon their citizenship.

Foreign Account Tax Compliance Act

The Foreign Account Tax Compliance Act (FATCA) was passed in 2010 as part of the Hiring Incentives to Restore Employment Act. FATCA will require all foreign financial institutions to enter disclosure compliance agreements with the U.S. Treasury, or face a 30% withholding on U.S. accounts. While final FATCA regulations are still being written in the lead up to the implementation date of

³ Robert Carroll, "Comparing International Corporate Tax Rates: U.S. Corporate Tax Rate Increasingly Out of Line by Various Measure," Tax Foundation, Fiscal Fact No. 143, August 2008. <http://www.taxfoundation.org/files/ft143.pdf>

January 1, 2013, it is already clear that the new reporting regime will place such burdens on foreign financial institutions that many will decide to stop taking U.S. clients and disinvest in the U.S. economy. In fact, a number have already started doing just that. In addition to leaving Americans living abroad without banking options, the reduced capital stock will also negatively impact U.S. corporations and workers.

Nonresident Alien Deposit Interest Reporting

On the other side of the coin from FATCA, which burdens Americans overseas and the foreign financial institutions which serve them, a recently proposed IRS regulation (REG-146097-09) would burden American financial institutions and drive foreign investors out of the U.S. market. Although Congress has repeatedly decided not to tax foreign deposit interest earned in the U.S., for the specific reason of making the U.S. an attractive destination for foreign capital, the IRS has taken it upon themselves to require reporting of this information so that it may be shared with foreign governments. The impact will be the same as if Congress sought to tax the interest directly – a flight of capital from the U.S.

For many foreign investors, the U.S. is not simply a good investment. It is also a safe haven from corrupt or venal governments, and criminal gangs which would seek to threaten depositors and their families with extortion, blackmail or kidnapping. If the IRS chooses to legislate the U.S. into no longer being an attractive destination for flight capital, these foreigners will take their investments elsewhere.

According to the Commerce Department, foreigners have over \$10 trillion passively invested in the American economy, with nearly \$3.6 reported by U.S. banks a securities brokers.⁴ While not all of this capital would be at risk, if even a portion of it were to be lost it would have a negative impact on American jobs and the economy.

For more, see the CF&P's informational website and video on the proposed regulation:

IRS's Information Sharing Regulation

<http://freedomandprosperity.org/issues/irs-information-sharing-regulation/>

The IRS Running Amok: Forcing American Banks to Put Foreign Tax Law Above U.S. Tax Law

<http://freedomandprosperity.org/2011/videos/the-irs-running-amok/>

Targeting Tax Havens is the Wrong Approach

Some in Congress – along with international organizations heavily subsidized by U.S. tax dollars, such as the OECD – look at fiscal deficits and see a need to squeeze more tax revenues out of corporations and citizens alike. They target so-called tax havens, while ignoring that the world's biggest tax haven is within the United States, believing that they somehow represent a threat to American fiscal soundness. Nothing could be further from the truth.

Low-tax jurisdictions, which we should remember have the same right to determine their own fiscal

⁴ Florida U.S. House delegation letter to President Obama. <http://freedomandprosperity.org/files/NRAreg/FL-Delegation.pdf>

policy as we have ours, actually benefit the global economy.⁵ Through tax competition, these jurisdictions help to promote good tax policy. Without competitive pressure to reduce tax rates, politicians would tax and spend excessively and cripple economic activity. The very fact that this hearing is taking place is indication that there are competitive pressures to maintain competitive tax rates and promote economic growth. And in the long run, greater economic growth would also mean higher tax revenues.

Anti-tax haven crusaders at the OECD in the U.S., who tend also to be advocates of bigger government and higher taxes, throw around phony numbers such as a supposed \$100 billion in lost U.S. tax revenue to low-tax jurisdictions. But this figure was long ago debunked when it was determined to be based off an estimate concocted by former Democratic staffer Jack Blum. When former House Majority Leader Dick Armey asked CRS to get the methodology for the number, Blum confessed that, for all intents and purposes, he made it up.⁶

Rather than easing the burdens and challenges which leave U.S. companies at a competitive disadvantage, those who routinely attack so-called tax havens would have us increase them. This is the wrong approach.

For more, see CF&P's three-part video series on tax havens:

The Economic Case for Tax Havens

<http://freedomandprosperity.org/2008/videos/the-economic-case-for-tax-havens/>

The Moral Case for Tax Havens

<http://freedomandprosperity.org/2008/videos/the-moral-case-for-tax-havens/>

Tax Havens: Myths vs. Facts

<http://freedomandprosperity.org/2008/videos/tax-havens-myths-vs-facts/>

Conclusion

The identified initiatives, which fail to recognize the diminishing returns that come from pursuing every last drop of potential tax revenue, should be abandoned. Rather than attacking tax competition, the U.S. should lead by example and recognize that tax competition promotes good tax policy by providing a check on the excesses of politicians.

The better solution is to replace the worldwide tax structure with a territorial system. This would level the playing field for U.S. corporations and citizens alike, increase exports, employment and competitiveness, and also reduce the dead weight costs of tax compliance. Corporate tax rates should also be lowered significantly. The ideal corporate tax rate is zero, but simply reducing it to a level that is more competitive with other developed nations would benefit U.S. corporations, their workers and investors, and the American economy as a whole.

⁵ For more see "Tax Havens: Myth Versus Reality" by Dan Mitchell. <http://archive.freedomandprosperity.org/Papers/th-myths/th-myths.shtml>

⁶ Congressional Research Service Memorandum, "Reported Estimate of U.S. Tax Revenue Lost through Use of Tax Havens," July 23, 2001. <http://archive.freedomandprosperity.org/Papers/blum-crs-ltr.pdf>

Chairman David Camp and Congressman Sander M. Levin, Joint Statement

The Honorable David Camp, Chairman
The Honorable Sander M. Levin, Ranking Member
United States House of Representatives
Committee on Ways and Means
1102 Longworth House Office Building
Washington D.C. 20515

May 26, 2011

Testimony to the Committee on Ways and Means Regarding the Need for Comprehensive Tax Reform to Help American Companies Compete in the Global Market and Create Jobs for American Workers

Dear Mr. Chairman Camp and Congressman Levin,

The associations co-signing this letter appreciate the opportunity to submit written testimony to the Committee on Ways and Means, as requested by the announcement of May 5, 2011. All of the undersigned are non-profit, non-partisan associations representing regional groups of American business councils and chambers of commerce based in Canada, Europe, the Middle East and the Far East, as well as the interests of American citizens working and residing overseas.

The focus of our testimony is on the need to reform the U.S. tax code to make American companies and individuals more competitive in today's global economy and increase exports from the United States to international markets, thereby generating much-needed U.S. jobs. We are honored to submit for your consideration some observations and recommendations based on the experience of our members as American businesses and individuals competing in very challenging foreign markets.

Increasing competitiveness of U.S. taxpayers must be oriented to significantly increase domestic investment and to reduce, and hopefully eliminate, the foreign trade deficit with the rest of the world. Domestic manufacturing must be encouraged to create good paying jobs in the U.S. Hence, enhancing competitiveness requires encouraging domestic investment and encouraging exports. To this end, we have three recommendations:

- **Adopt territorial taxation for U.S. corporations and simultaneously lower corporate tax rates and eliminate the "tax expenditures" and special tax breaks offered to specific industries**
- **Ensure American taxpayers overseas compete on a "level playing field"**
- **Eliminate the cap on the Foreign Earned Income Exclusion (FEIE) under Section 911 of the Internal Revenue Code**

Adopt territorial taxation for U.S. corporations and simultaneously lower corporate tax rates and eliminate the “tax expenditures” and special tax breaks offered to specific industries

This is the fundamental recommendation of the “Moment of Truth”, the December 1, 2010 report of the President’s National Commission on Fiscal Responsibility and Reform. The undersigned organizations broadly concur with this recommendation. It is certainly a necessary measure to take. A carefully designed package along these lines, lowering corporate tax rates to the 20% to 22% range would significantly enhance U.S. competitiveness, bringing the tax rates into line with those of most other countries with whom the United States competes. By eliminating the “tax expenditures” and specific subsidies to particular industries, the measure would be tax neutral and may even increase revenues. Equally important, it would close loopholes that lead to inequitable tax treatment and would greatly simplify the tax law and compliance.

In order to give U.S. corporations a real competitive advantage, Congress should lower the corporate income tax rate below 20% since higher U.S. taxes correspond to lower investment returns and hence a competitive disadvantage. The current Canadian government intends to cut corporate income tax from 21% to 15% over the next five years.¹ With all of the other dynamics and economies of scale of the U.S. economy, low corporate tax rates and a greatly simplified tax administration would provide the United States with a significant competitive edge.

Adopting territorial taxation is fundamental to any meaningful corporate tax reform, as all other industrialized nations practice territorial taxation. Adopting territorial taxation would not reduce tax revenue, as under current law, most corporate earnings realized abroad are not repatriated to the United States and, hence, there is little tax revenue from foreign earnings of U.S. corporations. Adopting territorial taxation would put the United States on a level playing field when corporations decide where to invest and develop manufacturing capacity. Adopting territorial taxation would liberate the more than \$1 trillion of overseas profits of U.S. corporations currently blocked overseas due to the penalizing tax situation. United States corporations would be able to repatriate the funds to invest in new manufacturing and research facilities in America. Even if some of these repatriated funds are applied to reduction of domestic corporate debt or to increase dividend payments to shareholders, the funds will stimulate the U.S. economy and produce tax revenue. This is far better than having the money lie fallow in foreign banks or invested in competing economies.

Equally important, lowering the tax rates and simplifying the tax compliance requirements will greatly encourage foreign investment in the United States. At today’s exchange rates, the United States is a low cost country. Increased direct foreign investment would stimulate job creation in the United States and lower imports. Over the long term it would lead to an increase in exports.

Those who argue for global taxation of U.S. corporations by eliminating the deferral of taxation on foreign earnings do not recognize the dynamics of worldwide competition. If the U.S. tax rates on corporate earnings remain higher than foreign competition and global taxation is instituted, many corporations will simply change their legal domicile or create other legal structures to build more business from a foreign base. If under global taxation, U.S. tax rates are lowered to competitive

international levels, the United States would not realize significant tax revenue from the overseas operations of its companies, as foreign tax credits would be comparable or higher than U.S. tax liability. The only way to enhance U.S. competitiveness is to adopt territorial taxation.

Ensure American taxpayers overseas compete on a “level playing field”

The corollary of territorial taxation is that any business activity undertaken by an American entrepreneur or worker residing and working overseas should be subject only to the taxes in the country of economic activity and domicile. This measure alone would truly enhance the competitiveness of Americans abroad, putting them on an equal footing with their foreign competitors. No one can promote U.S. exports better than an American working overseas as an importer and distributor of American goods or professional service provider representing American interests.

But today, American business people working abroad are unfairly affected by U.S. rules and regulations when compared to nationals from other countries that do not tax their citizens on income earned overseas. The cumulative impact of these various rules and regulations makes it extremely difficult if not impossible to do business successfully overseas. It leads to a negative environment for U.S. businessmen abroad.

First, an American citizen starting up his or her own business activity abroad, whether alone or in association with foreigners, must file either I.R.S. Form 5471, 8865 or 8858, which are described by tax professionals as administrative monsters. According to the I.R.S. itself, Form 5471 alone requires 80 hours to prepare. Reporting to the I.R.S. creates a serious unfair burden of double reporting and submission to arbitrary rules which systematically lead to penalization of Americans abroad. Something is fundamentally wrong when an American entrepreneur working abroad can be paying higher taxes in the country where he resides than an American in a comparable economic situation residing in the United States, and yet the overseas American still owes taxes to the United States.

Second, an American working abroad must contribute to U.S. social security and Medicare. This U.S. tax requirement is inequitable as American entrepreneurs abroad already contribute to the social security and medical programs in the country where they live. The requirement to contribute to Medicare is inherently and intrinsically unfair given that an American residing abroad does not have access to Medicare which is available only in the United States. The U.S. Social Security Administration has entered into totalization agreements with only 17 countries, subjecting many American entrepreneurs worldwide to double taxation. Even for those living in countries with totalization agreements, the reporting burden leads to a competitive disadvantage.

Third, the increased tax filing burden includes reporting not only to the I.R.S. in addition to filing in the country of residence, but also filing with the Treasury for the FBAR report and starting with fiscal year 2011, filing Form 8938, required by the FATCA legislation passed in March 2010, to report all foreign financial assets. This requirement to file all foreign financial assets, which the I.R.S. is defining in the broadest sense, is specifically discriminatory towards Americans working and residing overseas, and

represents an inappropriate extraterritorial application of U.S. law. Cumulative penalties on inaccurate FBAR and FATCA reporting are so severe that they are confiscatory; Americans working abroad are being treated *de facto* as presumptive tax evaders and criminals.

Fourth, the FATCA requirement that any foreign corporation or partnership with 10% U.S. ownership must report to the IRS is already shutting out American citizens abroad from entering into business ventures with foreigners. FATCA has converted Americans into the pariahs in the international business world. Foreign banks are closing bank accounts owned by American citizens or by a corporation with just partial American ownership; the perceived legal and financial risks combined with the heavy administrative burden imposed on foreign financial institutions by FATCA are making them very restrictive in their dealing with American citizens.

Fifth, the FBAR requirement to file financial account information on any account over which an American has signatory power but no financial interest is shutting American citizens out of job opportunities overseas. Disclosing such information of an employer is a criminal offense in many countries. This U.S. reporting requirement constitutes a counterproductive extension of U.S. rules to international settings and fails the cost/benefit analysis given the large number of financial institutions which are effectively precluded from hiring U.S. staff.

The Committee's efforts toward increasing competitiveness of American business abroad should include a critical review of the tax and reporting requirements for American business people operating overseas. Territorial taxation should be adopted. In parallel, FBAR and FATCA legislation should be significantly changed to eliminate the chains that are restricting business development by Americans abroad. Furthermore, the reporting requirements should be melded into one form and penalties for errors in reporting should be brought down into the range of reasonable, not confiscatory.

Eliminate the cap on the Foreign Earned Income Exclusion (FEIE) under Section 911 of the Internal Revenue Code

While Section 911 may on the surface appear to concern taxation of individuals, it is in fact an indirect tax on U.S. companies sending American staff abroad. It is usual for U.S. companies who ask their employees to relocate abroad to pay the additional expenses that the employee will incur in connection with the relocation, such as moving expenses for furniture, cars and household goods; airfare for the employee's family; tuition for English language school; overseas housing expenses; and in some cases an additional overseas allowance to compensate for the additional cost of living. The payment of such expenses are deemed to be taxable income of the American employee (in contrast to the treatment of State Department employees working in overseas embassies or other U.S. federal government workers who are not taxed upon such benefits). Because of the cap on the foreign earned income exclusion, U.S. companies generally must provide additional compensation to the employee to compensate him or her for the additional tax burden resulting from the overseas assignment. This compensation is then added to the taxable income in the following year, thereby increasing once again the cost of hiring Americans abroad to the point of making American overseas staff completely uncompetitive. The logical and

inevitable consequence is that U.S. companies operating overseas, as rational economic actors, time and time again will hire foreigners (many of whom are educated in the United States) for overseas positions rather than Americans.

The underrepresentation of American citizens abroad representing U.S. business interests creates a serious long-term competitive disadvantage as Americans do not gain the international experience required in today's global environment. By penalizing foreign-based corporations for hiring Americans, Congress has eliminated American voices at both operational and boardroom level decision making.

Eliminating the cap on the foreign earned income exclusion under Section 911 of the tax code would bring the legislation back to its original purpose (prior to 1962), i.e., encourage Americans to work abroad and U.S. companies to send their professional staff overseas. It must also be said that every time a U.S. corporation replaces an American abroad by a foreigner, job opportunities for American citizens decline. It must also be emphasized that, contrary to the classification of the Joint Committee of Taxation, application of the foreign earned income exclusion is not a "tax expenditure". If the United States based taxation on residence and not citizenship, there would be no need for the foreign earned income exclusion. It is the international reach of U.S. taxation which is the anomaly, not Section 911.

Conclusion

As Chairman Camp stated in calling for hearings on these issues, the U.S. tax system has not been comprehensively reviewed for 50 years and during that period, other nations have lowered their corporate tax rates and have brought their tax policies into conformity with prevailing international practices. If the United States wants to increase its competitiveness, its tax laws must adhere to the competitive setting created by the rest of the world. The measures recommended above all work to bring U.S. taxation in line with worldwide competitive norms and to thereby increase the competitiveness and attractiveness of the United States for investment and export development.

Although the organizations listed below are concerned with a variety of issues pertaining primarily to Americans living and working overseas, we are proud to partner with other citizen groups, such as the 362,000-member National Taxpayers Union (NTU), on several matters of mutual concern that have been discussed in this document. For example, NTU has pledged active support on behalf of many of the goals outlined here, including repealing the cap on the FEIE along with adoption of a territorial corporate tax system and reductions in tax rates. NTU recognizes the importance that wise fiscal policies such as these can have in strengthening the vital link between America's prosperity abroad and the well-being of citizens at home. We look forward to working in tandem toward these ends.

We thank you for your consideration of our views. We would welcome the opportunity to provide a more testimony and information. We request that this written statement be included in the Congressional Record.

Sincerely yours,

American Citizens Abroad
The Voice of Americans Overseas
Marylouise Serrato
Executive Director
Info.aca@gmail.com

**Association of Americans
Resident Overseas**
John Flint
President
aaro@aaro.org

**Federation of American
Women's Clubs Overseas, Inc.**
Lucy Stensland Laederich
U.S. Liaison
USLiaison@fawco.org

Swiss-American Chamber of Commerce
Martin Naville
Chief Executive Officer
martin.naville@amcham.ch

Middle East Council of American Chambers of Commerce
Anne Jafery
Chairman
anne@channelsmea.com

**AmCham MENA
Regional Council**
Gregory J. Golden
Chairman, AmCham Abu Dhabi
MEANA@amcham.org.eg

**Asian Pacific Council of
American Chambers of Commerce**
Adam Sitkoff
Executive Director
apcacsec@gmail.com

**The American Chamber of
Commerce in Canada**
Neil Sinclair
Founding President
rinsin@rogers.com

ⁱ The Economist, May 7, 2011, p. 49.

U.S. Chamber of Commerce, Statement



Statement
of the
U.S. Chamber
of Commerce

ON: Hearing on the Need for Comprehensive Tax Reform to Help American Companies Compete in the Global Market and Create Jobs for American Workers

TO: House Committee on Ways & Means

DATE: May 12, 2011

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance -- is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Chairman Camp, Ranking Member Levin, and Members of the Committee, the U.S. Chamber of Commerce greatly appreciates the opportunity to comment on the need for tax reform and issues related to global competitiveness.

INTRODUCTION

We live in an increasingly global economy. Technology advances have changed the way business works. Unfortunately, the U.S. tax code¹ has not kept pace. It is plagued by problems – including a too high tax rate, a bias against capital investment, an outdated worldwide system of taxation, and excessive complexity. Failure to act to address these problems could hurt the ability of American companies to compete, deter foreign investment in the United States, decrease capital investment, and result in American job losses.

COMPETITIVE CHALLENGES

For U.S. companies to compete in global markets, they need a level playing field. In 2011, the United States suffers the second highest corporate tax rate in the world. Moreover, the United States is the only major industrialized OECD country that continues to employ a worldwide system of taxation. This high tax rate and possibility of double taxation, while mitigated by provisions such as deferral and the foreign tax credit, harms the ability of U.S. companies to compete against foreign companies who face little or no home country tax.

The U.S. tax code is lagging sadly behind its worldwide competitors. First, the U.S. marginal corporate tax rate, at 35 percent, is completely out of step with other major industrialized OECD nations. As noted by the Tax Foundation,² a nonpartisan organization, “2011 marks the 20th year in which the statutory U.S. corporate tax rate has exceeded the simple average of the non-U.S. OECD nations and the twelfth year in which our rate has exceeded the weighted average OECD rate.”

Further, as noted in another Tax Foundation study,³ we not only shackle our businesses with high rates, but we have taken no action to lower our rate as other countries have acted. As the study notes, “[i]n the past four years alone, 75 countries have cut their corporate tax rates to make themselves more competitive.” Our major trading partners— Canada and Great Britain – have already taken steps to make themselves more competitive by dropping their corporate tax rates, while the United States has done nothing to reduce rates.

In addition to our high rates, we remain the last major industrialized OECD country with a worldwide system of taxation.⁴ As countries like Great Britain not only lower rates but shift to quasi-territorial systems of taxation, the United States continues to overburden American businesses. Other countries are shifting to more efficient and globally conducive systems of

¹ All references to the Code are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

² See Tax Foundation, Fiscal Fact No. 261, Countdown to #1 : 2011 Marks 20th Year That U.S. Corporate Tax Rate Is Higher than OECD Average, available at <http://www.taxfoundation.org/publications/show/27100.html>.

³ See Tax Foundation, Special Report No. 191, Ten Reasons the U.S. Should Move to a Territorial System of Taxing Foreign Earnings, available at <http://www.taxfoundation.org/files/sr191.pdf>.

⁴ See *id.*

taxation, while we are standing by and doing little to help American companies compete, let alone win.

U.S. companies are disadvantaged by not only high rates and our system of taxing foreign source income, but also by the uncertainty that results from the temporary nature of so many crucial business tax provisions. Since 1986, the code has seen over 15,000 changes, and, as of last count at the end of 2010, contained 141 temporary provisions, such as the CFC look-thru rule active financing exception, which generally require annual renewal by Congress.⁵

We must do something to address our high corporate tax rates and antiquated system of taxing foreign source income to allow U.S. companies to compete globally. Further, we must act to address the temporary nature of our code to provide businesses the certainty to most effectively make business decisions.

UNIVERSAL IMPACT

The Interrelationship of Large and Small Businesses

Small and large businesses work together to help each other and to strengthen the U.S. economy. According to a September 2010 study,⁶ the supplier-buyer relationship between American small businesses and large U.S. companies is a basic and entrenched aspect of our economy. It notes that large companies “are major customers of small businesses and play a critical role in their growth and success.”

The study concluded that:

- “Parent operations of U.S. multinational companies buy nearly a quarter of all the goods and services they use as inputs in their production from U.S. small businesses – more than an estimated \$1.5 trillion annually; and
- Every \$1 billion in new exports by large U.S. companies would result in approximately \$174 million in new purchases of goods and services from America’s small businesses.”

This study makes abundantly clear that changes to the tax code that impact large businesses also impact the small businesses that provide goods and services to them. If we continue to maintain a tax code which harms the competitiveness and profitability of large U.S. companies, it is clear that we also negatively impact the smaller companies in their supply chains.

⁵ See, e.g., Hearing Statement of Senator Max Baucus (D-Mont.), Regarding Changes in the Tax Code since the 1986 Tax Reform Act, available at <http://finance.senate.gov/imo/media/doc/03012011%20Baucus%20Hearing%20Statement%20on%20Changes%20in%20the%20Tax%20Code%20since%201986%20Reforms.pdf>.

⁶ See “Business Roundtable Study Shows America’s Large and Small Businesses Critical Partners in Economic Recovery,” available at http://businessroundtable.org/uploads/news-center/downloads/SME_Study_Release_v17.pdf.

Impact of Reform on Small Businesses

In addition to small businesses being impacted because they operate as part of larger companies' supply chains, the Chamber believes Congress would be remiss to take action to reform the code for businesses operating in C corporation structures while ignoring those operating in passthrough form.

According to a recent study by Ernst & Young, more than 90 percent of businesses in the United States are organized as flow-through entities. That study also found that individual owners of flow-through entities paid 44 percent of all federal business income taxes between 2004 and 2008 and, moreover, that flow-through businesses employ 54 percent of the private sector work force in the United States.⁷ Flow-through businesses are a critical source of job creation and innovation in the United States that cannot be ignored in fundamental tax reform.

Under current law, the same top marginal income tax rate of 35% applies both to corporations and pass-through entities. In addition, business tax expenditures included in the code apply to both corporations and flowthrough businesses. If corporate tax reform takes place separate from individual tax reform, pursuant to which the corporate rate is lowered in exchange for the elimination or reduction of business tax expenditures, passthrough entities will lose the benefit of business tax expenditures without a corresponding rate reduction. Piecemeal corporate tax reform thus could have a negative financial impact on passthroughs, putting jobs at risk.

GUIDING PRINCIPLES

The Chamber believes that any changes to the tax code should adhere to the following principles:

- Tax reform legislation should lower the corporate tax rate to a level that will enable U.S. businesses to compete successfully in the global economy, attract foreign investment to the United States, increase capital for investment, and drive job creation in the United States. Congress should consider the impact of a corporate rate reduction on passthrough entities.
- In addition to reducing tax rates, tax reform should eliminate the bias in the current U.S. tax system against capital investment. Capital investment should be expensed or recovered using a capital cost recovery system that provides the present value equivalent to expensing with due regard to the impact the system may have on cash flow.
- In the international arena, the current worldwide tax system should be replaced with a territorial system for the taxation of foreign source income to enable U.S. businesses to compete successfully in the global economy, as well as domestically against foreign firms, and to promote economic growth domestically.
- Changes should be permanent to ensure certainty for businesses striving to expand, create jobs, and remain competitive in the United States and abroad.
- Fundamental reform should take place in the near-term, and Congress should not, in the interim, adversely change the current tax policy.

⁷ Carroll and Prante, "The Flow-Through Business Sector and Tax Reform," April 2011, available at <http://www.scorp.org/wp-content/uploads/2011/04/Flow-Through-Report-Final-2011-04-08.pdf>.

- Congress preferably should pass comprehensive tax reform legislation; conversely, Congress should avoid undertaking tax reform on a piecemeal basis.
- Congress should enact simple, predictable and easy to understand tax rules to improve compliance and reduce the cost of tax administration.
- Tax reform legislation should ensure industry-specific neutrality and avoid special tax benefits or penalties targeted to one industry versus another. Tax reform should allow the marketplace, not the tax system, to allocate capital and resources.
- Comprehensive tax reform should include realistic transition rules to provide adequate time for implementation and help minimize economic hardships businesses may encounter in transitioning to the new tax system.

CONCLUSION

The Chamber thanks Chairman Camp, Ranking Member Levin, and Members of the Committee for the opportunity to comment on tax reform and global competitiveness. As Congress considers possible fundamental tax reform, the Chamber believes lowering the corporate tax rate, shifting to a territorial tax system, and addressing the uncertainty of our code are critical matters. Further, the Chamber believes that any tax reform effort must consider the role small businesses play in our global economy.

Matthew Lykken, Director, SharedEconomicGrowth.org, Statement

Submission for the Record

House Ways and Means Committee Hearing on the Need for Comprehensive Tax Reform to Help
American Companies Compete in the Global Market and Create Jobs for American Workers

May 12, 2011

Statement by Matthew Lykken, Director, SharedEconomicGrowth.org

While the recent attention to the effects of the U.S. tax system on competitiveness, as exemplified by this hearing, has been heartening, the discussion still tends to suffer from political rhetoric that obscures the real issues. I appreciate the opportunity to submit this document in an effort to stimulate greater clarity.

Loopholes and Policy Choices

The U.S. tax system reflects a number of policy choices that were consciously intended to promote the success of American industry. In a time of fiscal crisis it is appropriate to examine the costs and benefits of those choices, but this should be done explicitly and with clear analysis. One bad political habit that has gotten out of hand is the labeling of such choices as “loopholes”. A loophole, by definition, is not a policy choice, but rather is an unintended technical flaw in the law that allows policy to be undermined. A recent example of this abuse of language occurred in the 2010 discussion leading to the enactment of new § 901(m) of the Internal Revenue Code.

Congress has long permitted American companies to acquire foreign businesses and step up the tax basis of their assets, either through an election under § 338 for a corporation or an election under § 754 for a partnership. This provided American companies with an advantage over foreign rivals. To take an example, say that an American company buys a foreign corporation for \$100, and that corporation has zero tax basis in its assets and produces \$100 of pretax earnings. If it is in a jurisdiction with a 25% tax rate, the country of operation will impose a tax of \$25 on that income. If the acquirer had been a foreign company based in a territorial tax jurisdiction (as almost all foreign rivals are today), it would have paid the \$100, received \$75 after tax, and would receive no home-country benefit. It would not choose to make such a purchase. The American company, on the other hand, can make a § 338 election to step up the amortizable basis of the target’s assets to \$100. For U.S. tax purposes, then, there would be \$100 of amortization to offset the \$100 of pretax earnings, so the net U.S. tax would be zero. So far, this puts it on a par with its foreign rival – the target company has \$100 of earnings reduced by \$25 of local tax, with no residual tax imposed by the acquirer’s home country. However, U.S. law used to then permit the acquirer’s group to take a credit for the \$25 of local tax against other foreign income, effectively neutralizing that foreign tax. The American company, then, could pay \$100 and receive \$100 of earnings after tax. It could economically acquire the target, and so it would beat out its foreign competitors in going after that growth opportunity.

Why would the United States offer its corporations such a subsidy? Because large multinational groups have large U.S. headquarters that produce a gratifyingly large number of high-paying American jobs, and

American groups tend to prefer American providers of services and other suppliers. The dominance of U.S.-based service firms, like the dominance of English as the language of international business, has been driven by the ability of American companies to grab opportunities that were unattractive to foreign competitors. This subsidy had a cost. The Joint Committee scored its elimination at \$400 million a year. Prior Congresses thought was an acceptable price for ensuring that Americans were the global alpha hunters of the business world. A clear discussion on that cost-benefit analysis would have been interesting.

Instead, what we had was the branding of this hunter's subsidy as a "loophole," as though it was an unforeseen and secretive consequence of sections 338 and 754 that prior Congresses had been too ignorant to spot. Corporations, already demonized in the press, were not eager to stand up as the defender of a provision that was being held out to the public as an abuse rather than as a known and approved effort to preserve American primacy. Thus, it went away, and American companies lost their acquisition edge. Was that the best way to save \$400 million a year, an amount that is rounding error relative to the hundreds of billions spent on artificial economic stimulus? We never had the side-by-side comparison of alternative economic expenditures that would tell us. We had labels and spin.

My point here is not to advocate restoration of that particular provision, but rather to discourage further displays of obscuring rhetoric that would prevent this Congress from engaging in the cool and logical analytics that would enable us to find the best ways to spend our limited funds and the least-bad ways to obtain our needed revenues. Let's examine one sacred cow as an example.

The Best Way to Encourage Investment?

Special low tax rates on capital gains and dividends are viewed as an important subsidy for encouraging business investment. Certainly, someone with cash to invest will be more eager to do so when he has the prospect of earning very-low-tax income. The political tendency, however, is to go from this truism to broad insinuations that anyone who suggests a re-examination of the wisdom of special capital gains rates is anti-business, anti-success, and likely a socialist leech. Let's instead line up the benefits of low capital gains rates side by side with other possible investment stimuli with a similar revenue cost. What do we see?

What fraction of investments do capital gains rates stimulate? It is a fact that there are a lot of Americans with more money than they could easily spend on consumables. The top 0.2% of the population, individually and collectively, has an extraordinary amount of money – that fraction receives 1/6th of all the individual pretax income in America. Will they take all that money and put it under a mattress if they might suffer ordinary tax rates on it? Not likely. They will keep their money at work earning those extraordinary sums for them. For them, capital gains rates influence how they invest their money, distorting the decisions they would make and encouraging them NOT to pursue the best pretax investment available, which is not a good thing. Capital gains rates will only increase investment within a band where people with cash are unsure whether they prefer to invest that cash for the future or spend it on consumption now. It would be interesting to know exactly how much money falls within that

band. I would guess that it is not a huge amount. Further, it seems unclear at the moment that having those people invest rather than spend is necessarily a good thing. We need consumer spending.

What kinds of investments do capital gains rates stimulate? To begin with, there is no tax difference between gain on a holding in a foreign company operating entirely abroad and a gain on a U.S. company operating 100% right here in the U.S.A. Moreover, individual investments in the shares of foreign companies, unlike investments by American companies in foreign subsidiaries (which do NOT, of course, benefit from special capital gains rates), do not generate American headquarters, services, or supply jobs, or any of the secondary and tertiary jobs that depend on the spending from those jobs. So, a large amount of the subsidy to capital gains flows abroad and provides no benefit to the American people. Of the remainder, quite a bit goes to people who do not create companies and jobs, but rather engage in destabilizing speculation. That group benefits when the economy bounces around, without regard to the underlying health of the economy. Then there are investments we like, investments in American start-up companies with a new idea that may be part of America's future. Do we need to subsidize all capital gains just to encourage this group? It's a rational question to ask.

Are there alternative subsidies that we could provide within a market context that would better stimulate the things we care most about, American business operations and high-paying American jobs? So far we don't seem to be doing a very good job of looking for them. There is discussion of broadening the base of business taxation while lowering corporate tax rates. Lowering corporate tax rates is clearly a helpful thing, but the Reagan-era formula that sort of worked back then is not so attractive in the 21st century. Now we are starting from behind, with a high corporate tax rate and a much less dominant global position than we used to have. Reasonable base-broadening measures within the purely business context will not provide enough revenue to lower rates to a point that would make America an attractive investment location – we would just become less bad. Less bad is better than more bad, but Americans used to have higher aspirations than that. Lowering corporate rates without lowering individual rates will increase corporate earnings lock-in, create distortions and stimulate sheltering activity. Lowering both corporate and individual rates would be very expensive when we are already in an economic hole. So, what else can we do? I offer just a few points as an example.

- 1) As a start, we should admit that it is possible to lower corporate effective rates through allowance of a full or partial dividends-paid deduction, rather than a decrease in the actual rates. This mechanism reduces the net revenue loss, since the corporation only gets a benefit when it pays out a dividend to someone who gets taxed on it. With the appropriate collateral actions, we could afford to take the effective corporate rate to zero without creating a distortion between corporate income and flow-through income, making America the best place on the planet for corporations to place their high-value operations and jobs. It would also solve all of the problems that have been troubling Congress regarding the taxation of the foreign operations of American companies. This would create great pressure on corporations to pay out their income as dividends and then have to convince investors to give it back. That could be viewed as good (economically efficient and pro-transparency and accountability) or bad (corporations would not like the loss of their ability to be lazy). Further, the reduction in the revenue loss would be only partial absent adjustments on the shareholder side. Currently, all

dividends are lightly taxed, and a large fraction of dividends flows to non-taxable parties or lightly-taxed foreign investors, which brings us to point 2.

- 2) We should admit that we can make policy choices on the treatment of dividend recipients. We can get rid of special tax rates on dividends and capital gains (at least on equity). If we don't want middle-class workers to get a net benefit from the reduction of corporate tax imposed with respect to the shares they hold in their IRAs and other retirement accounts, we can impose a withholding tax – or we can decide that we want them to have that benefit and make up the revenue elsewhere. We can choose to have a difficult discussion with our foreign treaty partners and boost withholding taxes to make up, in whole or in part, for the benefit of the dividends-paid deduction. All of these are choices, with pluses and minuses, which need to be rationally considered.
- 3) If we grant a full dividends-paid deduction, we can make other choices. Granting such a deduction would be the equivalent, in terms of foreign income, of having a territorial tax system (because the residual U.S. tax on *all* income, including the foreign income, could be eliminated at the corporate level.) The OECD treaty model allows countries a choice between granting foreign tax credits or just not imposing tax on the foreign income. So, with a dividends-paid deduction and some difficult conversations, we could also make that choice – perhaps choosing to switch to a foreign tax deduction and thus increasing the dividend pay-outs and further reducing the revenue loss. This is NOT a choice absent granting a full dividends-paid deduction, if we want to live up to our treaty obligations.
- 4) We could admit that it is possible to impose a progressive VAT, if the VAT is used to replace FICA taxes and provide an equivalent subsidy to retirees. Such a VAT would only have a net impact on people who earn more than the FICA limit or who earn their money other than through work. It would thus be an alternative to raising income taxes on upper-income people, if one truly prefers consumption taxes. It could also be used to replace state and local sales taxes, getting rid of local distortions and administrative nightmares. That is a choice. It should be rationally considered and discussed.

There are other policy choices available that are not currently receiving serious discussion. I hope that this Committee will take the lead in engaging in serious, rhetoric-free, analytical discussion to find the best policy choices for the American people.

MATERIAL SUBMITTED FOR THE RECORD

Questions for the Record:

Hon. Bill Pascrell, Jr. and Hon. Jim McDermott

**ZIMMER HOLDINGS, INC.
345 EAST MAIN STREET
WARSAW, INDIANA 46580
PHONE: (574) 267-6131
FAX: (574) 372-4302**

June 17, 2011

The Honorable Bill Pascrell, Jr.
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Jim McDermott
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressmen Pascrell and McDermott:

Please accept this correspondence as the response of Zimmer Holdings, Inc. ("Zimmer") to your letter, dated May 31, 2011, directed to James Crines, Zimmer's Executive Vice President, Finance and Chief Financial Officer (the "Letter").

Prior to furnishing Zimmer's response to the three questions posed in the Letter, for clarity, we believe it is important that we correct a few factual misstatements that Mr. Pascrell voiced during his questioning of Mr. Crines at the Hearing on May 12, 2011, and which are repeated in the Letter.

In September 2007, Zimmer agreed to pay \$169.5 million (the "Settlement Payment") to the United States government pursuant to a Settlement Agreement, dated September 27, 2007 (the "Settlement Agreement"), entered into between Zimmer and the United States of America, acting through the United States Department of Justice ("DOJ") and on behalf of the Office of Inspector General of the Department of Health and Human Services, to fully resolve potential civil liability under claims alleged by the United States government. Please be advised that the \$311 million referenced in the Letter is the collective sum paid by Zimmer and three of the other orthopaedic companies that settled the DOJ's broad industry investigation on the same date, namely, DePuy Orthopaedics, Inc. (a subsidiary of Johnson & Johnson Corp.), Biomet, Inc., and Smith & Nephew, Inc. A fifth company, Stryker Orthopedics, Inc., also entered into a settlement

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arrangement with the United States government on the same date but did not make a settlement payment at that time.

Contemporaneous with its execution of the Settlement Agreement, Zimmer entered into a Deferred Prosecution Agreement (“DPA”) with the United States Attorney’s Office for the District of New Jersey (the “USAO”), pursuant to which Zimmer agreed to be subject to oversight by a federal monitor selected and appointed by the USAO for a period of 18 months. DePuy Orthopaedics, Inc., Biomet, Inc., and Smith & Nephew, Inc. also entered into DPAs with the USAO, while Stryker Orthopedics, Inc. entered into a Non-Prosecution Agreement with the USAO. Pursuant to this arrangement, Zimmer was required to bear all of the expense of its federally-appointed monitor, including fees, costs, and the retention of any consultants, accountants or other professionals who the monitor reasonably believed were necessary to assist in the execution of the monitor’s duties under the DPA (collectively, the “Monitoring Costs”).

Following the consummation of the DPA, the USAO appointed The Ashcroft Group Consulting Services, LLC (“AGCS”) to act as Zimmer’s federal monitor. Zimmer was neither consulted nor did it participate in the selection of its DPA monitor. Zimmer entered into two agreements with AGCS relating to retention of, and payment to, AGCS for its services as Zimmer’s federally-appointed DPA monitor (together referred to as the “Monitor Agreements”). The Settlement Agreement, DPA and Monitor Agreements are publicly available, as each was submitted by Zimmer in accordance with Form 8-K filings with the United States Securities and Exchange Commission.

Zimmer successfully concluded all of its obligations and the DPA expired at the completion of the 18-month term in March 2009. The USAO and DOJ withdrew the complaint against Zimmer and the Monitor Agreements expired.

With the foregoing factual record as context, set forth below is a copy of the three questions posed in the Letter, together with Zimmer’s corresponding response to each.

Question 1: Of the total \$311 million agreement between Zimmer Holdings, Inc. and the U.S. Attorney’s office, what were the amounts allocated for compensatory damages, punitive damages, and the oversight and monitoring agreement performed by the Ashcroft Group Consulting?

Zimmer Response to Question 1: As described above, Zimmer’s Settlement Payment was \$169.5 million, not \$311 million. This civil Settlement Payment was made pursuant to the Settlement Agreement with the United States of America, not the separate DPA entered into contemporaneously between Zimmer and the USAO. The Settlement Agreement was prepared and presented by the DOJ (Washington, D.C.) on behalf of the United States government and it did not stipulate allocation of the Settlement Payment among compensatory damages, punitive damages or otherwise. The Monitoring Costs were not referenced in the Settlement Agreement.

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Question 2: In negotiating and drafting the deferred prosecution agreement with the U.S. Attorney, what consideration, if any, was given by Zimmer to characterize these payments as compensatory or punitive under section 162(f) of the internal revenue code?

Zimmer Response to Question 2: The \$169.5 million civil Settlement Payment was made pursuant to the Settlement Agreement with the United States of America, not the separate DPA entered into between Zimmer and the USAO. Other than the amount of the Settlement Payment, Zimmer had little opportunity to negotiate the terms of the Settlement Agreement. Neither the Settlement Agreement nor the DPA characterized the nature of the Settlement Payment made pursuant to the Settlement Agreement, and the Settlement Agreement made no reference to the Monitoring Costs paid pursuant to the Monitor Agreements.

Question 3: Please explain in more detail the guidance that you received from the Internal Revenue Service regarding deductibility of portions of your settlement payments under the agreement?

Zimmer Response to Question 3: In September 2008, Zimmer and the Commissioner of Internal Revenue entered into a Pre-Filing and Closing Agreement (the "PFA"). The PFA request was initiated by Zimmer pursuant to Rev. Proc. 2007-17 and was formally submitted to the Internal Revenue Service in April 2008. The PFA pertained to the deductibility of the \$169.5 million Settlement Payment and the Monitoring Costs paid (or to be paid) to the federally-appointed monitor, AGCS. After considering the PFA request and concluding its own five-month review, the Internal Revenue Service reached the following conclusions: one-half of the Settlement Payment should be reflected as an IRC section 162(a) expense; one-half of the Settlement Payment should be reflected as a non-deductible payment under IRC section 162(f); and the Monitoring Costs should be deductible under IRC section 162(a).

We trust that the foregoing responses satisfactorily address the questions posed in the Letter.

Sincerely,

Zimmer Holdings, Inc.

By: 
Chad F. Phipps
Senior Vice President, General Counsel & Secretary

cc: The Honorable Dave Camp
Chairman
Committee on Ways and Means
U.S. House of Representatives

