

THE GLOBAL TAX ENVIRONMENT IN 2016 AND IMPLICATIONS FOR INTERNATIONAL TAX REFORM

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES

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**THE GLOBAL TAX ENVIRONMENT IN 2016 AND
IMPLICATIONS FOR INTERNATIONAL TAX
REFORM**

WEDNESDAY, FEBRUARY 24, 2016

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

The committee met, pursuant to notice, at 10:02 a.m. in Room 1100 Longworth House Office Building, the Honorable Kevin Brady [chairman of the committee] presiding.

[The advisory announcing the hearing follows:]



WAYS AND MEANS

CHAIRMAN KEVIN BRADY

Chairman Brady Announces Hearing on the Global Tax Environment in 2016 and Implications for International Tax Reform

Congressman Kevin Brady (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on the global tax environment in 2016 and how recent developments are further escalating the immediate need to reform and modernize the U.S. international tax system. **The hearing will take place on Wednesday, February 24, 2016, in Room 1100 of the Longworth House Office Building, beginning at 10:00 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.

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 make a submission, 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 Wednesday, March 9, 2016**. 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 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 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 submitted in a single document via email, provided in Word format and must not exceed a total of 10 pages. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.
2. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. The name, company, address, telephone, and fax numbers of each witness must be included in the body of the email. Please exclude any personal identifiable information in the attached submission.
3. Failure to follow the formatting requirements may result in the exclusion of a submission. All submissions for the record are final.

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 at <http://www.waysandmeans.house.gov/>.



Chairman BRADY. The committee will come to order. Welcome to the Ways and Means Committee hearing on the global tax environment in 2016, and implications for international tax reform. America needs a new 21st century tax code that will grow families' paychecks, grow local businesses, and grow our economy. It is why we are holding this hearing today about international tax reform, a critical component of our comprehensive plan to overhaul our tax system from top to bottom.

Global events demonstrate how it is more important than ever that we make progress now in reforming our broken tax code. When Americans read the news or turn on the television, they regularly learn another major American job creator that is moving their headquarters to another country.

First two months of this year we have already heard of three major American employers that decided to move overseas. And every one of these moves results in fewer American jobs, fewer small business opportunities, and weaker economic growth. To the millions of people who remain unemployed or under-employed, these developments are more proof that our economy isn't working for them.

We are holding this hearing today so we can talk about the real root cause of this issue, and determine the best path forward to save jobs and protect American workers.

As chairman of the committee, I look forward to hearing from witnesses and members about the impact of the current U.S. tax system, including our exorbitant corporate tax rate.

I also want to hear from you about the OECD's base erosion and profit-shifting project. Worldwide, American companies are rightly concerned that the BEPS project will result in higher foreign taxes, higher compliance costs, and double taxation. As countries around the world incorporate the BEPS ideas into their tax systems, many more companies could be forced to restructure their business operations and move U.S. activity such as research and development overseas.

And I would appreciate your thoughts on the European Union's state aid investigations that threaten to subject American businesses to retroactive taxes going back 10 years.

Each of these factors is making it harder for our businesses and the hard-working Americans they employ to compete successfully. The end result is driving American job creators to take their jobs and their investments to other countries.

So, instead of attacking American companies, wringing our hands, or suggesting the same old, tired Band-Aids, Congress should act now to fix our broken tax code, and stand strong against global developments that hurt our workers.

On this side of the aisle we are committed to delivering pro-growth tax reform that includes changes to our international tax system. I invite our colleagues on the other side of the aisle to join us. It is time to permanently lower America's tax rate, so that the estimated \$2 trillion in stranded U.S. profits can flow back into America to be invested in new jobs, new research, and new growth.

Our hearing today is another step in our plan to bring our tax code into the 21st century and protect American workers in their

jobs. American people want leadership on this issue, and this Committee will deliver it.

I thank all of our witnesses for joining us today. I look forward to your testimony.

Chairman BRADY. And I now yield to the distinguished ranking member from Michigan, Mr. Levin, for the purposes of an opening statement.

Mr. LEVIN. Thank you, Mr. Chairman. And welcome to all four of you.

There is no doubt that there needs to be tax reform, and that for it to be successful there must be changes on how companies engaged globally are taxed. There is considerable talk today that, as a first step, we should reform our tax code as it relates to companies that are American-based with operations overseas.

But there are immense difficulties in doing piecemeal tax reform, and it can't be done just to raise short-term revenue without considering long-term effects. And there are serious challenges in doing tax reform without considering the impact on domestic businesses. That is why the head of the Business Roundtable said last week—and I quote—“I don't think you can take them piecemeal, you have got to have revenue on the table. You have got to have lower tax rates on the table.”

The odds seem strong that the only way to address tax reform is to undertake it comprehensively—and I add—on a bipartisan basis. For example, the large number of pass-throughs represents a major challenge to how you do business reform without doing individual tax reform. That does not mean that Congress should be frozen in place. Not doing one big piece does not mean that we cannot act when there is a smaller piece that goes after the abuses that would have to be addressed in any tax reform.

That is the case with the rapid race of inversions. More and more of the horses are galloping out of the barn using a huge loophole. Failure to close the barn door is bad for the American economy and unfair to the typical American taxpayer, who cannot lower their taxes by simply changing their address to another country with a lower tax rate. The Joint Tax Committee score of more than \$40 billion on a legislation that we introduced to stop inversions shows how abused this tax dodge is.

What makes it worse is that the companies that invert often then engage in earnings stripping. The U.S. entity usually ends up paying excessive amounts in deductible interest payments to its foreign parent, ultimately lowering its U.S. taxes. We need to shut the barn door before more and more horses run off from the United States and race overseas to lower the taxes they pay to the United States.

I yield back.

Chairman BRADY. Thank you. And, without objection, other Members' opening statements will be made part of the record.

Today's witness panel includes four experts. Michelle Hanlon is the Howard W. Johnson Professor, and a professor of accounting at the MIT Sloan School of Management, where she teaches courses on taxation, business strategy, and accounting.

Raymond Wiacek is a partner in Jones Day's practice involving the tax and business aspects of financial and international trans-

actions, including mergers and acquisitions, cross-border financing, and transfer pricing.

Itai Grinberg specializes in cross-border taxation issues and U.S. tax policy. Before joining the faculty at Georgetown University, Professor Grinberg was in the Office of International Tax Council at the U.S. Department of the Treasury. In addition, in 2005 Professor Grinberg served as counsel to the President's Advisory Panel on Federal Tax Reform, where he advised a bipartisan presidential commission that made sweeping proposals to restructure U.S. tax code.

And Edward Kleinbard is the Ivadelle and Theodore Johnson Professor of Law in business at the University of Southern California's Gould School of Law, and a fellow at the Century Foundation. Before joining USC law, Professor Kleinbard served as chief of staff at the U.S. Congress's Joint Committee on Taxation, and was previously in private practice.

The committee has received your written statements. They will all be made part of the formal hearing record. You each have five minutes to deliver your oral remarks. We will begin with Ms. Hanlon. You may begin when you are ready. Welcome.

**STATEMENT OF MICHELLE HANLON, PROFESSOR OF
ACCOUNTING, MIT SLOAN SCHOOL OF MANAGEMENT**

Ms. HANLON. Chairman Brady, Ranking Member Levin, and distinguished Members of the Committee, thank you for inviting me to participate in this hearing.

As you know, the U.S. has one of the highest statutory corporate income tax rates in the world. In addition, the U.S. has a worldwide tax system. In contrast, 28 of the other 33 OECD member countries have adopted some form of a territorial tax system that allows active business income to be repatriated with little or no additional home country tax. The combination of the high corporate tax rate and the worldwide tax system is out of step with much of the rest of the world, and has led to negative economic consequences for the United States.

The U.S. has a worldwide tax system with deferral. Describing it at a very high level, it operates such that U.S.—the U.S. taxes active foreign earnings, but not until they are repatriated back to the U.S. Thus, U.S. corporations have strong incentives to leave the active earnings of foreign subsidiaries in the foreign subsidiaries because doing so defers the high U.S. tax.

Deferring the high U.S. tax increases current cash flows, often lowers the firm's effective tax rate for financial accounting purposes, and allows the U.S. multinational to more effectively compete for non-U.S. investments. As a consequence, U.S. multinationals are estimated to hold more than \$2 trillion—and rising—in un-remitted foreign earnings, a substantial portion of which is in cash.

In addition, there is anecdotal evidence and academic research that shows that this lockout of foreign earnings leads companies to borrow more in the U.S. in order to fund domestic investment and return value to shareholders.

It is extremely puzzling to me why we choose to retain a tax system that makes it economically rational for corporate managers to

hold such large cash reserves on foreign subsidiaries, while simultaneously issuing so much debt in the United States.

Ever more concerning, though, may be the consequences in the market for corporate control. The evidence and the academic research suggests that, after a cross-border M&A, the merged entity is less likely to locate the parent company in a country with a worldwide tax regime.

In addition, evidence suggests that acquirers and M&A deals are less likely to come from worldwide tax jurisdictions. There are also studies that specifically examine the effect of locked-out earnings and cash of U.S. multinationals. For example, the more locked-out cash a U.S. target has, the more likely it is that it will be acquired by a foreign acquirer.

There are also several studies that show that U.S. companies with large amounts of locked-out cash are more likely to spend that cash to purchase foreign but not domestic companies, and make foreign but not domestic capital expenditures.

Finally, we have the transactions that have grabbed the media headlines, inversions, where U.S. companies reincorporate as foreign companies through cross-border mergers. We should be concerned about inversions for a variety of reasons. However, continuing to only focus on legislation to discourage inversions will not correct the much bigger problem that we have, that corporations do not want to be domiciled here because of our high tax rate and worldwide tax system.

Many other changes are happening around the world, which the other witnesses here today will speak more about. But let me offer one example and potential consequence. Many countries have enacted or are contemplating innovation box tax policies that apply a lower tax rate to income attributable to innovation.

The OECD, as part of the BEPS project, has put guidelines in place that will require nexus, meaning some association to research and development. If the U.S. does nothing in terms of tax reform, it is likely that U.S. companies wanting the lower rate of the innovation box will have to move some R&D activities—meaning jobs—into those jurisdictions. This type of real response will take time. But if the U.S. does not act to make our tax code more in line with the rest of the world, such a response—at least to some extent—seems inevitable.

In summary, the United States is currently an outlier with a high corporate tax rate and a worldwide tax system, and this is leading to negative economic consequences. The U.S. has many attractive non-tax factors, but this is not an excuse for retaining an outdated tax code.

Moreover, the non-tax advantages of the United States are not as strong as they once were, and other countries are working hard to use their tax laws to compete. The UK, which has many similar non-tax factors has a significantly lower corporate tax rate, which is soon to be 18 percent, a territorial tax system, and a patent box.

In my opinion, we need to benchmark our tax system to other countries that are currently competing with us for business activity and jobs, and we need to reform our tax system in a way that attracts businesses and economic activity to our shores.

Thank you again for inviting me to participate in this hearing.
I look forward to your questions.
[The prepared statement of Ms. Hanlon follows:]

Testimony of Michelle Hanlon
Howard W. Johnson Professor, MIT Sloan School of Management

before the
United States House Committee on Ways and Means
February 24, 2016

Chairman Brady, Ranking Member Levin, and distinguished members of the Committee, I appreciate the opportunity to participate in this hearing. I am a chaired professor at the Sloan School of Management at the Massachusetts Institute of Technology. I teach and do research on financial accounting and taxation. I am an editor of the *Journal of Accounting and Economics*.¹

At 35% the United States has one of the highest statutory corporate tax rates in the world. But this was not always the case. In 1988, after the Tax Reform Act of 1986, the U.S. statutory corporate tax rate was five percentage points lower than the OECD average. Since that time, however, other countries have significantly reduced their corporate income tax rates. Indeed, according to the OECD, the combined U.S. and average state corporate income tax rate (at 39%) is over 14 percentage points higher than the average for the other 33 OECD member countries (at 24.6%).² A specific example is the UK which has a corporate income tax rate of 20% and is reducing it further to 18%. In addition to the high statutory tax rate, the U.S. has a worldwide tax system under which profits earned abroad face U.S. taxation (with allowed foreign tax credits) when brought back to America.³ While worldwide taxation was at one time more common around the globe, much has changed. Currently, all of the other G7 countries and 28 of the other 33 OECD member countries have adopted territorial tax systems that allow active business income to be repatriated without (or with very little) additional home country tax. Indeed, in 2009 both the UK and Japan moved to territorial tax systems. The United States has chosen to retain worldwide taxation and a high statutory tax rate even though both policy choices are out of step with much of the rest of the world. The combination of the high U.S. corporate tax rate and the worldwide tax system has led to negative economic consequences for the United States.

¹ Some portions of this testimony are taken from, or are very similar to, points I made in an op-ed in the *Wall Street Journal* published on June 11, 2014.

² OECD, Tax Database, Table II.1. <http://stats.oecd.org/index.aspx?Queryid=58204>

³ Some foreign earnings are taxed currently (without deferral) in the U.S. under what is known as subpart F.

In order to compete and/or maximize shareholder value, U.S. multinational corporations employ a type of do-it-yourself territorial tax system by accumulating foreign earnings rather than repatriating the earnings and paying the U.S. taxes. The result is that a company's immediate cash tax burden is lower because the incremental U.S. tax is not required to be paid until the earnings are repatriated to the United States. Leaving the earnings in the foreign subsidiaries allows a U.S. multinational to more effectively compete for non-U.S. investments. In a simplified example, assume a foreign subsidiary of a U.S. parent earns \$10 million and pays \$2 million in local tax to the foreign jurisdiction. The remaining earnings could be repatriated to the U.S. parent or left in the foreign subsidiary. If repatriated, there would be an additional U.S. tax of \$1.5 million ($[\$10 \text{ million} \times 35\% \text{ U.S. rate}] - \$2 \text{ million credit for foreign tax}$). Thus, if left in the foreign subsidiary, there would be \$8 million to invest, but if repatriated to the U.S., there would only be \$6.5 million to invest (less if state income tax is imposed). In contrast, a UK company, for example, could repatriate the \$8 million back to the UK and then invest the full \$8 million in their home country (or they could change their mind and invest the full \$8 million in a foreign country depending on the investment opportunities). The U.S. corporation has much less mobility of capital – if they repatriate the earnings, they have to pay the U.S. tax leaving less for future investments. Also, not repatriating active foreign earnings often reduces the company's reported effective tax rate for financial accounting purposes because companies are not required to accrue the incremental U.S. tax on their financial statements if management does not plan on repatriating those earnings to the United States. Thus, reported net income to shareholders is higher, all else constant.⁴

What all this means is that corporate managers have strong incentives to leave foreign earnings in their foreign subsidiaries because it increases cash flow, puts them closer to parity with non-U.S. companies for investment opportunities, and increases reported accounting earnings. U.S. multinational corporations are estimated to hold significantly more than \$2 trillion in unremitted foreign earnings, a substantial portion of which is in cash. This is cash that cannot

⁴ See Graham, Hanlon, and Shevlin (2011) for a discussion and tests of the effect of the financial accounting rules. Note that leaving the foreign earnings in foreign subsidiaries and designating the foreign earnings as permanently reinvested lowers the financial accounting effective tax rate for a U.S. company but there is an unrecorded liability that the company would have to pay should they repatriate the earnings in the future. Thus, the effective tax rate for a U.S. company is not directly comparable to the effective tax rate for a company in a country with territorial taxation because the former has an unrecorded potential liability and the latter does not.

be reinvested in the U.S. business or given to shareholders. The lockout of foreign earnings and cash leads companies to borrow more in the U.S. to fund domestic operations and return value to shareholders. This borrowing leads to additional leverage on balance sheets and additional deductions on corporate tax returns. Several companies have stated publicly that they borrow in the U.S. instead of repatriating foreign earnings. For example, Cisco Systems, Inc. in their financial statements for their fiscal year 2015, reports that they have not accrued U.S. taxes on \$58 billion in unremitted foreign earnings. The company's balance sheet shows (worldwide) cash and securities of over \$60 billion. Cisco has at the same time issued large amounts of corporate bonds in recent years increasing their debt levels. Indeed, they report short and long-term debt of over \$25 billion dollars on their fiscal 2015 balance sheet.⁵ For comparison, ten years ago, at the end of their fiscal year 2005, Cisco had "only" \$6.8 billion in permanently reinvested foreign earnings, \$7 billion in cash and securities, and zero interest-bearing debt on their balance sheet. Cisco is not alone in the accumulation of cash in foreign subsidiaries and the simultaneous issuance of debt in the United States.

My co-authors and I did a survey of corporate tax executives in 2007. We found that 44% of the companies that responded said they borrowed in the U.S. to fund domestic operations rather than repatriate foreign earnings to the United States (Graham, Hanlon, and Shevlin (2010)). Similarly, in another study, Albring (2006) examines 156 U.S. manufacturing companies and finds that as a company's repatriation tax cost increases, the company is more likely to borrow in the U.S. than repatriate foreign earnings. The global changes in terms of the reduction of corporate tax rates in other countries and fewer countries retaining a worldwide tax system have increased competitive pressures for such behavior and will only continue to increase these pressures on corporate management. The insanity of the U.S. tax system is clear when one simply considers the amount of locked-out cash and the effects on corporate debt policy.

While the cash holdings and leverage effects are very troubling, even more concerning may be the consequences in the market for corporate control. The evidence in the academic research suggests that merged entities are less likely to locate their parent company in a country with a worldwide tax regime and that the U.S. international tax system leads to U.S. companies

⁵ Cisco's debt is rated at less than AAA (the top rating) in recent years. (The same is true for Apple, Inc.)

being less competitive when trying to acquire other companies. For example, Huizinga and Voget (2009) examine cross-border mergers and provide evidence that the location of the parent firm after a cross-border merger is less likely to be in a country with worldwide taxation.⁶ Essentially, the international tax regimes of the countries of the merging companies affect the organizational structure after a merger deal (e.g., the U.S. is less likely to attract the location of the parent following a merger with a foreign company from a territorial jurisdiction). A more recent paper by Feld, Ruf, Scheuering, Schreiber, and Voget (2013) extends and builds on these results by testing the effect of changing to a territorial system from a worldwide system using the experience of the UK and Japan. The authors conclude that taxes on repatriated income (i.e., a worldwide tax system) reduces the competitiveness of companies in the market for corporate control. Specifically, the authors find evidence consistent with a lower likelihood of an acquirer in a cross-border deal being from a worldwide tax country relative to a country with a territorial regime. They also find that the larger the home country tax rate the larger the impact and show that the effect of Japan's change to a territorial tax system (when the rate was 40%) was greater than the UK's change (when the rate was 28%). The results in this paper suggest that a U.S. switch to territorial taxation would increase the number of cross-border mergers where the U.S. company is the acquirer rather than the target.

Other studies specifically examine the effect of locked-out earnings and cash of U.S. multinational corporations on M&A activity. For example, in a recent study by Bird, Edwards, and Shevlin (2015), the authors find that the likelihood of a U.S. target being acquired by a foreign firm increases with the amount of locked-out earnings. The authors find that this relation is stronger when the foreign acquirer is from a country with a territorial tax regime. While there

⁶ A variety of statistics are available regarding the location of corporate headquarters as well. The Business Roundtable issued a report in the fall of 2015 entitled "Tax Reform: Advancing America in the Global Economy." The report states that in 1960, American companies comprised 17 of the top 20 global companies ranked by sales. In 1985, the top 20 still included 13 American companies. In 2014, the latest data show just six American companies (rankings are from the Global Fortune 500 for various years). Of the 14 non-U.S. companies in the top 20 list, 10 were headquartered in countries that use territorial tax systems. Of the remaining four, three were state-owned companies headquartered in China, and the other was headquartered in South Korea, which has a 24.2 percent combined national and subnational tax rate. According to the report, within the OECD, 90 percent of the non-U.S. companies in the Global Fortune 500 in 2014 were headquartered in countries that use territorial tax systems, whereas in 1995 only 27 percent of the non-U.S. OECD companies in the Global Fortune 500 were headquartered in territorial countries (2014 Global Fortune 500 list available at <http://fortune.com/global500/> and the 1995 Global Fortune 500 list available at <http://fortune.com/global500/1995/>).

may be several effects at work here, the hypothesis in the study is that the foreign acquirer may be able to access some of the historic and future foreign earnings without as much U.S. tax liabilities and thus have a bidding advantage. There are also several studies that show that U.S. companies with large amounts of cash held in their foreign subsidiaries are more likely to purchase foreign companies than domestic companies and these acquisitions of foreign companies are less value enhancing than other acquisitions (Hanlon, Lester, and Verdi (2015), Edwards, Kravet, and Wilson (2016)). Thus, companies are both stockpiling cash and investing (seemingly poorly) in foreign locations because the U.S. tax policy impedes repatriation. Possible explanations for the (poor) foreign investment is that the cash burns a proverbial hole in managers' pockets or that the high cash balances make them an attractive takeover target (a la Bird et al., described above) so they spend the foreign cash to avoid being taken over.

Finally, the transactions that have grabbed the media headlines are what are known as inversions where U.S. corporations reincorporate as foreign companies through cross-border mergers. Without question, inversions are something we all should be concerned about for a variety of reasons. One reason is the potential for so-called earnings stripping where the newly formed foreign company reduces the U.S. tax base by making deductible payments from the U.S. entity to the new foreign parent. However, the main reason we should be concerned is because these deals say a lot about the antiquated nature of our tax code.⁷ Despite the sensationalism of inversions, I think it is important to maintain the focus on the broader effects of the U.S. tax system and what can be accomplished with tax reform. It would be better to reform our international tax regime more completely rather than enacting piecemeal legislation that is solely intended to increase the U.S. tax revenue from existing companies. However, in efforts to prevent inversions the U.S. has put targeted legislation in place that imposes penalties when the former shareholders of the U.S. company own too high of a share of the merged entity (e.g., the 80% and 60% thresholds). This seems to push managers into more substantive transactions that give more control to the shareholders of the foreign merger partner (relative to before there was anti-inversion legislation). These are possibly more harmful deals for the U.S. economy.⁸

⁷ For example, the high U.S. tax rate incentivizes the so-called earnings stripping.

⁸ A recent study by Rao (2015) is consistent with this conjecture. The author is cautious and describes the evidence as observational and not causal because of empirical research design issues (for example, endogeneity and time trend concerns). However, the evidence is consistent with inverting firms locating more employees abroad after an

Continuing to focus on legislation that prevents inversions (including targeted legislation to limit so-called earnings stripping) will not correct the bigger problem that corporations do not want to be domiciled here because of our high rate, worldwide tax system, and complicated tax code (nor will such legislation entice entrepreneurs to start businesses here). In summary, there are many determining factors, both tax and non-tax, in large, cross-border M&A transactions no matter whether the deal is an inversion, a friendly merger, or hostile takeover. But in all of these cases with the current tax policies of the U.S., the decision of where the merged entity should be located for tax purposes is clear: not the United States. We need to reform the U.S. corporate tax system to attract businesses and economic activity to our shores.

Beyond the lower corporate income tax rates and moves to territorial tax regimes, many other changes are happening around the world. For example, the OECD Base Erosion and Profit Shifting (BEPS) project is affecting the ways that other governments compete for and tax cross-border investment. It is hard to predict the economic effects of such changes and the economic effects of the interactions of, and responses to, these changes. However, let's consider just one example of the changes brought about by the BEPS project. Many countries have enacted or are contemplating innovation or patent box tax policies (e.g., the 10% UK patent box). An innovation box can take several forms, but in general it is a tax policy that applies a lower tax rate to income attributable to patents and other intellectual property associated with innovation. The idea behind such a policy is to attract mobile income. The OECD as part of the BEPS project has put guidelines in place that essentially will require nexus, meaning some association to economic activity (e.g., research and development located in the jurisdiction) before the income can be taxed at the lower rate of the innovation box. If the U.S. does nothing in terms of tax reform, one possible outcome of these innovation box policies is that U.S. companies will move (or keep) patents in the jurisdictions with patent box regimes in order to obtain lower tax

inversion relative to non-inverting firms. Furthermore, in a comparison of deals before and after the 2004 legislation that required more substantive transactions for the tax benefits of the transaction to be retained, Rao (2015) reports evidence consistent with the employment changes being concentrated in the post-2004 transactions. Rao includes transactions as inversions that meet the definition of an inversion in the tax code as well as transactions that do not meet the definition of an inversion in the tax code. The intent is to include transactions that obtain the tax benefits of an inversion but are structured to avoid the classification of inversion. More research is needed on employment effects before more definitive conclusions can be made.

rates (on the order of 5%-15%). Moreover, in order to meet the nexus requirements agreed to by participants in the OECD BEPS project, U.S. companies will have to move some R&D activities (jobs) as well. This type of real response may take some time to complete, but if the U.S. does not act to make its tax code more competitive, such a response, at least to some extent, seems inevitable.

In summary, the United States is currently an outlier with a worldwide tax system that taxes the operating income of foreign subsidiaries when repatriated at a 35 percent federal rate (foreign tax credits are allowed). This system leads U.S. companies to 1) leave more cash in foreign subsidiaries, 2) to borrow more in the U.S., 3) be at a competitive disadvantage relative to foreign competitors from territorial jurisdictions, 4) use foreign cash to invest more in foreign locations than U.S. locations, and 5) to engage in merger deals with, or be acquired by, foreign companies who have a tax advantage. It is true that there are many non-tax reasons businesses want to locate in the United States. The innovation culture, strong labor pools, great universities, excellent research environment and culture, (relatively) secure and safe financial institutions, the best capital markets in the world, and strong corporate governance make the U.S. a great nation and a very desirable place to do business. But having these competitive non-tax factors is not an excuse for retaining an outdated and uncompetitive tax code. Moreover, the world is changing. The non-tax advantages of locating a business in the United States are not as strong as they once were, and other countries are working hard to use their tax laws to compete. As mentioned above, the UK has significantly lower corporate tax rates, a territorial tax system, and a patent box. In addition, they have many similar non-tax factors when compared to the U.S. such as an educated labor pool and secure financial institutions. When considering the U.S. tax regime, it is imperative not to benchmark current policies to those of the U.S. in the past, but rather to the tax systems of other countries that are competing for business activity and jobs right now and in the future.

Thank you again for inviting me to participate in this hearing. I look forward to your questions.

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Chairman BRADY. Thank you, Professor.
Mr. Wiacek, you are recognized.

STATEMENT OF RAYMOND WIACEK, PARTNER, JONES DAY

Mr. WIACEK. Good morning, and thank you for inviting me to this important hearing. My name is Ray Wiacek, and I have been a tax lawyer for 40 years—hard to believe—and the head of our global practice for too many years to count. We were requested to testify on the global tax environment, what you face as you consider tax reform. So my written testimony touches on BEPS and state aid and great disparity and territoriality and a number of other issues.

I hope I get a BEPS question, for example, or a state aid question, but I want to talk about competition. And I want to talk about competition fought through the tax code. It is real. It is not the “C” word, it is not a word that just comes up from tax lobbyists. It is not an empty suit.

The UK has a 20 percent corporate income tax rate already scheduled to go to 18, and it taxes the return on intellectual property at 15 percent, already going to 18 percent. Of course, we have a 35 percent rate.

Now, the UK didn’t pass this elaborate rate structure and regime on a lazy Sunday afternoon for fun. They did it to compete. They did it to attract investments. They did it to attract jobs. And they did it through their tax code. And this competition is fierce and political. The UK would have you believe—it would tell its citizens that there would be no unemployment, there would be no cut in education costs, there would be no cut in rent subsidies, if only the American multinationals paid their fair share.

BEPS. BEPS has the avowed purpose of increasing the take, the revenue, from multinationals, many of which are American. And, by the way, they also—it also has as its objective to share that additional revenue more fairly with the rest of the world. That is, not with us.

State aid is kind of the little brother to BEPS, where, retroactively, the guys in Brussels are going after our companies and seeking big back taxes. For example, from Apple they are seeking \$8 billion to \$9 billion in back taxes with respect to a business plan that was submitted to the European governments involved in advance, fully disclosed, and approved in writing.

Now, let me tell you. That \$8 billion or \$9 billion, should the EU be successful, with either hurt our American company or, because it is a tax, will be creditable in the United States and we, the Treasury, will bear the burden of the state aid actions.

When we lose in this competition, when an American icon is taken over, it has terrible effects on jobs and our communities. People say that, you know, when an American company, an icon, becomes the subsidiary of the foreign company, it doesn’t make any difference. It is still a great company, it is still operating in America, the greatest marketplace in the world, so it doesn’t make any difference. To me, that is like telling somebody here who is in the Majority, maybe in a veto-proof Majority, and is now in the Minority that it doesn’t make any difference because, what the heck, you are still a Member. Well, I mean, Anheuser Busch was the king of

beers. Now it is one of a number of brands in a beer portfolio run by InBev from Brussels. That is not the same. That is not the same. And St. Louis is going to be hurt by that.

I am from Detroit. We are all rooting for Fiat Chrysler. My goodness, we hope it succeeds. The North Jefferson plant is humming. But Fiat Chrysler is not Chrysler, and Sergio Marchionne is not Lee Iacocca. It makes a difference when we lose these companies.

When I first started practicing long ago I represented Firestone. My firm started in Cleveland 125 years ago, and Firestone was one of the great companies of America. Now, of course, it is Bridgestone Firestone. Still a client, still a great company. But it is different. I used to go to Akron. Akron isn't what it used to be.

And just by chance, as I was thinking of this example, in the Sunday Times, this Sunday Times, there was a story about the difference between Akron then and now, and the story was about the hundreds and hundreds of dilapidated and abandoned homes in Akron because it is no longer the tire capital of the world.

Small businesses are affected, too. We talk about them all the time as the generator of jobs. They are the generator of jobs. But they are all part of the big guys' supply chain. Who do you think they make the labels for? Who do you think they make the boxes for?

I got an example there, too. GE moved to Boston, so we are not talking about a foreign takeover, but do you think the businessmen in Connecticut are happy with that? Do you think the restaurants that are lining up and down the parkway to feed the GE employees are happy with that? What if GE had been taken over and moved abroad?

So—but that is my message, the competition is real. And, you know, we can let the great be the enemy of the good, but—thank you.

[The prepared statement of Mr. Wiacek follows:]

Committee on Ways and Means
The Global Tax Environment and
Implications for International Tax Reform

* * *

Testimony of Raymond J. Wiacek
Jones Day, February 24, 2016

There is a general consensus that the United States should reform its tax system as applied to corporations acting globally. The issues presented are difficult, however, and there has not been a consensus on how to proceed. In the meantime, U.S. multinationals are taxed at high rates and on a worldwide basis, decreasing their competitiveness versus foreign corporations. These foreign competitors seek the same things we do -- they seek sales that might otherwise be ours, customers that might otherwise be ours, jobs that might otherwise be ours, and communities that sparkle like ours when our corporations prosper. So our competitiveness is important.

Equally important, the world doesn't wait. Globalization accelerates, the BEPS project gains momentum, the EU state aid cases inflame, and the world lurches toward a new tax system not always in our interest.

Here are some of the features of the global tax environment relevant to tax reform:

1. Rate disparity. This is the most oft cited feature of our international tax system -- our rates are very high. Yes, other countries may have a VAT, to which our companies might reply that we have state income taxes. But this is side chatter, because our rates are high, period. In contrast to our rate of 35%, for example, the United Kingdom's rate is 20%, already scheduled to go to 18% by 2020. And the United Kingdom taxes profits earned on intellectual property at

15%, scheduled to reduce to 10%. This is the United Kingdom, mind you -- our “cousins” -- not Cayman or Gibraltar. The United Kingdom understands the importance of tax rates in the competition for jobs and investment.

2. Worldwide versus territorial taxation. This is the other well known feature of our system that is at odds with the rest of the world. We subject profits earned outside the United States to taxation, and other countries do not. Other countries prefer to have a national “champion” competing internationally on their behalf, free of home country taxation. These foreign champions are already formidable competitors -- we have no monopoly on brains or ambition -- but they are certainly abetted in their competition against us by low tax rates and territorial taxation.

3. Politics. We have our own, of course, but it cannot be overlooked that taxation, particularly international taxation, is political everywhere. The current debate about international taxation might be traced to 2012 and the United Kingdom, when the Government of David Cameron began a public attack on Amazon, Apple, and Starbucks. The U.K. Government proclaimed at the time that, “Whilst what these companies have done is technically legal, it is immoral.” Legal is legal, and should not be modified by technically, particularly by a Government in a parliamentary system with the absolute power to change the law. But one suspects the attack had other purposes. It was publicized only a few days before that Government introduced another austerity budget, calling for further cuts in education, rent subsidies, and the like. The implication was that further sacrifice by British citizens might have been avoided if only American multinationals had paid their taxes. Members of the Government even called for a boycott of Starbucks, further diverting attention from the United Kingdom’s

slow recovery from the 2009 financial crisis. The attack was later extended to Google, another U.S. multinational. Obviously, U.S. multinationals do not vote.

On the other hand, the United Kingdom asserts that international tax planning can go too far. It is a big supporter of BEPS, and has put international taxation on the G-20 and G-7 agendas. So the United Kingdom has low rates intended to attract companies from the United States and elsewhere -- it even has a patent box -- but it also supports BEPS and tells its citizens that American companies are the boogey men. This is clever politics indeed. The United Kingdom embraces low rates and the competition for international business, while publicly crusading against the results.

4. The international tax system is outdated. The U.S. Internal Revenue Code was written in the last century. It is in many ways a physical code, a bricks and mortar code, a widget code. Where is the factory? From what warehouse was the widget shipped? These are among the relevant questions in a world where the biggest return is to the IP, not factories or warehouses. Buying software, for example, now entails sending one's credit card number electronically to a server of unknown location, receiving a password in return, entering that password, and receiving from the cloud the electrons constituting the software. There is nothing physical in this transaction. There is not even a disk or thumb drive. So questioning this transaction in accordance with existing Code principles -- where did title to the product pass -- is difficult. Can it matter where in its orbit the cloud satellite was at the time of "delivery"? Does it matter where the server that sends the password is located? Can India tax the transaction, as it has claimed in similar cases, because the server is there?

The mention of India requires mention of another feature of our Code that much of the world thinks is outmoded. Our Code is based in large part on so-called residence taxation. Where is the residence, the location, of the corporation that did the research, patented the outcome, made the product, and shipped it to a foreign customer? The answer to the residence question is most often the United States, or another Western country. It is rarely India, or Mexico, or Brazil. So these countries argue that taxation should be source based, at least in part.

Source taxation asks what is the source of the order, the source of the check that pays for the product. Countries in favor of source taxation argue that if they did not supply the customer, “the market,” there would be no revenue to the corporation resident in the United States. These countries also argue that, absent source taxation, they would realize little tax revenue from international transactions. The BEPS project supports source taxation, as discussed below. The point here is that our current Code conflicts with the views (and politics and needs) of much of the world.

5. BEPS. The OECD’s base erosion and profit shifting initiative is well known. In a series of 15 papers, the OECD is recommending fundamental changes to most important features of international taxation. For example, BEPS legitimizes source taxation, treating “the market” as an important contributor to profit. This will allocate taxable profit away from residence-based systems like the United States to less developed “market” countries. This also will give Congress less money to work with as it contemplates reforming our international rules.

Another BEPS proposal would require multinationals to report to *each* country in which they do business their revenue, expenses, profits, and taxes for *every* country in which they do business. There are privacy concerns, obviously, and there is particular concern where privacy

intersects with politics -- for example, where an American multinational proves useful as a scapegoat. Aside from politics, the breach of privacy might be cultural, as in Scandinavia, which believes in more transparency than most in tax matters. Or the privacy breach might come by way of a hacker, a wiki leaker.

BEPS flew below the radar screen for some time, because its proposals must be adopted country-by-country. In a sense, BEPS was viewed as advisory. But even where the United States does not adopt a proposal, what happens when other countries do? International taxation by definition involves the rules of at least two countries. No one country -- including the United States -- is ever in control. So post BEPS, one country may use residence taxation and insist on the privacy, by country, of tax returns. And another may push source taxation and demand extraterritorial tax returns. No country is likely to adopt all of the BEPS proposals, but most countries will adopt the proposals advantageous to them. Germany has already announced the proposals it considers priorities, and other countries are already complaining. Moreover, BEPS proposals will be selectively adopted by non-OECD countries. In fact, BEPS proposals are being cited already, before adoption, in selected countries on selected issues. For example, in tax audits outside the United States source taxation is already cited as the basis for proposed additional taxation. After all, it is the latest international norm as established by the OECD's BEPS project.

This is not the place to review BEPS proposal-by-proposal. Instead, one might ask what does BEPS mean overall. First, it means a decade or more of turmoil as the international tax system is reformed through the OECD, differently by country. The international tax system may have been outmoded and in need of change, but there is no gainsaying the uncertainty and disparate impact that will follow the opening of this Pandora's Box.

Second, BEPS means that the foreign tax burdens borne by U.S. multinationals will increase. The most basic objective of BEPS is to increase taxation of multinationals, and to skew that increase “more fairly” to countries other than the United States. In this regard, BEPS is big brother to the British attack on American multinationals. To maintain U.S. competitiveness, this in turn will increase the need for rate relief, perhaps territoriality.

Third, BEPS tells us the United States should get on with it. BEPS is out of the gate and galloping down the backstretch, but it has not turned for home. There are already divisions between the liberal and socialist officials at the OECD and in Brussels and the more center right governments now charged with adopting the BEPS proposals. BEPS is not done, and there is still time for the United States to put a stamp on the process.

6. State Aid. The EU forbids member states from granting subsidies and other “state aid” on a selective basis to attract business. This prohibition is administered under EU competition (antitrust) laws. (If the United States had such a rule, it might be considered an unfair trade practice under the jurisdiction of the Federal Trade Commission.) Tax credits and tax abatements can be considered such subsidies. Because international taxation is complex, American multinationals often get rulings from the Governments involved as to whether their plans are legal and compliant. That is, they disclose their plans in advance and get the written blessing of the relevant countries. The EU is now claiming that these rulings, granted by sovereign nations, constitute illegal state aid. The EU is ordering the countries involved to assess ten years of back taxes on the companies with the rulings. The United States has protested that this action seems directed solely at American companies. The EU has rejected this. The joke now is that, because of the U.S. protest, the next state aid case will certainly involve a EU company. But not a U.K. company, and certainly not before the United Kingdom votes whether

to leave the EU. And not a German company, with Germany ascendant in the EU. Maybe a Greek or Portuguese company, along with the Americans. Politics would seem to be at work here. With EU effectiveness in question over immigration and other issues, and with a populist attack on global businesses fanned by various national leaders, the state aid cases are perfect. But what about the rule of law? How can an American company the operations of which are admitted to be legal and which has a binding written agreement from the relevant government approving those operations be taxed, retroactively?

7. Shrinking U.S. companies and the loss of jobs and community. Some say that whether a corporation is based in the United States or abroad does not make much difference, because that corporation will still do business in the United States as the largest market in the world. That sentiment is wrong. When U.S. business that was done by a U.S. company is instead done by a more competitive foreign company, the local economy is harmed. When a U.S. company is acquired by a foreign corporation, the fact that the U.S. company is now a subsidiary controlled abroad harms the local economy. To posit otherwise is like telling a Member now in the minority but who was in the majority -- maybe even a veto proof majority -- that it doesn't matter, because he or she is still a Member.

My firm started over a hundred years ago in Cleveland, and we long represented Firestone, headquartered in Akron. We still represent Bridgestone Firestone, a great company headquartered in Tokyo. But when it came time to decide which plants to close and which to expand, that decision was made in Tokyo. The effect on Akron was evidenced by an article published just this Sunday in the New York Sunday Times. The article discussed the hundreds and hundreds of abandoned and decaying houses in Akron. These houses were built and Akron

had prospered because, per the Times, Akron was “once the tire capital of the world.” No more. And no longer are there Little League teams called the “Radials” or the “Firestone 500s.”

I am from Michigan and we Michiganders all wish Fiat Chrysler great success. But Sergio Marchionne is not Lee Iacocca. That’s perhaps a flippant way of making the point, but it makes the point.

It is also true that when a large multinational cannot compete, many, many smaller companies around it are harmed. We all praise how these companies are the job generators, and it’s true. But most of them are part of the supply chain of a multinational, or provide goods and services to the employees of that multinational. These businesses may employ a number of your constituents, and the owner may be a mainstay in your district. But most such businesses are ultimately dependent on the “big guy.” Just ask the businessmen of Connecticut about GE’s move to Boston.

The point is that competition, and its consequences, are real. Competitiveness is not just the “c” word, used in testimony on tax reform. When we are outcompeted, we are harmed, and that harm multiplies throughout the community. We can be outcompeted for a number of reasons. Another country may infringe our IP, management in the United States may be insufficiently nimble, environmental rules may be too lax in the competing country, or a competitor may simply invent something before us. But one should never omit from this list a non-competitive tax system burdening our champions and at odds with much of the world.

* * *

Thank you for inviting me to testify. I hope what I've said proves useful. It is based on almost 40 years of hands-on experience as a tax lawyer at the international law firm of Jones Day, with some 20 years as the head of Jones Day's global tax practice.



Chairman BRADY. Thank you, Mr. Wiacek.
Professor Grinberg, you are recognized.

**STATEMENT OF ITAI GRINBERG, ASSOCIATE PROFESSOR OF
LAW, GEORGETOWN UNIVERSITY LAW CENTER**

Mr. GRINBERG. Chairman Brady, Ranking Member Levin, and distinguished Members of the Committee, good morning. My name is Itai Grinberg, I am an associate professor of law at Georgetown. It is a pleasure to appear before you today to discuss the European Commission's state aid investigations, and the way that those investigations impact the international tax environment that we face.

The international tax environment around the world is becoming both less stable and less favorable to American business. The BEPS project at the OECD was justified as an attempt to prevent the old framework for international taxation from falling apart and being replaced by unilateral action, double taxation, and what the OECD termed "global tax chaos."

Unfortunately, the post-BEPS environment already shows signs of becoming characterized by much of the global tax chaos the BEPS project was supposed to prevent. We are seeing an increase in unilateral actions and more double tax disputes, especially in the transfer pricing area.

The European Union's state aid investigations with respect to tax ruling practices represent an extreme example of the emerging challenges. EU law generally prohibits so-called state aid that threatens to distort competition by favoring certain businesses. The European Commission can retroactively demand assessments that reach back up to 10 years when it labels a tax result "state aid."

EU state aid law dates the 1950s and was intended to prevent EU member states from subsidizing domestic national champion companies. In contrast, in the recent cases against American businesses, the Commission is claiming that EU member states provided illegal state aid to our companies merely by providing them legal certainty through tax rulings that clarified how generally applicable national law would apply to those companies' facts.

These investigations are novel and unprecedented. Moreover, they do not seem to meet the test for state aid, because the kind of rulings at issue were broadly available to multinationals around the world. The enforcement reality, though, is that almost all the revenue and all but one of the named company investigations involve American businesses, even though rulings of this type are held by many, many European-headquartered multinationals.

Moreover, the remedy the EU imposes when member states provide illegal state aid is deeply inappropriate, to say the least, when applied to a foreign firm, instead of the domestic national champion firms for which the state aid regime was created.

In the current cases, when the Commission finds that a member state has acted illegally, the remedy—the remedy—is to demand they take potentially billions of dollars from an American business. Importantly, those payments could be creditable. So the Commission's decisions may amount to demanding a multi-billion-dollar transfer from U.S. taxpayers to the EU member states the Commission claims acted illegally.

In addition to basic rule of law concerns, the state aid investigations raise questions about whether the European Union may be discriminating against American business. Studying the difficult issues that arise under Section 891 of the code, which was enacted to address such discrimination, is one important policy step the U.S. Government can take.

But more broadly, the EU's investigations are just one more indication of the urgent need for U.S. international tax reform. Our singularly high corporate tax rate and worldwide system are severely out of line with international norms. These EU investigations highlight yet another negative consequence of that.

Our international tax system is allowing American businesses and the U.S. fisc to be turned into pawns in an inter-European fight between high-tax France and low-tax Ireland. In the current environment, with many countries searching for politically painless revenue sources, the foreign tax credits provided by our current system and that would exist in a minimum tax are a ripe target for governments looking to effectuate transfers from foreign taxpayers to their own coffers. Other developed economies can't be targeted in the same way the United States can, because they have true dividend exemption systems.

More generally, continuing to impose relatively high income tax rates on multinationals places the U.S. at a disadvantage in today's global economy, given the mobility of capital, intellectual property, and, importantly, high-skilled, high-quality jobs.

So, thank you for the opportunity to testify before you today. I would be delighted to take any questions you may have.

Chairman BRADY. Thank you, Professor.

[The prepared statement of Mr. Grinberg follows:]

TESTIMONY OF ITAI GRINBERG
ASSOCIATE PROFESSOR, GEORGETOWN UNIVERSITY LAW CENTER
BEFORE THE COMMITTEE ON WAYS AND MEANS
HEARING ON THE GLOBAL TAX ENVIRONMENT IN 2016 AND IMPLICATIONS FOR
INTERNATIONAL TAX REFORM

February 24, 2016

Chairman Brady, Ranking Member Levin, and distinguished members of the Ways and Means Committee, good morning. My name is Itai Grinberg, and I am an Associate Professor of Law at Georgetown University Law Center. It is a pleasure to appear before you today to discuss the global tax environment and its implications for international tax reform. My testimony will focus on the European Commission's state aid investigations with respect to tax ruling practices and the implications for US international tax policy.

The international tax environment around the world is becoming both less stable and less favorable to American business. The Base Erosion and Profit Shifting (BEPS) Project at the Organisation for Economic Co-operation and Development (OECD) was justified as an attempt to prevent the old framework for international taxation from falling apart and being replaced by unilateral actions, double taxation of cross-border business, and what the OECD termed "global tax chaos."¹ Unfortunately, the post-BEPS environment already shows signs of becoming characterized by much of the global tax chaos the BEPS Project was supposed to prevent. We are seeing an increase in unilateral actions, growing disregard for long-standing international tax norms, and more double tax disputes, especially in the transfer pricing area. The European Union (EU) state aid investigations with respect to tax ruling practices represent an extreme example of the emerging challenges in this new international tax environment.

Background on State Aid

EU law generally prohibits so-called "state aid" that threatens to distort competition within the European Union by favoring certain businesses.² The Directorate General for Competition of the European Commission effectively has plenary authority regarding what countries, companies, or practices to investigate or not investigate under these rules. When it finds illegal state aid, it can demand assessments that claw back that aid, including what it views as underpaid taxes, going back ten years with interest.

The state aid rules date to the late 1950s and were originally designed to prevent EU member states from subsidizing domestic "national champion" companies in ways that

¹ Organisation for Economic Co-operation and Development [OECD], *Action Plan on Base Erosion and Profit Shifting*, at 10-11 (2013), <http://www.oecd.org/ctp/BEPSActionPlan.pdf>.

² Consolidated Version of the TFEU, art. 107(1), May 9, 2008, 2008 O.J. (C 115) 91-92.

would undermine a competitive marketplace within Europe. In a series of decisions reaching back fifty years, the European Commission (Commission) has found specific cases of state aid to violate EU rules and required the offending member state to recover that aid from the affected company. The history and scholarship surrounding state aid law suggest that this regime has been an important political tool of the Commission in many contexts.

State aid decisions focusing on indirect subsidies provided through tax benefits are not new as a general matter. The first tax-related state aid case dates to the 1970s. In the late 1990s the Commission issued a notice on the application of state aid rules to business taxation.

Until recently, state aid cases in the tax area generally involved statutory rules that selectively favored domestically headquartered companies in a given EU member state or regimes that provided tax benefits to only a very narrow group of taxpayers. Then, just as press exposés and high-profile legislative hearings abroad concentrated the attention of the European public on legal tax planning undertaken by US multinationals—often simply to achieve effective tax rates that were comparable to their global competitors—the Commission decided to take its state aid work in a new direction. In the cases against Amazon, Apple, Fiat Chrysler, Starbucks, and McDonald’s, the Commission is claiming that EU member states provided illegal state aid to foreign-headquartered companies merely by providing them legal certainty through tax rulings that clarified how generally applicable national law would apply to those companies’ facts.

These tax rulings do not appear to meet the Commission’s own requirements for finding state aid in that they do not seem to be “selective.” Similar rulings were broadly available from the tax administrations of those same EU governments that issued the rulings being challenged by the Commission. Moreover, the relevant national governments strenuously assert that those rulings were consistent with the general income tax systems of the relevant countries. Finally, the new state aid cases largely relate to transfer pricing matters, which present notoriously difficult fact-specific determinations that are ill-suited to a state aid analysis.³ For all of these reasons, the current EU state aid tax investigations are novel and unprecedented.

Given the importance of state aid as a political tool of the Commission, the current investigations should perhaps be considered in the context of the Commission’s broader regulatory agenda. The President and others have suggested that, at least in the technology sector, that agenda has often amounted to a protectionist attack on US

³ Luxembourg and the Netherlands generally assert these same points in their appeals of the two final decisions reached to date by the Commission. Case T-760/15, *Netherlands v. Comm’n*, CURIA (Dec. 30, 2015), <http://curia.europa.eu/juris/document/document.jsf?text=&docid=174409&pageIndex=0&doclang=en&mode=req&dir=&occ=first&part=1&cid=632814>; Case T-755/15, *Luxembourg v. Comm’n*, CURIA (Dec. 30, 2015), <http://curia.europa.eu/juris/document/document.jsf?text=&docid=174369&pageIndex=0&doclang=en&mode=req&dir=&occ=first&part=1&cid=633222>.

companies, driven by frustration at European companies' inability to compete in that area.⁴

The new state aid investigations can be understood as part of that broader trend. All but one of the company-specific investigations and almost the entire potential amount in controversy involves US multinationals. This remains true even when the more general investigation launched by the Commission into Belgium's excess profits regime is taken into account. The enforcement reality that almost all the revenue at stake comes from US multinationals contrasts with the simple fact that tax rulings of the type that the Commission has recently decided to examine were also routinely procured by European-headquartered multinationals.

Moreover, the remedy that state aid law imposes against member states that provide illegal state aid is deeply inappropriate when applied to a foreign firm instead of the domestic "national champion" firms for which the state aid regime was originally intended when it was created in the 1950s. When the Commission finds that a member state has provided illegal state aid to a foreign firm, the remedy is to require that member state to collect a revenue windfall from the foreign-headquartered company. That does seem to make for great politics: when the Commission reprimands a member state for violating EU law, that member state wins.⁵

Concerns the State Aid Investigations Raise for US International Tax Policy

The state aid investigations raise basic rule of law issues in attempting to tax American business retrospectively rather than prospectively. The legal positions taken by the Commission also disregard international tax norms as they stood during the period the Commission is investigating. Importantly, the investigations could give rise to US multinationals paying EU member states amounts that may be creditable taxes under our law. Thus, the Commission's decisions may in effect amount to demanding a multi-billion dollar transfer from US taxpayers to the EU member states the Commission claims acted illegally.

These issues were articulated in testimony given to this committee and the Senate Finance Committee by Treasury Deputy Assistant Secretary Bob Stack, as well as in a letter from the Senate to Secretary Lew.⁶ In addition to the concerns articulated in those

⁴ See, e.g., Murad Ahmed, Duncan Robinson, & Richard Waters, *Obama Attacks Europe over Technology Protectionism*, FIN. TIMES (Feb. 16, 2015), <http://www.ft.com/intl/cms/s/0/41d968d6-b5d2-11e4-b58d-00144feab7de.html#axzz3uloMQQb>.

⁵ See Michael J. Graetz, *Behind the European Raid on McDonald's*, WALL ST. J. (Dec. 3, 2015), <http://www.wsj.com/articles/behind-the-european-raid-on-mcdonalds-1449187952>.

⁶ *OECD Base Erosion and Profit Shifting (BEPS) Project: Before the Subcomm. on Tax Policy of the H. Comm. on Ways and Means*, 114th Cong. (2015) (statement of Robert B. Stack, Deputy Assistant Secretary for International Tax Affairs, U.S. Department of Treasury); *International Tax: OECD BEPS & EU State Aid: Before the S. Comm. on Fin.*, 114th Cong. (2015) (statement of Robert B. Stack, Deputy Assistant Secretary for International Tax Affairs, U.S. Department of Treasury); Letter from Orrin G. Hatch, Ron Wyden, Rob Portman, & Charles Schumer, Comm. on Fin., U.S. Senate, to Jacob Lew, Secretary, U.S. Dep't of Treasury (Jan. 15, 2016),

settings, I believe it is important to consider whether these investigations rise to the level of discrimination against American business under section 891 of the Code, what these investigations tell us about whether the United States will be able to continue treating EU member states as sovereigns for tax purposes, and what the existence of these investigations tells us about the international climate the United States faces as it considers international tax reform.

Discrimination Against Corporations of the United States Under Section 891 of the Code

The state aid investigations raise serious questions about whether the European Union is discriminating against American business. After all, the Commission has requested a list of all companies that have received tax rulings from all member states, and it is clear that European-headquartered multinationals hold many such rulings. Yet all but one of the named investigations involve American companies. Section 891—a rarely mentioned provision dating to the 1930s—seems to have been enacted precisely to address the kinds of concerns raised by this type of fact pattern.

Section 891 provides:

Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax imposed by sections 1, 3, 11, 801, 831, 852, 871, and 881 shall, for the taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each citizen and corporation of such foreign country. . . .⁷

Difficult technical questions arise under section 891 when considered in connection with the state aid investigations. One of these regards the circumstances under which a foreign tax measure should be viewed as rising to the level of being discriminatory. On this issue, the legislative history of section 891 does seem to suggest that the analysis should focus on the impact of the foreign rule as applied. Thus, the fact that rulings are broadly available to multinationals across the globe, but that almost all the revenue at stake is coming from US multinationals, would appear to be highly relevant. Another issue relates to the relationship between section 891 and US tax treaties concluded with EU member states after the date of enactment of section 891. This is a highly challenging issue, but in my view section 891 may be made operative, at least in part, to the extent that discriminatory taxation by a foreign country violates the terms of a tax treaty of the United States. Separately, it is worth noting that for purposes of section 891, the European Union itself may be a “foreign country.”⁸

<http://www.finance.senate.gov/imo/media/doc/Finance%20Committee%20Members%20Push%20for%20Fairness%20in%20EU%20State%20Aid%20Investigations.pdf>.

⁷ Revenue Act of 1934 § 103, 48 Stat. 680, 703 (current version at 26 I.R.C. § 891 (2015)).

⁸ The issues discussed in this paragraph as well as other issues of statutory interpretation of Section 891 are covered in greater depth in Itai Grinberg, *A Constructive U.S. Counter to EU State Aid Cases*, TAX NOTES INT'L, Jan. 11, 2016, at 167.

Of course, actually applying section 891 would be unprecedented—but no more so than the Commission’s decision to use its “competition law” to engage in retroactive tax takings from American businesses and attempt to alter EU member states’ tax policies at the same time. Thus, although numerous practical obstacles and technical questions must be addressed, studying the issues that arise under section 891 in the context of the EU state aid investigations is an important policy step the US government can take.

How the United States Relates to the European Union in Tax Matters

Every EU member state has held itself out to the international community as sovereign for tax purposes, regardless of its membership in the European Union. The United States has conducted its international tax affairs in good faith based on that representation. The EU state aid investigations, however, suggest that member states of the European Union cannot uphold their bargains in the way one expects of a sovereign. Rather, we are learning that the EU state aid rules impose a stringent set of constraints on tax policy and administration in EU member states, and that these rules trump tax treaties reached by EU member states. For example, when the positions taken by the Commission with respect to the application of the arm’s length standard under EU law are inconsistent with the understandings reached in tax treaties, the Commission appears to consider itself empowered to disregard the meaning of the arm’s length standard intended by the relevant tax treaty.

The state aid investigations therefore bring into doubt the United States’ ability to continue treating EU member states as sovereign for tax purposes. If the present EU state aid investigations continue and are upheld by the European Court of Justice, it could in effect amount to abrogating EU member states’ tax treaties. The eventual result may be that the United States will need to formalize that decision by terminating its tax treaties with European sovereigns and negotiating a tax treaty with the European Union. Importantly, many EU member states, both large and small, would disfavor this outcome. That the Commission is undermining an element of sovereignty that member states tend to vigorously defend is further evidence that in these investigations the Commission has likely overstepped its bounds. Nevertheless, the Commission has now also announced that it plans to negotiate for state aid provisions in various agreements with third countries as a means to ensure that its vision of “fair tax competition” is adopted internationally.⁹ So unless member states can change the course of events, US tax treaty policy appears to be on a collision course with the Commission.

International Climate in Which We Consider International Tax Reform

The European Union’s state aid investigations are also one more indication of the urgent need for US international tax reform. Our singularly high corporate tax rate and worldwide system are severely out of line with international norms. These EU investigations highlight yet another negative consequence of having such broken and aberrant international tax rules. Our international tax system is allowing American

⁹ *Communication from the Commission to the European Parliament and the Council on an External Strategy for Effective Taxation*, at 7, COM (2016) 24 final (Jan. 28, 2016).

businesses and the US fisc to be turned into pawns in an intra-European fight between the likes of (high tax) France and (low tax) Ireland.

Every other G7 country and 28 of the other 33 OECD member countries have international tax rules that allow their resident companies to repatriate active foreign business income to their home country without paying a significant additional domestic tax.¹⁰ This system of taxation is usually referred to as “dividend exemption.” Another important feature of dividend exemption systems is that they do not provide foreign tax credits for active foreign business income that can be repatriated tax-free.

Unlike exemption systems, our system generally provides a credit for foreign taxes in order to avoid double taxation. Unfortunately, in the current international tax environment, in which many countries are searching for politically painless revenue sources and most countries utilize exemption systems, the foreign tax credits provided by our current system are a ripe target for governments looking to effectuate transfers from US taxpayers to their own coffers.

Indeed, a report prepared by Policy Department A of the Directorate General for Internal Policies of the European Parliament’s TAXE Special Committee proposes that the European Union should find ways to ensure state aid assessments are creditable taxes in those countries that “may grant a credit to a resident company for taxes paid abroad on foreign activities.”¹¹ Although the language is somewhat opaque, the goal of the proposal is clear: to make certain that the revenue the European Union seeks through state aid investigations is extracted directly from the United States Treasury.

In this regard, it is important to recognize that a reformed system that includes a minimum tax could continue to leave the United States exposed to other countries seeking to extract revenue from US multinationals in ways that leave US taxpayers footing the bill. In contrast, a true dividend exemption system would not be vulnerable to efforts by foreign sovereigns to extract revenue from US taxpayers by way of imposing tax on US multinationals. Promptly enacting a dividend exemption system along with a mandatory deemed repatriation of presently undistributed foreign earnings might also reduce the temptation for the EU or other foreign sovereigns to target those historical earnings for additional foreign taxation.

The interconnectedness of today’s global economy and the mobility of capital, intellectual property, and high-skilled labor makes all attempts to impose high income tax rates on multinational corporations counterproductive. The global market for corporate control combined with the continued home-country bias for high-quality headquarters

¹⁰ See also *Evolution of Territorial Tax Systems in the OECD*, Report Prepared for Technology CEO Council, PwC 3 (Apr. 2, 2013), www.techeocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf. (illustrating that 91% of the non-US OECD-headquartered companies on the Forbes 500 list of the world’s largest companies for 2012 were headquartered in countries with a dividend exemption system).

¹¹ Raymond Lujala, Directorate Gen. for Internal Policies, Policy Dep’t A: Econ. and Sci. Policy, *EU State Aid Law and National Tax Rulings*, at 20, IP/A/TAXE/2015-02 (Oct. 13, 2015).

and R&D jobs means that mistakes in this area can be costly in terms of employment and opportunity, especially for the younger generation. The post-BEPS environment has accelerated the timetable on which we must act to reform our international tax system because BEPS is likely to succeed in requiring companies to align functions with tax benefits. Among other things, the BEPS Project was meant to prevent companies from shifting income to lower-tax jurisdictions without also shifting jobs to those jurisdictions. At least in that sense, BEPS is likely to succeed. Moreover, we cannot unring the BEPS bell. So without pro-growth, internationally competitive tax reform, we may well see high-quality American jobs migrate offshore. At minimum, this suggests moving to a much lower corporate tax rate and a dividend exemption regime that does not incorporate a minimum tax that is akin to a worldwide tax system.

It is also important to recognize that countries around the world are moving away from residence country taxation and towards source country taxation, and away from corporate income taxation and toward consumption taxation. One noteworthy consequence of these developments is to exacerbate the consequences of the disjunction in US law between the treatment of US-domiciled and foreign-domiciled multinationals. Thus, another priority in international tax reform should be to level the playing field in this regard. International tax reform efforts should work to define the US source base we intend to defend and consider taxing in the future exclusively on that basis, rather than on the basis of corporate residence.

Thank you for the opportunity to testify before you today. I would be delighted to answer any questions you may have.



Professor Kleinbard, you are recognized and welcome.

**STATEMENT OF EDWARD D. KLEINBARD, PROFESSOR OF LAW,
UNIVERSITY OF SOUTHERN CALIFORNIA GOULD SCHOOL OF
LAW**

Mr. KLEINBARD. Thank you. You know, Akron isn't what it used to be. But neither is Birmingham, England, neither is Clermont-Ferrand, France. Let's not in this hearing confuse worldwide macroeconomic trends on the one hand with tax policy on the other.

And further, let's not confuse international tax reform with the taxation of outbound investments by U.S. firms in the form of foreign direct investment. International is a two-way street. And let's think a little bit more about what international tax reform means when we consider the United States of America as a source country, as a place in which to invest.

Yes, we need to redesign the outbound international tax system. The United States is, by far, the largest exporter of foreign direct investment in the world. And, yes, the U.S. statutory corporate tax rate is too high. But the statutory rate is largely irrelevant to the foreign operations of U.S. firms.

For example, Pfizer tells shareholders that it operates under a 25 percent worldwide effective tax rate. But it appears that Pfizer's cash tax bills on its worldwide income actually are in the neighborhood of six or seven percent. The same is true for many U.S. multinationals. And what is more, when U.S. firms borrow in the United States to fund dividends to shareholders, as Apple just did, that operates as the economic equivalent of a tax-free repatriation of those funds.

The essence of a territorial tax system is that income should be taxed where it is really earned. But it defies credulity that single-digit tax rates reflect the taxation of earnings in the places where they actually arose. And yet, in fact, U.S. firms would claim that 53 percent of all their foreign business income has its economic nexus in 6 tax havens.

I don't claim that the international tax system is harmless, much less desirable. But of all its many faults, anti-competitiveness is not one. When it comes to BEPS and EC state aid cases, I find U.S. multinational cries of pains to be hyperbolic and premature. The U.S., along with every other G20 country, endorsed the final OECD BEPS package in September 2015.

I am disappointed in particular that country-by-country reporting is at all controversial. Companies do not have a legitimate claim that their stateless income tax planning techniques that they use to drive down their tax rates to single digits somehow constitute protected, proprietary information akin to the formula for Coca Cola.

Like it or not, U.S. multinationals will not enjoy single-digit tax rates on their foreign income indefinitely. Adopting toothless territoriality will not forestall foreign countries from asserting their taxing rights, but will lead to more erosion of the U.S. domestic tax base, and that is the real irony at work here.

There is a big tax competitiveness problem that is staring at us, but it is the competitiveness of the United States, as a business en-

vironment. The U.S. is also the largest importer of foreign direct investment in the world. International tax reform should, therefore, involve rethinking the attractiveness of the U.S. as a source country, as a place in which to invest, not just a jurisdiction from which to invest.

Lower domestic statutory rates lead to more domestic investment by both foreign and domestic investors. And with more domestic investment, comes more national income, more jobs, and better paying jobs.

Lower U.S. rates by themselves reduce the gap between the effective rates that U.S. multinationals and their foreign peers report to their shareholders, but so too does addressing earnings stripping, which is one of the two big payoffs from inversions. By stanching the bleeding of the U.S. domestic tax base, Congress would simultaneously protect U.S. revenues and raise the worldwide effective rate on those inverted companies and on other foreign firms that use earnings stripping into—from the United States to turn the U.S. into a low-tax paradise for themselves.

I don't fault companies for inverting, I don't hold them to some higher obligation to corporate patriotism, but I do hold Congress to a higher standard. Repairing flaws in the model is not a tax hike, but, rather, reflects an appropriate commitment to maintaining the enormous and delicate machine that is the tax code that has been entrusted to this Congress by the 50 congresses that preceded it. Thank you.

[The prepared statement of Mr. Kleinbard follows:]

TESTIMONY OF PROF. EDWARD D. KLEINBARD

International Tax Reform Begins at Home

TESTIMONY PREPARED FOR HEARING ON
“THE GLOBAL TAX ENVIRONMENT IN 2016”

U.S House of Representatives Committee on Ways and Means

February 24, 2016

Chairman Brady, Ranking Member Levin, and distinguished members,

Thank you for inviting me to testify at this hearing. My name is Edward Kleinbard; I am the Ivadelle and Theodore Johnson Professor of Law and Business at the University of Southern California’s Gould School of Law. From 2007-2009 I was privileged to serve as Chief of Staff of the Congress’s Joint Committee on Taxation.

Introduction.

Over the last several years, this committee has worked diligently and productively on corporate tax reform in general, and international tax issues in particular. I have written previously of my admiration for the work underlying former Chairman Camp’s comprehensive corporate tax proposal.¹ But today, the global tax environment in which multinational corporations operate is evolving more rapidly than at any earlier time in my 40 years of work in the area. The question is, what (if anything) must be done, right now?

Pressures seem to be mounting from all directions. Most important for immediate U.S. tax policy and revenues are corporate inversions. In an inversion, a U.S. multinational firm acquires a smaller competitor in a tax-congenial environment, but structures the transaction upside down, so that the foreign minnow as a formal matter

¹ Edward D. Kleinbard, *3 Cheers for Dave Camp*, 138 Tax Notes 619 (Feb. 4, 2013).

acquires the stock of the U.S. whale.² The combination presumptively makes business sense, but the upside down acquisition structure does not, excepting U.S. tax considerations. Closely related to this, we see the problems of earnings stripping, in which a foreign multinational group uses interest paid from its U.S. subsidiaries to foreign affiliates as a device to reduce its U.S. tax bill in respect of its U.S. domestic operations. We see the same phenomenon as well in the overleveraging of U.S. multinationals with large hoards of offshore liquid assets, as I describe below.

Moreover, every Member here is aware that the U.S. statutory corporate tax rate is the highest in the OECD, even if effective (that is to say real-world, after all tax breaks are considered) tax rates are not so out of line. And every Member here also is aware of the so-called overseas “trapped earnings” of U.S. multinationals, amounting to (very roughly) some \$2.1 trillion in offshore assets, which gnaw at the hearts of chief financial officers everywhere. Again speaking very roughly, half of this amount is in cash and other liquid assets, and the other half in real investments in non-U.S. businesses. What might not be as obvious is that, at least by report, some multinational firms are under pressure from their accountants to do something productive with their stockpiles of offshore cash: after all, it is inherently implausible that cash that remains on the balance sheet year after year really is “permanently reinvested” anywhere, which is the test for booking the benefits of tax deferral for GAAP purposes.

From an international perspective, the mounting tax pressures on multinational businesses and tax laws include, first, the successful conclusion of the G20-OECD Base Erosion and Profit Shifting (BEPS) project, which outlined a wide array of new principles of arm’s-length pricing, along with proposed reforms for national governments to

² I here use the term “inversion” to refer to a deal that, in the domestic context, would be called a “reverse acquisition,” in which the smaller foreign firm is the putative acquiror of the larger U.S. one. An inversion in the more technical sense of Code section 7874 requires that former shareholders of the U.S. firm control at least 60 percent of the combined company. A recent article suggests “corporate expatriation” as a catch-all term for all acquisitions of a U.S. firm by a foreign one, regardless of relative size. Stephen E. Shay, J. Clifton Fleming Jr., and Robert J. Peroni, *Treasury’s Unfinished Work on Corporate Expatriations*, 150 Tax Notes 933 (Feb. 22, 2016).

implement.³ The United States, along with every other G20 country, endorsed the final OECD package of BEPS action plans in September 2015.

Second, partially in response to the so-called LuxLeaks scandal, the European Commission has launched a broad inquiry into whether some member states used tax administrative mechanisms – in particular, Advance Pricing Agreements – in effect as a surreptitious means to deliver unlawful government subsidies (that is, “state aid”) to multinational firms, rather than to employ the APA process to determine in good faith the application of arm’s length transfer pricing principles to the facts of a particular multinational firm’s operations.⁴ Third, many countries around the world have radically stepped up their audits of the local operations of multinational firms, and at least in the view of some observers have adopted novel theories of transfer pricing inconsistent with global norms.

In short, like figures caught in an ever-tightening vise, U.S. multinationals are feeling increasing tax pain from every direction. Their squealing, the high statutory U.S. tax rate, and the inversion phenomenon have together inspired a narrative that the U.S. international tax system is “uncompetitive,” and that we need a more multinational-friendly international tax system as soon as possible. U.S. firms have further convinced many observers that they are the victims of unprincipled revenue grabs by foreign jurisdictions looking to raise some money without imposing on their own citizens.

³ For overviews of BEPS, see Jeffrey M. Kadet, *BEPS: A Primer on Where It Came From and Where It’s Going*, 150 *Tax Notes* 793 (Feb. 15, 2016); Yariv Brauner, *What the BEPS?*, 16 *Florida Tax Rev.* 55 (2014). The texts of the final package of action plans are available at <http://www.oecd.org/tax/beps.htm>.

⁴ For background on the LuxLeaks scandal, and a scathing analysis of the “substance” of the hundreds of advance tax agreements between Luxembourg and multinational firms that were disclosed through this leak, see Omri Marian, *The State Administration of International Tax Avoidance*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2685642, especially Section IV.B. For a short overview of the scandal and its relationship to the state aid cases, see Jones Day, *Luxembourg Leaks: Potential Risks to Companies Whose Luxembourg Tax Rulings Have Been Released to the Public*, <http://tinyurl.com/jsmfmggr>.

This is a false narrative. There is no tax competitiveness crisis in respect of outbound investments by U.S. firms. And if U.S. firms are discomfited by foreign audits and the European Commission's state aid investigations, they are reaping what they themselves have sowed, through years of aggressive tax reduction schemes that routinely have reduced their putative foreign tax rate burdens to single digits. The rule of law has not been abandoned in Europe, and U.S. firms have and will receive the same opportunities to defend their tax planning as is afforded to a European competitor in the same position.⁵

If you are looking for an individual villain to blame for all the tax pain felt by U.S. multinationals, I am your man. I am proud of the contributions that my *Stateless Income* series of articles⁶ have made to a better understanding of how U.S. firms became the world leaders in implementing tax avoidance technologies, and in pointing towards some possible solutions. But I remain a friend to American business, albeit in a Dutch uncle sort of way,⁷ and therefore set out below some recommendations for how this committee can best advance the interests of American businesses, while protecting U.S. tax revenues.

Competitiveness.

The competitiveness narrative is an empty suit pleading for narrow self-interest. I've developed the point in a short article titled *Competitiveness Has Nothing to Do With*

⁵ Jones Day, *European Commission Concludes that Starbucks and Fiat Tax Rulings Constitute Illegal State Aid and Orders Payment of Back Taxes*, <http://tinyurl.com/hpww2oh>, at 3 (describing judicial appeals process).

⁶ Edward D. Kleinbard, *Stateless Income*, 11 Florida Tax Rev. 699 (2011); *The Lessons of Stateless Income*, 65 Tax Law Rev. 99 (2011); *Through a Latte, Darkly: Starbucks' Stateless Income Planning*, 139 Tax Notes 1515 (Jun. 24, 2013).

⁷ I gather that the turn of phrase may betray my age. Wikipedia helpfully explains: "A **Dutch uncle** is an informal term for a person who issues frank, harsh, or severe comments and criticism to educate, encourage, or admonish someone. Thus, a "Dutch uncle" is the reverse of what is normally thought of as avuncular or uncle-like (indulgent and permissive)." https://en.wikipedia.org/wiki/Dutch_uncle.

It, which I've attached to this testimony.⁸ A U.S. firm could be said to face an uncompetitive international tax environment if it paid cash taxes on its international operations at a burdensome rate, if the financial accounting presentation of its international operations inevitably required provisions for future tax liabilities that created the impression of a less profitable firm, or if the costs of maintaining the firm's stateless income machinery, including the cost of financing U.S. operations without touching the cash left abroad, was unduly burdensome. But none of these is true.

As to the first point, we know from a great many sources that the most successful U.S. multinationals pay foreign tax in respect of their foreign operations at derisively low rates. Alphabet (that is to say, Google) enjoyed a 6.3 percent tax rate on roughly \$12 billion of foreign earnings in 2014, through its infamous Double Irish Dutch Sandwich stateless income generator.⁹ Microsoft's effective foreign tax rate is on the same order of magnitude, as can be seen by inspection of Microsoft's tax footnote in its financial statement. In a sense it is unfair to single out these firms, because same is true for dozens of other sophisticated U.S. multinational companies.

But one more example might be instructive. Pfizer Inc. has been the subject of much attention lately, because of its proposed not-quite inversion combination with Allergan PLC.¹⁰ In its 2014 annual financial statements, Pfizer reported to shareholders a worldwide effective tax rate in the neighborhood of 25 percent. (*Competitiveness Has Nothing to Do With It* is useful here in explaining the basic financial accounting presentation of tax liabilities.) Pfizer's Chief Executive Officer, Ian Read, has described the U.S. tax system as requiring that Pfizer compete against foreign rivals "with one hand

⁸ Edward D. Kleinbard, *Competitiveness Has Nothing to Do With It*, 144 Tax Notes 1055 (Sept. 1, 2014). I thank the publishers for permission to redistribute the article.

⁹ Jeremy Kahn and Jesse Drucker, *Google Lowered Taxes by \$2.4 Billion Using European Subsidiaries*, Bloomberg Business, Feb. 19, 2016 (<http://www.bloomberg.com/news/articles/2016-02-19/google-lowered-taxes-by-2-4-billion-using-european-subsidiaries>)

¹⁰ My understanding is that the transaction has been structured such that former Pfizer shareholders will control more than 50 but less than 60 percent of the combined company, thereby avoiding tripping the 60 percent wire of an inversion in the technical tax sense, as defined by Code section 7874.

tied behind our back,” and has further indicated that a principal driver of the proposed inversion transaction is to reduce Pfizer’s reported effective tax rate.¹¹

A worldwide effective tax rate of 25 percent is roughly congruent with the weighted average of OECD corporate tax burdens. But a careful study of Pfizer’s financial statements suggests that Pfizer’s cash tax liabilities are far lower than this implies, and that Pfizer in fact has paid cash tax bills on its *worldwide* income at a rate on the order of 6 or 7 percent over the last several years.¹² A Pfizer representative essentially acknowledged the accuracy of the analysis in a Wall Street Journal story.¹³ In fact, Pfizer’s financial statements maintain that Pfizer has lost billions of dollars in the United States year after year, notwithstanding that the United States accounts for about 40 percent of the company’s sales and roughly 50 percent of its assets.

Under SEC rules, a firm is obligated to disclose in its tax footnote to its financial statements the U.S. tax cost of repatriating its “permanently reinvested” foreign earnings at the end of each year, unless doing so is “not practicable.” The greater the hypothetical U.S. tax cost that is disclosed to shareholders, the lower the foreign taxes that have been paid on those offshore earnings, because those foreign taxes would be creditable against the firm’s hypothetical U.S. tax bill. Some companies, like Microsoft, comply with this requirement, even when in Microsoft’s case doing so signals that its foreign earnings bear

¹¹ Richard Rubin and Jamie Heller, *Pfizer CEO Says U.S. Tax Regime Pushing Him to Seek Alternative*, Wall St. J., Oct 29, 2015. (<http://www.wsj.com/articles/pfizer-ceo-says-u-s-tax-regime-pushing-him-to-seek-alternative-1446140269>)

¹² Frank Clemente, Americans for Tax Fairness, *Pfizer’s Tax Dodging Rx: Stash Profits Offshore* (Nov. 2015) <http://www.americansfortaxfairness.org/pfizers-tax-dodging-rx-stash-profits-offshore/>. Essentially, Pfizer records each year for financial statement purposes a U.S. tax provision – a reserve, if you will – for the ultimate U.S. repatriation tax on a large portion of its low-tax foreign earnings, even though Pfizer devoutly hopes never to pay any such repatriation tax, at least at the statutory 35 percent rate. This explains the enormous difference between the 25 percent worldwide effective tax rate that Pfizer reports to shareholders and the cash taxes actually paid each year.

¹³ Richard Rubin, *Pfizer Piles Profits Abroad*, Wall St. J. (Nov. 8, 2015) <http://www.wsj.com/articles/pfizer-piles-profits-abroad-1447031546?alg=y> (“The gap between Pfizer’s 25.5% tax rate and the 4.8% reported by Actavis PLC before it changed its name to Allergan is somewhat illusory, an artifact of tax accounting rules and Pfizer’s decisions about how to show the information to shareholders.”).

foreign tax at single digit rates. For reasons that are not clear, however, the majority of large, sophisticated U.S. multinational firms, each which employs dozens or hundreds of tax professionals, are inordinately modest about their tax forecasting abilities in this regard, and profess that it is not practicable to calculate the hypothetical U.S. tax cost of repatriating their foreign earnings. Pfizer falls into this category of confessed tax incompetence, which is doubly puzzling, given that Pfizer has no difficulty calculating this liability for the portion of its low-tax foreign earnings for which it *does* record a U.S. tax provision each year.¹⁴ Pfizer's actual effective foreign tax rate would have been a bit more evident to investors had it worked a bit harder to calculate this one hypothetical tax bill.

Another way of approaching things is to look directly for evidence of profit shifting by U.S. firms. Economists have done just that, in several major studies. In the most recent of these, Kimberly Clausing estimated that base erosion and profit shifting reduced U.S. tax revenues at a rate between \$77 billion and \$112 billion per year in 2012.¹⁵

In another recent and highly technical working paper, three economists from the Staff of the Joint Committee on Taxation closely analyzed nonpublic tax return data of U.S. corporations; they concluded that "there is considerable shifting of profits to lower tax jurisdictions."¹⁶ Indeed, they found that in 2010, 53 percent of the global earnings of foreign subsidiaries of U.S. multinationals were booked in six tax haven countries.¹⁷ At least as relevant to this hearing, they found that the effective tax rate (the real world average tax rate) paid by U.S. multinationals on their global non-U.S. income was 17 percent; even their income booked in non-tax havens had an effective tax rate of only 18

¹⁴ Pfizer 2014 Financial Statements, note 5, Section C. See also footnote 12, *supra*.

¹⁵ Kimberly Clausing, *The Effect of Profit Shifting on the Corporate Tax Base*, 150 Tax Notes 427 (Jan. 25, 2016).

¹⁶ Tim Dowd, Paul Landefeld and Anne Moore, *Profit Shifting of U.S. Multinationals*, http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2711968, at 4.

¹⁷ *Id.* at 23.

percent.¹⁸ Other objective studies lead to similar estimates of the revenue hemorrhaging from countries around the world to multinational firms and their shareholders.

In short, U.S. multinationals in general pay non-U.S. tax at rates that are the envy of their foreign competitors. And so long as a firm is able to satisfy its auditors that its offshore earnings will be kept offshore indefinitely, shareholders of the firm see it through territorial-tinted lenses: that is, the firm reports its worldwide profits to investors as if there is no residual U.S. repatriation tax to worry about.

Finally, U.S. firms are not cash starved in the United States by virtue of leaving their foreign profits offshore. The reason is simply that the firms that concern us here are very large, and have easy access to capital markets. This sets into motion a systematic tax arbitrage, in which firms finance U.S. cash needs by borrowing in the capital markets (at historically low rates, as it happens), deducting the resulting interest expense against their U.S. *domestic* income, while their foreign offshore earnings continue to accumulate in a tax-privileged environment.

This is not ivory tower theory: on February 16th, for example, Apple announced a \$12 billion bond offering, the proceeds of which will be used to pay dividends and buy back Apple stock.¹⁹ The interest expense will be fully deductible by Apple, and its enormous hoard of foreign earnings will continue to grow. If the foreign assets held by Apple or any other company engaged in this arbitrage are active business operations, the result is similar to borrowing to invest in tax-exempt bonds – a pure tax-driven arbitrage profit. If the foreign assets are liquid investments, then the income from those investments will be taxable in the United States, which economically will offset the interest expense from the bond offering (plus or minus any interest rate differential). But in that case the *principal* of the bond offering will be the *economic equivalent of a tax-*

¹⁸ Id. at 10. The figures in the paper that are repeated in the text are simple averages; that is, the global non-U.S. average rates are not weighted by the relative amounts of income earned in different countries.

¹⁹ Liz Moyer, *Apple Plans \$12 Billion Bond Sale for Buybacks and Dividends*, NY Times (Feb. 16, 2016) <http://www.nytimes.com/2016/02/17/business/dealbook/apple-plans-12-billion-bond-sale-for-buybacks-and-dividends.html?emc=eta1&r=0>

free repatriation – in this case of \$12 billion.²⁰ That is, if the interest rate on the bond offering is offset by interest income from the offshore cash hoard, the net effect is that Apple (in this case) will be in the same position as if it repatriated \$12 billion tax free and distributed the money to shareholders (again subject to any interest rate differentials).

And of course, the “trapped” offshore earnings are not buried in a backyard in Zug: they either are invested in real foreign business assets, or in U.S. dollar denominated financial assets (typically, bank deposits, commercial paper, money market funds and Treasury securities). So in the latter case the money is reinvested in the U.S. economy, it is just not in the pockets of shareholders.

None of this is to excuse the current international tax system as harmless, much less desirable. Operating the stateless income machinery costs money, and offshore cash burning a hole in a CFO’s pockets can lead to a tax-induced incentive to invest in more foreign businesses, just to have something to do with the cash. But of all the faults of the current U.S. tax system, anti-competitiveness is not one.

Inversions.

If U.S. international tax rules are not anti-competitive in the simplistic way that firms describe their predicaments, why the rush to invert? I develop the answers in *Competiveness Has Nothing To Do With It*, but basically an inversion that threads the needle of the 2014 and 2015 anti-inversion Treasury Notices (as Pfizer – Allergan and Johnson Controls – Tyco are designed to do) opens up three possibilities. First, such an

²⁰ For example, imagine that Apple borrows \$12 billion at 5 percent, and a tax haven subsidiary of Apple has cash investments of \$12 billion also yielding 5 percent. Under subpart F, that offshore interest income is taxable immediately in the United States, and in turn cash equal to that income (\$600 million) can be repatriated to the United States tax-free. Apple’s tax return thus will show \$600 million of interest income by virtue of its subpart F inclusion, and \$600 million of interest expense on its bond issue, for net taxable income in respect of these two items of zero. What is more, the cash yield from the investments held in the tax-haven subsidiary, once repatriated tax-free to the United States, can be used to service the cash interest coupons on the bonds issued by Apple. The result is that Apple has no net cost for raising \$12 billion in cash through the bond offering, just as if it repatriated \$12 billion tax-free. The \$12 billion can then be distributed to shareholders; Apple’s global income goes down by \$600 million/year (because it has a new interest expense and no new assets on its balance sheet, having distributed the bond proceeds to shareholders), but that is the same result as would obtain had Apple actually liquidated some of its offshore income-yielding assets, repatriated the cash tax-free to the United States, and distributed the cash to its shareholders.

inversion enables the surviving firm to get its hands on the U.S. company's offshore cash to fund stock buybacks or dividends, or even to fund the inversion deal itself, through a "hopscotch" loan of the cash directly from the tax haven subsidiary holding it to the new foreign public parent company, jumping over the intermediate immediate U.S. parent.

Second, once a foreign parent company is in place, the wide world of earnings stripping sport opens up. The stock of the U.S. company (now a first tier subsidiary of the putative foreign acquiror) is recapitalized into debt as well as equity, up to the generous limits now provided in section 163(j) of the Code, a large new interest charge appears on the firm's U.S. tax return that is *invisible* to investors (because it is an inter-affiliate transaction eliminated in financial consolidation), and the U.S. tax base on U.S. domestic earnings is thereby depleted. The firm proudly trumpets a lower global effective tax rate, but it has simply engaged in self-help tax reform to deprive the United States of tax on U.S. *domestic* business income, in ways that an entirely domestic U.S. competitor cannot do. This *is* profoundly anti-competitive, but the victims are not the multinational firms who profess that the Internal Revenue Code has driven them to invert, but rather the wholly domestic firms that have been left behind.

Third, inversions offer a long-term congenial tax environment for firms, if they choose their domicile well. But this is very much a long-term agenda item, fraught with all the uncertainty that attends any tax law prediction.

The Treasury has done what it feels it can to restrict inversions through its 2014 and 2015 notices on the subject. But, greatly simplifying, what the notices have done is to create a safe harbor of sorts for combinations that are inversions in a commercial or economic sense, but in which the putative foreign acquiror is large enough that the shareholders of the U.S. firm own more than 50 percent (so that economic control rests with them) but less than 60 percent of the combined company (so that the transaction is not an inversion in the technical sense the word is used in Code section 7874). In this sweet spot, there are no restrictions at all on hopscotch loans, for example.

To be clear, I think it childish to fault companies for inverting. I don't impute much by way of some higher calling to corporate tax patriotism. But I do hold this Committee, and Congress more generally, to a higher standard. The Internal Revenue

Code is a complex model of all of economic activity, written in words rather than math symbols. Congress owns the model, and this Committee is the first line of defense of the model's integrity. If the model yields results that people find troubling, then it is up to Congress to repair it. Patching the model so that it again produces the results that Congress had always expected is not an exercise in "tax hikes" or the like, but rather reflects an appropriate commitment to maintaining the enormous and delicate machine that has been entrusted to this Congress by the 50 Congresses that preceded it.

What Must Be Done Immediately?

Once the reasons for inversions are more clearly understood, and the fuzzy claims of U.S. tax law as systematically anticompetitive in the international setting swept away, then it becomes possible to move forward in a targeted way that stanches the revenue bleeding from inversions without foreclosing or foreshadowing any particular future business tax reform.

Three immediate tweaks are needed. First, lower section 7874's inversion threshold to 50 percent. (The Stop Corporate Inversions Act of 2015, introduced by Mr. Levin and Mr. Doggett, does this in an elegant fashion that distinguishes real business transactions from tax-motivated upside down structures.) Second, recognize that hopscotch loans are simply a tear in the fabric of the Code – a longstanding oversight that leads to the unintended avoidance of the principles of section 956 (the Code section that treats loans to an immediate U.S. parent as a deemed dividend repatriation). Hopscotch loans are relevant whenever a new foreign parent emerges as the owner of a U.S. multinational firm, regardless of the level of continuing ownership of the U.S. target's shareholders; like an impending execution, inversions have simply focused our minds more clearly on them. Section 956 should be amended to treat hopscotch loans as constructive distributions to the immediate U.S. parent.

The same is true of earnings stripping. Earnings stripping is profoundly anti-competitive, because it works to permit foreign-owned U.S. businesses to operate in the United States in an ad hoc privileged low tax environment, to the detriment of wholly domestic U.S. competitors and taxpayers generally. Again inversions have focused our

minds on earnings stripping, but the issue is not in any way limited to inversions.²¹ U.S. domestic business income should be taxed by the United States, and earnings stripping fundamentally violates this core principle. Mr. Levin has recently introduced an anti-earnings stripping bill, and the President in his Fiscal Year 2017 Budget has proposed a thin capitalization variant, which the Treasury Department has estimated will raise \$71 billion in revenue over the next ten years. Again, this \$71 billion does not represent a tax hike on business, but rather the recovery of tax revenue on U.S. domestic business that otherwise is leaking away.

These suggestions leave untouched vitally important issues, from the structure of a new outbound direct investment U.S. tax regime, to anti-abuse rules, to what to do with the existing stockpile of offshore earnings, to the definition of corporate residence. All these must be addressed. The point of my testimony, though, is that the United States is *not* today failing in some global tax competitiveness contest, but it is hemorrhaging tax revenues. Stanch the bleeding first.

BEPS and State Aid.

I have devoted very little space to this point to discussing BEPS and the EU state aid cases. I have done so because I believe that U.S. multinational firms' cries of pain are hyperbolic and premature.

²¹ There is some uncertainty in the economic literature about whether earnings stripping is a serious problem outside the context of inverted firms, but no doubt at all that inverted firms generally indulge in earnings stripping as far as section 163(j) allows. U.S. Treasury Department, *Report to the Congress on Earnings Stripping*, <https://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf> (Nov. 2007) (finding clear evidence of stripping with respect to inverted companies, but not in other cases); Patrick Driessen, *Do Foreign Corporations Really Not Strip the U.S. Tax Base?*, 150 Tax Notes 927, 929 (Feb. 22, 2016) (The view that non-inverted foreign controlled domestic corporations do not engage in earnings stripping “defies intuition”); J. Clifton Fleming, Jr., Robert J. Peroni and Stephen E. Shay, *Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytical Framework*, 93 N.C. L. Rev. 673 (2015).

The BEPS project has concluded by outlining a wide array of proposed reforms for national governments to implement; the United States, along with every other G20 country, endorsed the final OECD package of action plan in September 2015.

The first of the BEPS initiatives to be rolled out on a global basis will be “country-by-country” (“CbC”) information reporting by large multinational enterprises to tax authorities in those countries where a multinational does business. CbC reporting is designed to give tax authorities in one country a better understanding of the business activities that the enterprise conducts elsewhere, and the methods by which it determines the allocation of its gross income, expenses and profits across those countries. The United States Treasury has issued proposed regulations to implement the CbC rules mandated by the G20’s agreement, with a proposed effective date of tax years beginning after the promulgation of final regulations.²²

Whether BEPS succeeds in engendering more principled and more economic tax outcomes to cross-border activity will not be known for some time, but I believe that the United States, as one of the G20 countries that commissioned the project and that endorsed its conclusions, must give BEPS a fair chance. In particular, I am disappointed that CbC reporting is at all controversial. The argument that CbC reporting will lead to trade secrets being leaked to competitors smacks of the sort of argument that lawyers invent when they cannot come up with anything more substantive to complain about. A quick glance at the geographic and business line reporting that the SEC requires today of all public companies, along with industry securities analysts’ reports, will demonstrate how much we know about where the real business of firms is conducted. What is more opaque today are the locations where the income is booked for tax purposes, in which particular affiliate the income is booked, and through what mechanisms.

²² Prop. Treas. reg. section 1.6038-4 (Dec. 2015). For an overview of the CbC and other BEPS action plans, see Jeffrey M. Kadet, *BEPS: A Primer on Where It Came From and Where It’s Going*, 150 Tax Notes 793 (Feb. 15, 2016).

Companies do not have a legitimate claim that stateless income tax planning techniques used to drive down tax rates to single digits somehow constitute protected proprietary information, akin to the formula for Coca Cola. Phrased differently, it is incongruous that firms routinely state that they comply with all local laws, and that their tax planning is entirely above board, but then are unwilling for that tax planning to be transparent to overwhelmed tax administrators in the many countries in which those firms do business.

As noted in the Introduction, the European Commission (EC) has launched a broad inquiry into whether some member states have used Advance Pricing Agreements to deliver unlawful government subsidies (that is, state aid) to multinational firms in return for the multinationals shifting jobs or income to those countries. If a member state has done so, then under EU law the advantaged company is required to disgorge to the member state the value of the advantage it received.²³ The APA process of course is an instrument of tax administration designed to determine in good faith the application of arm's-length transfer pricing principles to the facts of a particular multinational firm's operations.

These state aid cases have elicited a great deal of agitation in the United States, including claims that U.S. firms are being unfairly targeted, but of the first two cases decided by the European Commission, one involved an Italian firm (Fiat) and the other a U.S. one (Starbucks). The analysis in the Starbucks state aid ruling, to the extent it has been made public, has largely mirrored my findings in my case study of Starbucks' stateless income tax planning (*Through a Latte, Darkly*). The recent Belgian "excess profits" ruling by the EC, holding that a Belgian system that gave multinational firms a discount on their Belgian tax bill was illegal, also relied on the idea that the system operated as state aid to induce firms to locate operations in Belgium.²⁴ The majority of

²³ "[T]ax rulings may constitute illegal State aid if they provide favorable tax treatment to specific taxpayers that deviate from the issuing jurisdiction's normal tax rules or tax regimes, and may therefore be viewed as according favorable tax treatment to a specific taxpayer or industry." *European Commission Concludes that Starbucks and Fiat Tax Rulings Constitute Illegal State Aid and Orders Payment of Back Taxes*, <http://tinyurl.com/hpww2oh>, at 2.

²⁴ <http://www.telegraph.co.uk/finance/newsbysector/industry/12092808/Belgian-sweetheart-tax-deals-are-illegal-says-EU.html>

affected firms in that ruling were European. Whether by serendipity or the EC's careful timing, the unfair targeting argument falls of its own weight.

The state aid cases are further described by apologists for U.S. multinationals as exercises in bad faith, or extralegal takings, or retroactive changes in tax rules, or as the EU impermissibly meddling in the tax affairs of a member state (which is not permitted under the EU constitution). But I think that the facts – or more accurately the alleged facts – belie the most excited of these claims. As I read the EC's 2014 preliminary report on its state aid investigation of Ireland and Apple, for example, the EC's argument is that these agreements were not tax administration agreements at all – they were shams designed to resemble tax agreements so as to deliver state aid in a manner that would on their face pass muster as confidential tax cases solely within the purview of a member state. As reported by the EC, in its APA process Apple did not produce comparables or propose a transfer pricing methodology so much as it simply negotiated to a number. Apple described how many employees it maintained in Ireland, observed that it was reviewing its worldwide operations, and then negotiated an APA that in part was “reverse engineered so as to arrive at a taxable income of around USD [28-38] million, although [this figure] . . . does not have any economic basis.”²⁵

It may be that that the EC's preliminary allegations are false, or that by the time it releases its actual decision in the Apple and other cases the EC will have refined its argument in some other direction. But regardless, Apple or any other affected firm has the same rights and remedies (including appeal to the European Court of Justice) as does any European company.²⁶ The fact that the EC has not previously made such arguments overlooks the fact that, as best I understand matters, the EC had no notice of the existence

²⁵ State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) – Ireland Alleged aid to Apple, Recitals 36, 37, 62 (http://ec.europa.eu/competition/state_aid/cases/253200/253200_1582634_87_2.pdf). See also Omri Marian, *The State Administration of International Tax Avoidance*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2685642 (analysis of Luxembourg APA agreements).

²⁶ See note 5, *supra*.

of these aggressive applications of the transfer pricing process until 2013. Further, restrictions on state aid have been an integral part of the EU treaty for decades.

Like the United States, Europe honors the rule of law. I doubt that the claims in the state aid cases are any more surprising to affected firms than were the reactions of taxpayers and the Internal Revenue Service alike to *Arkansas Best v. Commissioner*, in which the Supreme Court held that decades' worth of settled law on the taxation of business hedges were all based on the misapprehension of an earlier Supreme Court case, thereby changing the operation of U.S. tax law in this area retroactively for all open years.

International Tax Reform Begins at Home.

Finally, I want to return to the important work that this Committee has done on the structure of international tax reform. The more I reflect on matters, however, the more I am convinced that the most important underlying international tax design issues actually are not territorial vs worldwide rules for foreign direct investment, but first and foremost, domestic tax rates, and second, the tax-induced incentives to overleverage U.S. businesses.

The United States is by far the largest exporter of foreign direct investment capital in the world. In 2014, and ignoring the Netherlands and Luxembourg, as artifacts of artificial tax planning as much as real investment, the United States held more than three times as much outbound foreign direct investment as did the second biggest exporter of foreign direct investment, the United Kingdom.²⁷ This is consistent with the theme that outbound international tax reform is a vital priority.

But the United States also is the largest *importer* of foreign direct investment from other countries in the world. Again in 2014 (and with the same caveat) the United States accounted for \$2.9 trillion in inbound foreign direct investment; mainland China was second, with \$2.3 trillion.²⁸ In this respect alone, then, international tax reform

²⁷ International Monetary Fund, Coordinated Direct Investment Survey Database, <http://data.imf.org/?sk=40313609-F037-48C1-84B1-E1F1CE54D6D5&slid=1390030109571>.

²⁸ *Id.*

should involve rethinking the attractiveness of the United States as a *source* country – as a place *in which* to invest, not just a jurisdiction from which to invest.

But of course domestic corporate tax rates are much more important than just this. Lower domestic corporate tax rates make investing in the United States by both foreign investors and by U.S. persons or firms more attractive. And with more investment comes more national income, more jobs, and better paying jobs.

We know that the U.S. statutory corporate tax rate is the highest in the OECD. The first part of this testimony has demonstrated that the statutory U.S. rate is largely *irrelevant* to the foreign operations of U.S. firms (except insofar as it distorts investment decisions, as described below). But it is highly relevant to domestic investments by foreign or domestic investors, because, regardless of tax preferences (other than the domestic manufacturing deduction afforded by section 199), it is the marginal tax rate imposed on successful U.S. businesses, particularly services businesses.

These points attract bipartisan agreement; the President has called for lower domestic corporate tax rates, for example. The United States will never compete with Ireland in respect of its corporate tax rate, but it does not need to. The United States offers access to the world's largest national consumer market and the world's best large economy business environment, when all relevant factors (such as labor flexibility) are taken into account.

I therefore find it odd that the U.S. tax rules for outbound foreign direct investment should attract so much attention, while the rules for inbound foreign direct investment and for investment by domestic investors and firms are asked to play second fiddle. Corporate tax rates inside the United States should be our highest priority for these reasons alone.

But there is still more at stake. High domestic corporate tax rates stoke the corporate flames both to relocate real investments and artificially to shift reported income from the United States to lower tax countries. A lower domestic U.S. tax environment reduces the returns to these noneconomic activities. The U.S. domestic corporate tax rate thus is important even in a territorial tax environment for outbound foreign direct investment, because the rate differential will be one relevant factor in measuring the

relative attractiveness of the United States and a foreign jurisdiction as the site of real business activity, as well as the payoffs to artificial profit shifting. For the same reason, a lower domestic rate reduces to some extent the long-term attractiveness of inversions or stateless income planning, even under current law (because the residual tax burden on repatriations goes down commensurately).

Admittedly, a lower U.S. tax rate by itself will not eliminate base erosion and profit shifting by U.S. multinational firms. The recent working paper by three economists at the Joint Committee on Taxation that I cited earlier emphasizes the nonlinearity of firm responses to tax rates: as a jurisdiction's tax rates approach zero, tax shifting to that jurisdiction ramps up exponentially. But lower domestic rates are directly relevant to firm decisions as to where to site real investment, and can help somewhat to soften firms' hunger for base erosion and profit shifting strategies.²⁹

All these points are redoubled when our overgenerous rules for the deductibility of interest are taken into account.³⁰ First, simply reducing the corporate tax rate without anything more reduces the tax-induced preference for debt financing, because the value of an interest deduction goes down as the the tax rate goes down.

Today, the combination of accelerated depreciation and interest deductibility lead to *negative* effective tax rates on marginal investments in equipment – we *pay* companies to make those investments. This is not a loopy or partisan claim; both the Treasury Department and the Congressional Budget Office came to this conclusion in separate studies during the George W. Bush administration, and the Congressional Budget Office has reaffirmed this point in 2014. So our high statutory tax rate is applied to a narrow

²⁹ Tim Dowd, Paul Landefeld and Anne Moore, *Profit Shifting of U.S. Multinationals*, http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2711968.

³⁰ The systemic harms of tax law's biases in favor of debt finance are analyzed in Ruud de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, International Monetary Fund Staff Discussion Note SDN/11/11 (May 3, 2011), available at <http://www.imf.org/external/pubs/ft/sdn/2011/sdn1111.pdf>.

base that, when turbocharged with interest deductions, leads to precisely the opposite result than that which might be expected.

Overgenerous interest deductibility erodes our domestic corporate tax base in at least three more ways. First, as the earlier example of Apple's bond deal showed, U.S. multinationals today can obtain results that effectively amount to tax-free repatriations of offshore cash (or better), by borrowing in the United States and letting foreign profits ride. Second, the domestic base is eroded through earnings stripping, which again is an arbitrage operation designed to bridge the difference between the U.S. domestic tax rate and a foreign rate; lowering the domestic tax rate and restricting interest deductions paid to offshore affiliates work together to keep taxable profits where the income in fact is earned – the United States.

And finally, our overgenerous rules for interest deductibility lead in general to the overleveraging of U.S. domestic corporations, again eroding the U.S. domestic tax base (because many fixed income investors are tax exempt). At least as important for the economy as a whole, the overleveraging of American businesses makes firms more fragile, with all the attendant dislocations that follow when in stressful circumstances many of them fail.

In the end, corporate or business tax reform will require more than “loophole closing” or revoking tax expenditures to make the numbers work. The missing piece is interest deductibility. A real “thin capitalization” law that operates domestically as well as in cross border cases to constrain a firm's total interest deductions relative to its income not only will bridge the missing revenue gap that this Committee will face, but also will constrain all the other pernicious effects of leveraging outlined above.

For the reasons outlined in this testimony, I recommend that this Committee takes as its most urgent responsibility patching the inversion, earnings stripping and hopscotch lending revenue leaks I described earlier, so that there is a corporate tax system left to reform. Moving forward from there, and although my recommendation may seem backwards, I believe that the most important first step in broader international reform is to make the United States a more congenial tax environment for inbound and domestic investment, through a lower domestic corporate income tax rate and general limitations

on interest deductibility, to limit the effects of domestic base erosion.³¹ These moves will not eliminate the need to redesign the outbound foreign direct investment international tax system, but they should come first simply because they are more important to U.S. businesses, and to American taxpayers, taken as a whole.

³¹ I have a more comprehensive idea for fundamental business income tax reform that I believe should gain bipartisan interest, called the Dual Business Enterprise Income Tax, which I would be pleased to discuss with the Committee and its staff.

‘Competitiveness’ Has Nothing to Do With It

By Edward D. Kleinbard



Edward D. Kleinbard

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The recent wave of corporate inversions has triggered interest in what motivates these tax-driven transactions now. Corporate executives have argued that inversions are explained by an anti-competitive U.S. tax environment, as evidenced by the federal corporate tax statutory rate, which is high by international standards, and by its worldwide tax base. This report explains why that competitiveness narrative is largely fact free, in part by using one recent articulation of it as a case study.

The recent surge in interest in inversion transactions is explained primarily by U.S.-based multinational firms’ increasingly desperate efforts to find a use for their stockpiles of offshore cash (now totaling around \$1 trillion) and by a desire to strip income from the U.S. domestic tax base through intragroup interest payments to a new parent company located in a low-tax foreign jurisdiction. These motives play out against a backdrop of corporate existential despair over the political prospects for tax reform, or for a second repatriation tax holiday of the sort offered by Congress in 2004.

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The Competitiveness Narrative

In the movie *Night After Night*, a young and naive coat check girl admires Mae West’s jewelry. “Goodness,” says the woman, “what beautiful diamonds!” — to which Mae West replies, “Goodness had nothing to do with it.”

And so it is with the recent wave of corporate inversion transactions.¹ Despite the claims of corporate apologists, international business competitiveness has nothing to do with the reasons for these deals.

Inversions are economically rational deals as reimagined by Lewis Carroll’s Humpty Dumpty. In economic substance, a large U.S. firm acquires a much smaller target domiciled in a tax-friendly jurisdiction (for example, Ireland), but the deal is structured as the foreign minnow swallowing the domestic whale. (In the U.S. domestic consolidated return context, these would be called “reverse acquisitions.”) U.S. shareholders of the U.S. firm must pay immediate capital gains tax for the privilege of this upside-down acquisition structure,² and the

¹For brief summaries of recent deals, see, e.g., Martin A. Sullivan, “Lessons From the Last War on Inversions,” *Tax Notes*, May 26, 2014, p. 861; Sullivan, “Short-Term Inversion Fix May Be Necessary,” *Tax Notes*, June 9, 2014, p. 1090; Mindy Herzfeld, “What’s Really Driving Inversions? Walgreens Revisited,” *Tax Notes*, July 28, 2014, p. 393; “Inverse Logic: The Rush of Firms Fleeing America for Tax Reasons Is Set to Continue,” *The Economist*, June 21, 2014.

For more detailed descriptions of recent inversion transactions and the underlying issues they raise for the U.S. tax system, see Stephen E. Shay, “Mr. Secretary, Take the Juice Out of Corporate Expatriations,” *Tax Notes*, July 28, 2014, p. 473; Bret Wells, “Corporate Inversions and Whack-a-Mole Tax Policy,” *Tax Notes*, June 23, 2014, p. 1429; Donald J. Marples and Jane G. Gravelle, “Corporate Expatriation, Inversions, and Mergers: Tax Issues,” Congressional Research Service report R43568 (May 27, 2014); and Wells, “Cant and the Inconvenient Truth About Corporate Inversions,” *Tax Notes*, July 23, 2012, p. 429.

²Laura Saunders, “How a Corporate ‘Inversion’ Could Raise Your Taxes,” *The Wall Street Journal*, Aug. 1, 2014. The technical reason is that reg. section 1.367(a)-3 generally requires shareholders of a U.S. firm who exchange their U.S. target company stock for stock of a foreign acquirer in an otherwise tax-free reorganization to nonetheless recognize gain (but not loss). In turn, the helpful exception to the general rule provided in reg. section 1.367(a)-3(c), which protects U.S. shareholders from current tax in bona fide acquisitive reorganizations by foreign firms, is not available when more than 50 percent of the foreign acquirer’s stock is received by U.S. transferors.

COMMENTARY / SPECIAL REPORT

U.S. company emerges as the nominal subsidiary of a publicly held foreign corporation.

Current section 7874(b), adopted in 2004, effectively negates so-called self-inversions, in which a foreign shell company is employed as the putative acquirer of a U.S. multinational, by treating the foreign company as a U.S. corporation for U.S. federal income tax purposes. Nonetheless, section 7874(b) characterizes a foreign acquirer in a merger of unequals as a bona fide foreign corporation as long as the former shareholders of the U.S. target own less than 80 percent of the combined firm.³ This means that a foreign acquirer in a post-2004 inversion transaction can be as small as one-quarter the size of the U.S. target.

U.S.-based multinationals that are pursuing inversion transactions have been quick to wrap themselves in a mantle of simple virtue, forced to take the unpalatable step of inverting into Irish, U.K., or Swiss public companies because their love goes unrequited by a country that cruelly saddles them with both the highest corporate tax rate in the world and a uniquely punitive worldwide tax base. The result, they claim, is that U.S. tax law has rendered them uncompetitive in international business, which in turn explains the sudden wave of inversion transactions.

Heather Bresch, the CEO of Mylan Inc., a pharmaceutical manufacturer that is pursuing an inversion into a Dutch firm, effectively spoke for many other chief executives when she recently gave an interview describing herself as entering into the inversion deal only “reluctantly.”⁴ In her telling, she has abandoned hope that Congress will overhaul the code to make U.S. companies “more competitive,” and therefore must pursue a tax-driven redomiciliation in the Netherlands against her patriotic instincts, and even though (and here is a point that Bresch forgot to mention) the merger will subject her firm’s taxable owners to capital gains tax.

But all this is a false narrative: U.S. multinationals’ competitiveness arguments are almost entirely fact free. My reasoning is laid out in painful detail in my article “Stateless Income.”⁵ Very briefly, so-

phisticated U.S. firms operate today, not under a worldwide tax system, but rather in an ersatz territorial tax environment, without any of the antiabuse rules that a thoughtful territorial tax system would impose, but subject to a bizarre constraint that they must park their foreign earnings offshore to remain within the ersatz territorial regime. This means that in practice, U.S. firms *do* capture the benefit of operating in lower-tax jurisdictions, both as a cash tax matter and — more importantly — for purposes of U.S. generally accepted accounting principles, which is the lens through which investors and corporate executives measure a firm’s performance.

But the story does not end with U.S. firms simply capturing the benefits of actual business operations in lower-taxed countries. Through large investments in aggressive tax planning technologies, and unencumbered by any of the antiabuse rules to which non-U.S. multinationals domiciled in jurisdictions with better designed territorial systems might be subject, U.S.-domiciled multinational firms have become adroit at moving income that as an economic matter is earned in high-tax foreign countries to very low-taxed ones. (This is the essence of what I mean by “stateless income.”)

Stateless income privileges multinational firms over domestic ones by offering the former the prospect of capturing “tax rents” — low-risk inframarginal returns derived by moving income from high-tax foreign countries to low-tax ones. Other important implications of stateless income include the dissolution of any coherence to the concept of geographic source, the systematic bias toward offshore rather than domestic investment, the more surprising bias in favor of *investment* in high-tax foreign countries to provide the raw feedstock for the generation of low-tax foreign *income* in other countries, the erosion of the U.S. domestic tax base through debt-financed tax arbitrage, many instances of deadweight loss, and — essentially unique to the United States — the exacerbation of the lockout phenomenon, under which the price that U.S. firms pay to enjoy the benefits of extremely low foreign tax rates is the accumulation of

³Some corporate apologists have tried to limit the term “inversion” exclusively to describe the initial pre-2004 wave of self-inversions. These individuals prefer to pretend that the current tsunamis of inversions are just ordinary course cross-border mergers, but this is commercially inaccurate.

⁴Andrew Ross Sorkin, “Reluctantly, Patriot Flees Homeland for Greener Tax Pastures,” *The New York Times*, July 14, 2014.

⁵Edward D. Kleinbard, “Stateless Income,” 11 *Fla. Tax Rev.* 699 (2011). This was the first of three articles studying the phenomenon. Kleinbard, “The Lessons of Stateless Income,” 65 *Tax L. Rev.* 99 (2011), extended the analysis to consider the

(Footnote continued in next column.)

economic efficiency consequences of stateless income and possible policy responses. Kleinbard, “Through a Latte Darkly: Starbucks’s Stateless Income Tax Planning,” *Tax Notes*, June 24, 2013, p. 1315, was a case study of one well-known firm; in light of Starbucks’s business model as a high-street face-to-face retailer, the article concluded that if Starbucks can generate stateless income, anyone can. Condensed versions of the first two articles were published as Kleinbard, “Stateless Income’s Challenge to Tax Policy,” *Tax Notes*, Sept. 5, 2011, p. 1021; and Kleinbard, “Stateless Income’s Challenge to Tax Policy, Part 2,” *Tax Notes*, Sept. 17, 2012, p. 1431.

extraordinary amounts of earnings (about \$2 trillion, by the most recent estimates) and cash (about \$1 trillion) outside the United States.

The problem of stateless income planning is not unique to U.S. multinationals, but we can take a perverse pride in the knowledge that U.S. firms have been world leaders in developing the requisite tax technologies. The situation is now so out of control that in 2012 the G-20 group of countries deputized the OECD to propose, on an extremely accelerated timetable, a concrete set of action plans to address what the OECD calls base erosion and profit-shifting problems.

U.S. firms incur costs to operate their stateless income tax machinery, which is wasteful, but at the same time enjoy an essentially unfettered tax planning environment in which to strip income from high-tax foreign jurisdictions to very low-taxed ones. And this sits on top of transfer pricing, selective leverage of group members, and other devices used to move income that economically is earned in the United States to foreign affiliates.

As a result, whether one measures effective marginal or overall tax rates, sophisticated U.S. multinational firms are burdened by tax rates that are the envy of their international peers. And this is true whether one studies cash taxes paid or — more important in the case of public firms — U.S. GAAP accounting for taxes. *Stateless Image* reviews a raft of data on this point, but to take one more recent example, the Government Accountability Office observed in 2013 regarding cash taxes paid:

For tax year 2010 (the most recent information available), profitable U.S. corporations that filed a Schedule M-3 paid U.S. federal income taxes amounting to about 13 percent of the pretax worldwide income that they reported in their financial statements (for those entities included in their tax returns). When foreign and state and local income taxes are included, the ETR [effective tax rate] for profitable filers increases to around 17 percent. The inclusion of unprofitable firms, which pay little if any tax, also raises the ETRs because the losses of unprofitable corporations greatly reduce the denominator of the measures. Even with the inclusion of unprofitable filers, which increased the average worldwide ETR to 22.7 percent, all of the ETRs were well below the top statutory tax rate of 35 percent.⁶

⁶GAO, “Corporate Income Tax: Effective Tax Rates Can Differ Significantly From the Statutory Rate,” GAO-13-520 (May 2013). See also Kleinbard, “Stateless Income,” *supra* note 5, at 722-724, 737-750.

It is true of course that the federal corporate tax rate — nominally, 35 percent — is too high relative to world norms, and that the ersatz territorial system requires firms to waste money in tax planning and structuring, but effective marginal tax rates and overall effective tax rates reach the level of the U.S. headline rate only when firms studiously ignore the feast of tax planning opportunities laid out before them on the groaning board of corporate tax expenditures. Moreover, and contrary to the claims of corporate lobbyists, under the usual water’s-edge principle of state taxation, the foreign income of a U.S. multinational when repatriated usually is taxed by U.S. states either very lightly or not at all (other than a couple of oddball cases involving income booked in certain tax havens).⁷ As a result, and without regard to firms’ stateless income tax planning, to claim that U.S. firms face a tax rate approaching 40 percent on their foreign income by virtue of their state tax liabilities is simply false.

To offer just one domestic example, under current U.S. law, the combination of accelerated tax depreciation on new equipment purchases and the deductibility of interest expense on debt incurred to purchase that equipment actually yields a *negative* effective tax rate. This means that we collectively pay companies to make those investments.⁸

In the international arena, U.S. multinational firms have established themselves as world leaders in global tax avoidance strategies, through the generation of stateless income. The result is that many well-known U.S. multinationals today enjoy single-digit effective tax rates on their foreign income, and effective tax rates on their *worldwide* income far below the nominal 35 percent federal corporate tax rate. This is true both as a cash tax and as a GAAP matter.

We can see the payoffs to stateless income tax planning through the evidence presented in a recent study, to the effect that in 2006, controlled foreign corporation subsidiaries of U.S. firms faced a “cash” average (that is, effective) foreign tax rate (foreign taxes paid divided by pretax earnings and profits) of only 15.6 percent. With the exception of mining, the most tax-disadvantaged industry for U.S. firms outside the United States was retail trade, in which CFCs faced an average foreign tax rate of 22.5 percent.⁹ Leslie Robinson of Dartmouth’s Tuck

⁷Special state tax rules not considered in the text can apply to banks and other financial services firms.

⁸Congressional Budget Office, “Taxing Capital Income: Effective Rates and Approaches to Reform” (Oct. 1, 2005).

⁹Melissa Costa and Jennifer Gravelle, “Taxing Multinationals: Average Tax Rates,” 65 *Tax L. Rev.* 391, at Table 1 (2012).

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School of Business recently summarized the academic financial accounting literature in testimony before the Senate Finance Committee as establishing that “there is no evidence that U.S. MNCs face greater tax burdens as a consequence of how foreign profits are taxed, relative to their competitors.”¹⁰

From a GAAP perspective, the magnitude of the tax discounts to which firms have helped themselves is apparent not only by examining their effective tax rate reconciliations in their financial accounting statements, but also by glancing at firms’ aggregate foreign earnings designated for GAAP purposes as “permanently reinvested” offshore low-taxed earnings (about \$2 trillion), as well as their stockpile of offshore low-taxed cash (about \$1 trillion).¹¹ (I explain the financial accounting terminology immediately below.) In short, no matter what perspective one adopts, the tax burdens imposed on the foreign operations of U.S. firms are far lower than that implied by the nominal U.S. headline rate.

Investors and managers care about GAAP accounting for taxes. They have no direct access to tax returns, have no reason to believe that tax measures of revenue and expense are superior to GAAP measures or are more consistent over time, and further need to understand how much of a company’s cash tax rate in any given year reflects timing differences that will reverse in subsequent years. It therefore is worth reminding non-accountants of how a U.S. multinational firm’s tax rate looks when viewed through the lens of GAAP.¹²

Financial accounting and tax accounting are quite different, but financial accountants of course think that their worldview is correct, and so differences between actual cash tax liabilities and what the financial accountants would have expected as tax liabilities must be explained. Financial accountants therefore start with the financial accounting measure of earnings before income taxes (EBIT), apply a 35 percent tax rate to it, and then look up and ask, “why isn’t that the firm’s actual tax bill for the year?”

There are several answers that explain the difference in outcomes, but putting aside audits and

potential disagreements as to the interpretation of the law between the firm and the IRS, the answers basically fall into two groups. First, there are temporary differences, for example when the tax rules for depreciation are different from the financial accounting rules for depreciation. These differences theoretically reverse themselves over time.

The financial accountants deal with these timing differences through the deferred tax assets/liabilities accounts. These accounts keep track of all the individual timing differences between when cash taxes actually are due and when under financial accounting principles those taxes would have been due. (Of course, if the firm stays in business, the aggregate balance may never change, as depreciation on new assets replaces reversal of depreciation on old assets, and so on.) Because future cash tax bills will reflect the reversal of these timing differences, the balance of the deferred tax liability (more cash taxes to be paid in the future because “too little” is due this year) or deferred tax asset (“too much” tax actually paid this year relative to what financial accountants believe is the firm’s income this year) is shown on the consolidated balance sheet. Temporary differences thus affect cash flow, but not GAAP effective tax rates or financial accounting net income (and therefore earnings per share).

The other accounting differences are “permanent.” Interest on tax-exempt bonds is the simplest example. The financial accountants see tax-exempt bond coupons as income and therefore would expect a 35 percent tax bill, but of course no tax will ever be due. So the financial accountants create a second category of book-tax differences that does not appear labeled as such on the face of the balance sheet or income statement, but that is shown in the tax footnote to all GAAP financials. This is the effective tax rate reconciliation table, which lists those items that permanently reduce (or increase) a firm’s tax rate from the statutory 35 percent tax rate.

Permanent differences are not liabilities or assets, but they do affect net effective tax rates shown on the face of the firm’s income statement (financial accounting tax expense divided by EBIT). This means that for all practical purposes — because GAAP is the lens through which all relevant private parties view a company — a permanent tax difference simply negates the nominal statutory rate. Firms yearn for permanent differences; at healthy firms with strong cash flows, only the corporate treasurer gets very excited about timing differences.

Savvy U.S.-based multinational firms show very low GAAP effective tax rates because they do some actual business in low-taxed jurisdictions and engage in aggressive stateless income tax planning, and because they record the resulting low foreign

¹⁰Testimony of Leslie Robinson, associate professor, Tuck School of Business at Dartmouth University, before the Senate Finance Committee’s hearing titled, “The U.S. Tax Code: Love It, Leave It or Reform It!” (July 22, 2014).

¹¹Richard Rubin, “Cash Abroad Rises \$206 Billion as Apple to IBM Avoid U.S. Taxes,” Bloomberg Business News, Mar. 12, 2014.

¹²Kleinbard, “Stateless Income,” *supra* note 5, at 744-750, covers this ground in a slightly more formal fashion than do the next few paragraphs.

tax rates that they pay as a permanent difference between the GAAP measure of tax expense and the nominal 35 percent tax rate. How is this possible, given that corporate apologists keep reminding us that the United States imposes worldwide tax on U.S. corporations?

Under GAAP accounting, a firm presents a worldwide consolidated picture of its operations and results, which therefore includes all of its foreign operations. But the income of foreign subsidiaries of a U.S. firm that are derived from active business operations are not subject to actual tax in the United States until those earnings are returned to the United States as actual dividends or as constructive dividends under section 956 (for example, when a foreign subsidiary lends money to its U.S. parent). This leaves financial accountants in a quandary — U.S. federal income tax will be due only when the active earnings of foreign subsidiaries are repatriated as dividends, but that tax trigger is under the control of the parent company. This fact pattern therefore is not a clear timing difference that will automatically reverse, and it is not a purely permanent difference like tax-exempt bond interest income.

Financial accountants resolve this conundrum by requiring a U.S. firm to record as a liability the U.S. tax bill on the ultimate repatriation to the United States of its foreign earnings, *unless* the firm demonstrates to the satisfaction of its accountants that it has no present intention to repatriate the money and incur the tax.¹³ Readers who are financial accountants will, I hope, forgive me when I suggest that the financial accounting profession has not been the sternest of taskmasters when it comes to reviewing a client's claims regarding its plans to redeploy its foreign cash hoard offshore.

Amounts so designated are colloquially referred to as “permanently reinvested earnings.” In reality, there is nothing permanent about the designation: Firms do sometimes change their minds, with the permission of their accountants. When eBay Inc. made news recently about repatriating its foreign cash, that is what happened — it changed its mind and told its accountants that perhaps it would repatriate its foreign cash hoard after all; as a result, it was required to provide immediately for the U.S. tax cost for doing so, even though it had not yet actually triggered the tax bill by moving the money.

The reduction from the 35 percent statutory tax rate in a firm's effective tax rate reconciliation in the tax footnote for “the effect of foreign operations” or words to that effect thus signals to investors that the company will not in fact pay 35 percent tax on all of

its earnings. It is a discount from the U.S. tax that would have been paid if the United States in fact taxed the worldwide income of the firm, attributable to the fact that (1) the overall group's foreign earnings are not currently taxed in the United States (because the earnings are derived by foreign subsidiaries engaged in active business operations), and (2) the firm represents to the accountants that its intentions are to permanently reinvest the earnings outside the United States. As far as investors and management alike are concerned, because this item is a “permanent” difference for GAAP purposes, it serves as a final discount to the nominal U.S. federal corporate tax rate.

Under U.S. GAAP, a firm's net effective tax rate is presented as a single worldwide rate. If one makes some plausible assumptions about the geographic mix of a company's business, this means that the tax rate actually imposed on a U.S. multinational's non-U.S. income can be much lower than that imposed on the non-U.S. business of a foreign multinational that appears on its face to have the same effective tax rate. In such cases, the competitiveness argument immediately collapses.

For example, imagine that all firms wherever domiciled pay a 35 percent effective tax rate on their U.S. income and lower rates on their non-U.S. income. A U.S. multinational firm earns \$1 billion in EBIT, does 60 percent of its business in the United States, and 40 percent abroad. It reports to investors that its effective tax rate is 25 percent. Its tax expense therefore is \$250 million. A Freedomian enterprise has exactly the same profile in all respects, except that it earns 40 percent of its income in the United States and the rest abroad.

The U.S. firm's tax expense for its U.S. operations alone would be \$210 million ($0.35 \times \600 million). For the U.S. firm to record a \$250 million worldwide tax expense, it must therefore have incurred a \$40 million tax expense for its non-U.S. income, which is a 10 percent effective tax rate on its \$400 million of non-U.S. income. The Freedomian firm, by contrast, will have an implicit U.S. tax expense of \$140 million ($0.35 \times \400 million), and \$110 million of tax expense attributable to its non-U.S. operations, which is an 18.3 percent effective rate. The U.S. firm completely dominates the Freedomian enterprise along the standard competitiveness yardstick.

This example is not entirely fanciful. Consider the February 2014 Form 10-K of Bresch's firm, Mylan. The Form 10-K informed investors and other interested stakeholders that Mylan's *worldwide* GAAP effective tax rate — the taxes it paid or set aside a provision to pay, divided by its worldwide GAAP income — was not 35 percent (the U.S.

¹³*Id.* at 745-746.

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statutory corporate tax rate) or some greater rate, but 16.2 percent in 2013, 20 percent in 2012, and 17.7 percent in 2011.¹⁴

The firm's tax footnote showed a permanent discount for 2013 from the 35 percent statutory tax rate as applied to worldwide income of 13 percentage points, attributable to Mylan's "foreign [tax] rate differential." (The reduction was smaller in 2012 but about the same in 2011.) In other words, Mylan told its shareholders and other stakeholders that, without regard to any other "permanent" differences, the benefit Mylan captured by paying low foreign taxes by itself garnered Mylan a 13 percentage point discount from its nominal worldwide income tax bill (not just for its foreign income — its *worldwide* income) from an "uncompetitive" 35 percent tax rate to 22 percent.

In 2013 Mylan derived about 57 percent of its worldwide revenues (essentially, gross receipts) from the United States; yet, as just noted, told investors that its worldwide effective tax rate was 16.2 percent.¹⁵ Assume, just by way of illustration, that Mylan's taxable profits followed its revenues as allocated for financial accounting (and presumptively, management) purposes — admittedly, a heroic assumption, thanks to stateless income planning internationally, and tax expenditures domestically — and that Mylan, through adroit domestic tax planning, incurred a 25 percent effective tax rate on its U.S. income (federal and state taxes combined). This would imply that Mylan's tax expense for its foreign profits was roughly 4.5 percent.¹⁶

We would have a clearer window into Mylan's actual foreign effective tax rate if it more faithfully complied with the SEC requirement that it identify in its tax footnote the U.S. tax cost of repatriating its offshore cash (from which one can deduce the quantum of foreign tax credits that would come along with the repatriation), but like the vast ma-

jority of companies in this situation, Mylan modestly avers that calculating this number is "not practicable."

AbbVie Inc., another inverting firm, reported in its 2013 annual report's tax footnote an 11.5 percent reduction for 2013 in its global statutory tax rate for "the effect of foreign operations." (The effect of foreign operations was a much greater number in 2011 and 2012.) Again, this means that AbbVie is telling investors and its own managers that it does not operate in a 35 percent tax rate environment at all; to the contrary, AbbVie's effective *global* tax rate for 2013 (again, including U.S. taxes on its U.S. domestic income, where permanently reinvested earnings are irrelevant), after some smaller permanent differences in both directions, was 22.6 percent. This is a permanent tax discount of about one-third off the headline federal rate insofar as AbbVie's investors and management are concerned.

But what about the anti-competitive effects of U.S. domiciled multinationals' "trapped cash?" As readers know, U.S. tax law (but not that of most other countries) effectively induces U.S. multinational firms to keep their surplus low-taxed foreign profits in their foreign subsidiaries because the U.S. parent would be required to pay full U.S. tax on the repatriation of those earnings (less a credit for any foreign income taxes already paid). As a result, U.S. firms now hold about \$1 trillion of "permanently reinvested" earnings in cash (usually, U.S.-dollar-denominated short-term debt instruments, like Treasury bills, bank deposits, commercial paper, and money market funds).¹⁷ As explained above, by doing so firms not only minimize their cash tax liabilities but also help themselves to a permanent discount on their GAAP financials from the statutory corporate tax rate charge that would otherwise apply to their pretax GAAP earnings.

It is a great overstatement, popular in the business press, to claim that the cash "trapped" by this rule has large businesses, competitive implications, or that the repeal of current law would lead to a wave of business reinvestment in the United States. This is a vast overstatement. First, a U.S. multinational's offshore cash hoard invariably is invested in the U.S. economy, in the form of investments in dollar assets.

Second, as Apple Inc. demonstrated in 2013, large multinational firms often can access their offshore earnings without incurring a tax cost, simply by borrowing in the United States and using the earnings on the offshore cash to pay the interest costs. (The interest earned on a firm's offshore cash hoard is includable in the U.S. parent's income as subpart

¹⁴The *New York Times* article cited in note 4, *supra*, appears to have accepted at face value Bresch's recollection that her firm's effective tax rate was "about 25 percent." The February 2014 Form 10-K summarized in the text contains the most recent data released to investors, because quarterly condensed financial statements do not contain an effective tax rate reconciliation. It is a pity that Bresch did not remember with greater clarity the information her firm provided to its owners and the interested public in its audited financial statements.

¹⁵Mylan Inc. Form 10-K (filed Feb. 27, 2014), note 13 to audited financial statements.

¹⁶That is, 0.25 (assumed domestic effective tax rate) \times 0.57 (presumptive fraction of profits attributable to the United States) = 14.25 percent effective tax rate on global profits attributable to U.S. federal and state taxes. On the foreign side, $0.045 \times 0.43 = 1.95$ percent additional effective tax on global profits, for a total of 16.2 percent effective tax rate on global income.

¹⁷See *supra* note 11.

F income, and therefore can be repatriated free of any additional tax cost.) The U.S. parent's income inclusion of the interest earned on its offshore cash offsets the tax deduction for the interest expense on the firm's U.S. borrowing, and the firm is left in the same economic position as if it had simply repatriated the cash tax free (plus or minus a spread for differences in interest rates between the two streams).

Third, we conducted a natural experiment, in the form of a corporate offshore cash tax amnesty in 2004; more than \$300 billion over and above the usual level came back to the United States from foreign subsidiaries of U.S. firms. Most studies, however, have concluded that the cash went to prop up stock prices through stock buybacks or dividends, not to invest in productive capacity (as the law nominally required).¹⁸

If large U.S. multinationals were credit constrained (as is true for many small wholly domestic enterprises), the "trapped cash" story might have some modest traction to it, but almost all these firms are not: Their domestic cash flow and their ability to borrow in the U.S. capital markets (economically but not technically secured by their offshore cash) are more than sufficient to fund any domestic investments they wish to make. The meager earnings on the trapped cash are dilutive of earnings per share, but this is not a business competitiveness crisis.

In sum, there is no credible evidence as a matter of cash taxes or as a matter of GAAP accounting that U.S. firms are at a fundamental international business competitive disadvantage under current law. Again, this is not to excuse current law or to hold it up as an exemplar; it is highly distortive and inefficient.¹⁹ But one of the few deficiencies it has avoided is imposing an unfair international business tax competitive burden on sophisticated U.S. multinationals.

If this conclusion seems incredible, ask yourself this: Why is it that following the first rush of self-inversions more than a decade ago, inversions have been so infrequent relative to cross-border mergers and acquisitions activity generally over the last decade (that is, since the introduction of section 7874), until this year?²⁰ How have most U.S. multi-

nationals managed to compete for the last decade if inversions alone are the economically compelled self-help route to a competitive tax environment? Something else must be going on to explain why U.S. firms believed themselves to be competitive from 2004 to 2013, and only now are scouring the earth for suitable bite-sized merger partners to use as inversion vehicles.

A Competitiveness Fable

Notwithstanding the contrary evidence from their tax returns and GAAP financial statements, U.S. multinationals and their apologists continue to hammer the international business competitiveness narrative to justify inversion transactions. One leading example of this is a recent op-ed published in *The Wall Street Journal* by Walter Galvin, the retired vice chair and CFO of Emerson Electric Co., in which he presents his story of how the U.S. tax system conspired to help Emerson's French arch rival, Schneider Electric, steal American Power Conversion Corp. (APC) from Emerson's grasp.²¹ Galvin has offered the same story in testimony before the House Ways and Means Committee, and it has figured prominently in papers authored by the Alliance for Competitive Taxation, a lobbying organization.

As related in a corporate autobiography, *Performance Without Compromise: How Emerson Consistently Achieves Winning Results*,²² Galvin is a talented financial executive of great personal probity. A close reading of the public record surrounding the APC deal, however, leads to the conclusion that this gripping tale represents a corporate false memory, like the adult recollection of a childhood trauma that never took place.

Here in Galvin's words is the indignity worked on Emerson by the U.S. corporate tax system:

In 2006, Emerson sought to acquire a company called American Power Conversion (APC). This was a Rhode Island-based company that made more than half of its earnings outside the U.S. Unfortunately, Emerson competed against Schneider Electric, a French company, to acquire APC. Emerson offered more than \$5

transactions. Neither are redomiciliations of firms from one foreign domicile (e.g., the Caymans) to another (e.g., Ireland) to lock in tax treaty benefits. Of the relative handful that remain on the list, most were small firms by multinational standards; Eaton Corp. was probably the biggest exception to that.

¹⁹Walter Galvin, "Why Corporate Inversions Are All the Rage," *The Wall Street Journal*, July 27, 2014.

²⁰Charles F. Knight (with Davis Dyer), *Performance Without Compromise: How Emerson Consistently Achieves Winning Results* (2005). The author was at the time of publication the chair emeritus of Emerson.

¹⁸Dharmika Dharmapala et al., "Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act," 66 *J. Fin.* 753 (2011).

¹⁹These inefficiencies in fact are the true competitiveness costs of the current U.S. tax system, but these costs must be netted against the savings conferred by the unconstrained de facto territorial regime in which U.S. companies operate.

²⁰Some summaries overcount here. Bona fide acquisitions by larger foreign firms of smaller U.S. firms are not inversion

(Footnote continued in next column.)

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billion, but ultimately Schneider acquired APC by offering a bid in excess of \$6 billion.

Why was Schneider willing to offer more? Schneider outbid us because France's tax code — typical of most OECD countries — exempts 95 percent of foreign-source income from taxation, while the U.S. tax code fully taxes such income. APC's profits were worth more to Schneider because, once absorbed, APC's global profits (net of the taxes paid in the countries where those profits were earned) could be repatriated to Schneider's headquarters in France, where they would be taxed at less than 2 percent.

In contrast, earnings repatriated to the U.S. are subject to a tax rate of nearly 40 percent, with a credit for taxes paid abroad on that income. That dramatic difference made it possible for Schneider to offer more for APC. So what had once been an American company became French.

APC was a U.S. firm with extensive low-cost manufacturing operations outside the United States. APC specialized in manufacturing uninterruptible power supplies (UPS) and other critical power systems, predominantly for smaller commercial customers, and had by far the largest global market share by dollar volume in the UPS markets.²³ Schneider (through its MGE subsidiary) was a major player in the market for larger-scale UPS systems, particularly in Europe. Emerson also had a substantial UPS business through its subsidiary Liebert Corp.; it had about the same share of the global market as did Schneider, but was stronger in North America.

At the time it was acquired, APC had enjoyed strong top-line revenue growth but had struggled to generate comparable net income growth; in fact, its profits for the six-month accounting period ending before the acquisition were down sharply on a year-over-year basis. Compared with industrial giants Schneider and Emerson, APC was a smaller and more specialized company, probably with capital constraints that did not apply to the other two. At the time of the Schneider deal, the *Financial Times* cattily observed that "APC is one of the most shorted stocks, and the least liked by analysts, in the S&P 500."²⁴

²³Frost & Sullivan, *World UPS Markets*, Figure 2-19 (2006); Jennifer Levitz, "APC Deal Reflects Demand for Data Protection; France's Schneider Electric Agrees to Pay \$6.1 Billion for Emerging U.S. Rival," *The Wall Street Journal*, Oct. 31, 2006.

²⁴Lex column, *Financial Times*, Oct. 30, 2006. A parallel story helpfully observed that "margins at APC are under pressure." (Footnote continued in next column.)

Schneider paid a 30 percent premium over APC's stock price (which had been performing poorly) to acquire APC. This valuation was universally criticized in the financial press as extremely aggressive, but within a year APC's performance within the Schneider group took some of the pressure off the earlier criticism.²⁵

No doubt in response to the blistering criticism among financial analysts and the financial press, Schneider prepared a 49-page slide show to justify the APC acquisition. The word "tax" appears nowhere in the document. The same is true of the unusually long and defensive press release that Schneider prepared that covered much of the same ground.

Schneider's CEO, Jean-Pascal Tricoire, was brand new to the job at the time, and very young by French CEO standards (43). The press described him as eager to make his mark by reorienting Schneider's business to critical power supplies and other "smart" products.²⁶

For its part, Emerson had a legendary corporate culture (as reflected in the corporate autobiography referenced above). A 2006 *Financial Times* profile, published shortly before the APC takeover battle, described the firm as highly disciplined and "relentlessly profitable," with a "near-unbroken run of earnings increases stretching back 50 years."²⁷ The article emphasized that Emerson believed its central tasks lay in developing its technology and in grooming its senior executives to take on new responsibilities. The CEO of Emerson closed the profile by saying, "People may call us boring — but if we are, then boring is OK."²⁸ Emerson had throughout this period a very high GAAP global effective tax rate, close to the statutory 35 percent rate.

APC enjoyed tax holidays in China and India, and booked a large effective tax rate benefit for "foreign earnings taxed at rates lower than the U.S. statutory rate," attributable primarily to its operations in Ireland and the Philippines.²⁹ (As is typically the case, the annual financial statement does not give sufficient detail to offer any independent judgment on APC's transfer pricing practices or the

cash conversion is poor, rising raw material costs pose an ongoing threat, while projected cost synergies [in the Schneider deal] look aggressive."

²⁵Lex column, *Financial Times*, Oct. 23, 2007.

²⁶Pan Kwan Yuk, "Schneider Chief Makes His Power Plays Abroad," *Financial Times*, Nov. 21, 2007.

²⁷Peter Marsh, "When Boring Beats Buccaneering," *Financial Times*, June 7, 2006.

²⁸*Id.*

²⁹APC 2005 Form 10-K, at 55. Because APC was acquired in 2006, this is the last annual report that APC filed with the SEC.

like.) APC's GAAP effective tax rates (after removing some extraordinary items) were 26 percent, 25 percent, and 22 percent in 2003, 2004, and 2005, respectively. Schneider's French GAAP effective tax rates for the same period (other than 2003) were a bit higher, in the 28 to 29 percent range. (The French statutory corporate tax rate at this time was essentially identical to the U.S. federal statutory rate.) So to investors, the addition of APC, a U.S. company, to the mix of Schneider's businesses might be expected to reduce Schneider's effective tax rate modestly, not because of French tax shenanigans, but because APC's effective tax rate was already somewhat lower than Schneider's. By 2009, by which time APC had been fully digested, Schneider's global effective tax rate was 24.3 percent.

Now we can begin to dissect Galvin's claim that the advantages afforded by France's territorial tax system explained why Schneider outbid Emerson by 20 percent in their battle to take over APC. On its face, this 20 percent price difference in the offers that the two firms made is an implausibly large premium to attribute to tax rate differentials. And in fact, when you think about it for a minute, you realize that the story is precisely backwards.

The key fact is that APC was a U.S. company with some foreign subsidiaries. Schneider's purchase did not miraculously spring APC's CFCs out from under APC. Far from helping APC escape U.S. tax, Schneider became enmeshed more deeply in the U.S. tax web because it now owned a major U.S. subsidiary that in turned owned non-French, non-U.S. subsidiaries. APC's foreign earnings remained inside the U.S. tax system.

As a GAAP matter, if Emerson had bought APC, Emerson would presumably have been able to continue APC's practice of classifying its low-taxed foreign earnings as permanently reinvested outside the United States, thereby obtaining a significant GAAP effective tax rate benefit relative to its very high effective tax rate ex-APC.³⁰ In other words, Emerson would have gained entree into APC's ersatz territorial tax environment by acquiring that firm; Emerson was never precluded from capturing the benefits of lower foreign tax rates.

As a cash tax matter, Galvin observes that the repatriation to France of APC's earnings through dividends would be subject to only a 2 percent French tax. This ignores the full 35 percent U.S. federal income tax that (in Galvin's telling) would be imposed on APC's domestic and foreign earnings, when those foreign earnings were distributed

up the chain, plus a 5 percent U.S. withholding tax on dividends from APC to Schneider (before the 2009 amendment to the France-U.S. tax treaty). It further ignores the fact that dividends from APC to Emerson would have been entirely tax free because APC would have been a member of the Emerson consolidated group.

Where is the tax disadvantage there?

In a March 2014 white paper, the Alliance for Competitive Taxation, a lobbying group, sought to amend and restate Galvin's points here by suggesting that what he meant to have written was that *future* non-U.S. investments relating to the APC business would be structured directly underneath Schneider and therefore would bear a lighter net tax burden in Schneider's hands than they would in Emerson's, once fully repatriated to the parent company (without actually identifying any underlying income tax rate applicable to these hypothetical future investments).³¹ The alliance's suggested corporate structure for future investments by Schneider is a presumptively sensible starting place, but the comparison is not.

First, the purchase price paid for APC related to a large extent to the present and future earnings power of APC and its existing foreign subsidiaries (once the supply chain and similar problems identified below were resolved), all of which remained in the U.S. tax net after the Schneider acquisition. Second, had Emerson bought APC, it would presumably have been savvy enough *not* to repatriate APC's low-taxed foreign earnings; to do so would have been a value-destroying move. By not repatriating low-taxed foreign earnings on a current basis, Emerson would have enjoyed for GAAP and for cash tax purposes a quasi-territorial tax environment outcome indistinguishable from that enjoyed by Schneider. Most U.S. multinationals are able to fund their U.S. cash needs without difficulty out of domestic cash flow, domestic borrowing capacity, and judicious repatriations of a steady stream of foreign earnings that bring with them highly concentrated FTCs sufficient to cover the U.S. repatriation tax.³²

Third, Schneider, with all the advantages of a territorial tax system, in fact reported a *higher* effective tax rate in the years leading up to the merger than did APC, a company burdened by the allegedly uncompetitive U.S. system. Why is it inevitable then that new investments would be

³¹Alliance for Competitive Taxation, "ACT Tax Facts, U.S. Tax Code Encourages Foreign Takeovers of U.S. Companies" (Mar. 2014).

³²For a description of a tax department's "tax distillery" in operation, see Kleinbard, "Stateless Income," *supra* note 5, at 725-727.

³⁰APC's profits were roughly half the size of Emerson's, so in effect one-third of Emerson's post-acquisition EBIT would have become subject to a tax expense in the low 20s.

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subject to light effective tax rates? Emerson's effective tax rate in this period was higher still, but the right question to draw from this is, why was Emerson unable to control its effective tax rate as well as did APC or many other U.S. companies? The U.S. tax system and U.S. GAAP offered discounts of all sorts and sizes from the headline corporate tax rate, and Emerson itself had significant international operations. Emerson's possible frustration with its own tax profile should not be read as proof of a general anti-competitive U.S. tax environment.

If tax differences do not on their face explain the big difference in valuations for APC, what does? One explanation, familiar to anyone who has worked on M&A deals, is the difference in corporate cultures — a very young “outsider” CEO at Schneider, anxious to make his mark, competing against a highly disciplined U.S. firm whose internal financial analysts no doubt shared the view universally expressed on the street that Schneider's valuation was much too high.

But Schneider was not reckless. It had a clear strategy, and one that had nothing to do with taxes. Schneider and Emerson were both on acquisition binges because the electric equipment industry (and in particular, the critical power systems segment) was undergoing rapid consolidation. Schneider wanted to move aggressively into “smarter” product lines like critical power systems. Schneider saw great complementarity in geographic penetration and product lines between its MGE business and APC, and further estimated that, as by far the largest player in the world markets in the UPS space following the acquisition, it would be able to radically cut costs and get control over APC's production chain problems.

Schneider's press release for the deal summed all this up, emphasizing that the valuation was justified, among other reasons, because the deal would “generate significant [operational] synergies (including, among other things, purchasing, R&D, support functions, sales, services) estimated at around US\$220 million, leverage significant R&D programs and APC's innovative architecture,” and “accelerate the profitability improvement of large UPS systems thanks to MGE's strengths in services.”³³

As it happens, history appears to have proved Schneider's judgment to be correct. By the time

³³Schneider Electric SA press release (Oct. 30, 2006). Unlike documents prepared by tax lobbyists, M&A press releases are not unconstrained puff pieces, since they are filed with securities regulators and relied on by investors.

Schneider published its 2006 annual report, filed with its French securities regulators in March 2007, its CEO reported that:

APC is now part of Schneider Electric. It is the global leader in integrated critical power and cooling systems, with 2006 revenue of close to \$2.4 billion — a 20 percent increase from 2005.

This transaction gives Schneider Electric world leadership in one of the fastest growing areas of electrical distribution. . . . We've created a critical power and cooling services business unit that combines APC's resources with those of Schneider Electric subsidiary MGE UPS Systems. Their people have been brought together under a single management team.

We confirm our synergy target of \$220 million. If we meet this target — and we fully intend to do so — the value created will total \$3.3 billion.³⁴

In addition to this highly credible business case, there was another fascinating back story at work. According to *The Wall Street Journal*, a few months before the APC deal, Schneider itself had been the object of a \$25.5 billion takeover bid from a consortium of private equity firms. (Had the deal been consummated, it would have been the largest private equity deal in history to that point.) The article explained that “while the APC purchase has strategic merit, it was also a defensive move to help protect Schneider from another such approach, people close to the matter say.”³⁵

In short, the tax story on its face is backwards, and the business explanations for Schneider's valuation of APC are plausible and well documented. Yet Galvin's competitiveness narrative reappears whenever corporate apologists are asked to defend inversion transactions, without anyone pausing to ask whether the story possibly makes any sense, or looking at the public record.

But wait, there's more. As Galvin points out, in 2010 Emerson acquired Chloride, a U.K. firm that was arguably the largest remaining independent UPS specialist manufacturer in the world. (It was the fourth largest UPS firm in the world at the time, behind Schneider, Emerson, and Eaton.) Galvin is right that this provided a tax-efficient way to deploy Emerson's offshore cash, but the story is a bit more nuanced than that. Emerson began its takeover attempts in 2008, offering to pay £270 per share for Chloride, which the latter promptly rejected.

³⁴Schneider Electric SA 2006 Annual Report, at 6.

³⁵Jason Singer, “Schneider Got Takeover Approach Before Deciding to Purchase APC,” *The Wall Street Journal*, Nov. 4, 2006.

Two years later Emerson returned, and in a move that bemused the financial press, raised its two-year-old offer by £5 per share, to £275. A bidding war broke out, and in the end Emerson prevailed, paying £375 per share. The ironic part is that the underbidder was ABB, the Swiss electric equipment maker, which was itself desperate to get into the UPS business before the continuing wave of global consolidation locked it out. So the U.S. tax system, which allegedly is punitive in its application to U.S. multinationals, did not stand in the way of Emerson acquiring a *foreign* target (unlike APC) and outbidding a rival domiciled in one of the world's great fiscal paradises.

What Really Is Going On?

If the competitiveness story is threadbare, what does explain the sudden tsunami of inversions? Here is my narrative, which I believe to be consistent with the public record and reasonable readings of the tax tea leaves.

The short answer is that the current mania for inversions is driven by U.S. firms' increasingly desperate need to do something with their \$1 trillion in offshore cash, and by a desire to reduce U.S. domestic tax burdens on U.S. domestic operating earnings.

The year 2004 is a good place to start, because that year's corporate offshore cash tax amnesty (section 965) had a perfectly predictable knock-on effect, which was to convince corporate America that the one-time never-to-be-repeated tax amnesty would inevitably be followed by additional tax amnesties, if only multinationals would importune their legislators enough.³⁶ The 2004 law thus created a massive incentive to accumulate as much permanently reinvested earnings in the form of cash as possible.³⁷ At the same time, the Big Four accounting firms, no doubt chastened by their overzealous selling of risible corporate tax shelter deals, scaled up their educational mission to teach the less savvy U.S.-based multinationals how to generate serious quantities of stateless income.

The convergence of these two phenomena led to an explosion in stateless income strategies and in the total stockpile of U.S. multinationals' permanently reinvested earnings. But U.S. multinationals

are now hoist by their own petard. The best of the stateless income planners are drowning in low-taxed overseas cash, which today earns only negligible rates of interest. The meager earnings on the cash drag down earnings per share, while shareholders focus with laser intensity on that cash as more usefully deployed directly in their hands.

It is less than a secret that firms in this position really have no intention at all of "permanently" reinvesting the cash overseas, but instead are counting the days until the money can be used to goose share prices through stock buybacks and dividends. The Apple solution (domestic leverage) cannot absorb all this cash, as firms other than Apple with existing debt might find themselves overleveraged if they pursued this solution indiscriminately. And in turn, one hears whispers from time to time that the financial accountants to firms sitting on vast hoards of offshore cash are getting more and more uncomfortable accepting representations as to the use of the offshore cash that fly in the face of financial and commercial logic.

The obvious solution from the perspective of the multinationals would have been a second, and then a third and fourth, one-time-only repatriation holiday, but there are still hard feelings in Congress surrounding the differences between the representations made to legislators relating to how the cash from the first holiday would be used, and what in fact happened. The other *deus ex machina* resolution was thought to be fundamental corporate tax reform, because most observers believe that whatever the precise contours of that legislation, one of its key components will be to reset the clock on permanently reinvested earnings by requiring their inclusion in the income of U.S. shareholders at some discounted rate over some reasonable period of time. But congressional paralysis has led to growing existential despair, and multinationals' representatives and earnest policy wonks alike rightly fret that they may never live to see sensible fundamental corporate tax reform legislation.

Against this desperate backdrop, extraordinary measures can seem almost sensible, and so we see the rush by cash-rich firms to impose tax on all their shareholders, and to merge with less than ideal minipartners, in order to set themselves up as foreign public companies. Doing so does not by itself free the U.S. firm's tax haven subsidiary from the strictures of section 956 or permit the distribution of cash up the chain tax free, but it does open up the possibility to orchestrate what I have described as a "hopscoch" transaction.³⁸

³⁶The JCT staff in fact took this into account in its revenue estimate for the 2004 holiday, although in retrospect the staff perhaps underestimated the enthusiasm that corporate America would bring to the task. Kleinbard and Patrick Driessen, "A Revenue Estimate Case Study: The Repatriation Holiday Revisited," *Tax Notes*, Sept. 22, 2008, p. 1191.

³⁷Thomas J. Brennan, "What Happens After a Holiday? Long-Term Effects of the Repatriation Provision of the AJCA," 5 *Nat. J. L. & Soc. Pol'y* 1 (2010).

³⁸"Inverse Logic," *supra* note 1.

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The idea, which I do not believe can be addressed through regulation or judicial challenge, is that section 956 has a fatal vulnerability in that it applies to loans made by a CFC only to a “United States shareholder” of that CFC. The new foreign public parent is not a U.S. shareholder, and as a result the tax haven subsidiary holding the offshore cash hoard can lend the cash directly to the new foreign parent, thereby skipping over the United States entirely. (Alternatively, the CFC could directly buy new foreign parent stock in the market.) From there, the public foreign company can use the cash to buy back “its” stock (which in an economic sense is just the old U.S. company’s stock by another name), to pay dividends, to invest in real assets in the United States, or to repay the acquisition debt incurred to finance the inversion transaction in the first place. The interest income earned by the tax haven subsidiary is subpart F income, but that also is true today.

Moreover, cash is fungible. The existing cash stockpile alternatively can indirectly fund foreign operations through low-interest loans to foreign affiliates located in the wholly foreign chain, while foreign operations held outside the U.S. chain of companies can fund U.S. domestic operations. The result is to reduce the importance of the offshore cash over time and to hold more and more of the group’s assets and income entirely outside the U.S. tax net.

The other reason for the wave of inversions relates to the same existential despair over the failure of Congress to engage with fundamental corporate tax reform, but this time the focus shifts to the tax imposed on U.S. domestic income. Many domestic-centric U.S. firms, particularly those in the services industries — say, a large chain of retail drugstores — actually pay federal corporate tax at effective rates not that far removed from the statutory rate. Companies in this situation have every reason to feel aggrieved that Congress has not addressed the high U.S. statutory rate, which burdens them disproportionately. An inversion transaction does little for those firms regarding their offshore cash, because they typically have little or none in a tax haven kitty, but the creation of an offshore parent located in a tax treaty jurisdiction does permit easy earnings stripping of the U.S. tax base on domestic operating income through newly created internal leverage, up to the ceiling set by section 163(j). But that ceiling is far too high, because it basically allows firms to strip out 50 percent of their earnings before interest, taxes, de-

preciation, and amortization.³⁹ After depreciation and amortization reduce what remains, there are slim pickings left for the U.S. Treasury.

These two reasons — hopscotch trades to put offshore cash into the hands of U.S. shareholders, and new avenues for eroding the tax base in respect of U.S. domestic operations — are sufficient to explain the current inversion mania. These motives do not apply with equal force to every firm that has explored an inversion transaction: Walgreens (which has now abandoned its inversion plans) has a large domestic tax base, a 37 percent effective tax rate, and essentially no foreign operations. Other firms have low effective tax rates, and very large stockpiles of offshore cash.

Until very recently, it might have been argued that inversions were naturally limited by the size of interested U.S. firms and the pool of available foreign merger partners. It was generally thought that those foreign merger partners were required to be (1) domiciled in a low-tax jurisdiction with a comprehensive tax treaty with the United States (for example, Ireland, the Netherlands, Switzerland, or the United Kingdom); (2) just the right size relative to an interested U.S. company (not too small to run afoul of section 7874, but no larger than necessary to accomplish the tax agenda that drives the deal); and (3) conducting a business that was at least a reasonably plausible business fit with the U.S. inverting company.

Now, attention has shifted to custom tailoring either a U.S. inverting firm (by spinning out some assets from a much larger U.S. company to a smaller U.S. vehicle suitable for inverting) or its foreign partner.⁴⁰ Mylan’s inversion, for example, involves a custom-tailored foreign merger partner;⁴¹ AbbVie is itself a recent spinoff from Abbott Labs, although the spin and the inversion are not part of a single transaction. Through such “spinversions” and similar tactics, the pool of U.S. assets that might be inverted, and the pool of foreign merger partners, have substantially increased.

One additional motivation for inversions, which is not substantive but certainly accords with my own experience working on Wall Street for three decades, is herd behavior. CEOs find it difficult to be the only gazelle on the veldt that remains in place when all the others madly gallop off in one

³⁹Sullivan, “The Many Ways to Limit Earnings Stripping,” *Tax Notes*, July 28, 2014, p. 377.

⁴⁰Brooke Sutherland, “Spinversions: How a Mega Co. Can Join In on Tax-Cutting Deals — Real M&A,” *Bloomberg News*, July 10, 2014.

⁴¹Stephanie Soong Johnston, “Mylan to Acquire Abbott Drug Unit for \$5.3 Billion,” *Tax Notes*, July 21, 2014, p. 221.

direction or another. Because this reason sounds in psychology rather than tax policy, I do not consider it further.

Longer term, inversion transactions may open up additional stateless income planning opportunities, if one believes, for example, that over time Ireland will consistently be a more tax-congenial platform than the United States from which to headquarter one's base erosion strategies. (Interestingly, the Irish government may be a net loser in inversion transactions to date. The reason is that Ireland is not picking up significant new tax revenues from these deals, because in fact nothing changes; for example, senior executives in the United States do not pick up and move to the Emerald Isle. But the larger revenues of the expanded Irish parent company are treated as Irish for gross national product purposes, which has the consequence of increasing Ireland's share of EU budget costs.⁴²)

The usual long-term strategy is to allow the foreign subsidiaries of the old U.S. parent to atrophy, at the same time that revenues ramp up in the entirely foreign chain descending from the new foreign public company. If one is patient, this does not require aggressive transfer pricing, exotic tax-free reorganizations, or the like; simply situating every new business opportunity in the wholly foreign chain, combined if needed with some leveraging of any high-taxed CFCs, does the trick. (Neither the United States nor the OECD treats pure business opportunities as subject to transfer pricing analysis.)

This third explanation has some explanatory power to it, but it is often overstated. The argument essentially is the one offered by Bresch of Mylan. Implicit in her competitiveness explanation for inversions is the idea that firms domiciled outside the United States today have an even easier time than do U.S. firms of generating stateless income, and that it is desirable to encourage an ever-accelerating slide down a slippery slope to negligible tax rates on multinational firms. In many cases, however (for example, the Schneider example discussed earlier), the claim that multinationals domiciled in other jurisdictions are making out even better than U.S. firms is not easily demonstrated, and it ignores anti-base-erosion developments like the OECD's BEPS project or the EU's common consolidated corporate tax base. The second leg to Bresch's argument essentially is analogous to claiming that if one country engages in export subsidies, all countries should. We have gotten past that race to the bottom in trade and in explicit subsidies, and it is

time we did so as well for tax mercantilist behaviors by sovereigns. Finally, this argument plainly would lead to economic distortions in markets where multinationals compete with domestic competitors in their own markets, since firms like Mylan already enjoy global effective tax rates lower than those imposed on wholly domestic firms in most of the markets in which these multinationals actually do business.⁴³

Regardless of the desirability of export subsidies hidden in the tax code, I view this third reason for inversions as a less powerful motivation than the first two. Savvy U.S. multinational firms already enjoy very low effective tax rates, although of course future U.S. tax regimes are uncertain. Another reason to be skeptical that this reason is a principal motivation is to return to the observation that relatively few genuine U.S. inversion transactions took place in the 2004-2013 period, when measured against the overall volume of cross-border M&A deals. If U.S. firms were running far behind the pack in a race to the bottom, we would have seen many more inversions over this period, but in fact in many cases U.S. firms occupied the pole position.

The final reason to be skeptical is that this sort of strategy requires a long-term perspective. A firm reasonably should be reluctant to impose capital gains tax today on all its taxable owners with unrealized gains against the prospect that its effective tax rates years from now will be materially lower as an Irish rather than as a U.S. company, taking into account the risks that by then the BEPS "actions" may be both delivered and implemented, source countries generally more effective at policing their tax systems against multinational deprecations, and the EU's common consolidated corporate tax base may have been implemented.

What Then Should We Do?

It is very important to remove the false narrative of international business competitiveness from discussions about how policymakers should respond to the current wave of corporate inversions, because its continued presence in debates leads people to believe that allowing inversions to continue might be the lesser evil, if the alternative is to condemn U.S. firms to a punitively burdensome operating environment in which they will lose ground to multinationals domiciled elsewhere. I have limited patience for the idea of corporate national champions, but I recognize the idea's rhetorical power.

⁴²Maureen Farrell, "Ireland: U.S. Tax Inversions Aren't Helping Us Much Either," *The Wall Street Journal*, July 8, 2014.

⁴³Kleinbard, "The Lessons of Stateless Income," *supra* note 5, discusses these issues in much greater detail.

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Once one understands, however, that U.S. multinational firms today operate in a tax environment that essentially is one of ersatz territoriality, with none of the safeguards of a well-designed territorial system, but with an odd balance-sheet-bloating (and admittedly generally stupid and inefficient) rule for where the fruits of offshore base erosion and profit shifting must be stored, the case for inaction essentially dissipates.

From the other direction, the case for action is urgent, both to protect the U.S. domestic tax base and to preserve existing law's premises of how the international tax system is supposed to operate. Inversions are an immediate threat to fiscal stability because they enable inverted firms to strip their U.S. *domestic* corporate tax base, and to use existing offshore cash to fund dividends or stock buybacks to U.S. shareholders, which today cannot be done without paying U.S. tax. (I briefly discuss the risk of tax revenue hemorrhaging below.) And once a company has inverted, it is gone: The United States will find it difficult to undo the damage to the tax base in subsequent corporate tax reform.

In my view, the necessary responses require legislation rather than Treasury regulations, but the measures that I suggest below rest on firm policy grounds and are properly constrained in their application to address the faults in the code's architecture that inversion transactions have made so salient. While large-scale corporate tax reform is necessary, the legislative solutions offered here do not in any way foreclose the shape of that reform; to the contrary, the more plausible prediction is that they will be integral components of any future tax reform legislation. For this reason, there is no reason to wait until a major tax reform bill can work its way into law, and every reason to act now.

The first component of the necessary legislative package is the most obvious: Revise section 7874 so that it parallels domestic law's consolidated tax return principles, by treating a reverse acquisition of a U.S. firm by a smaller foreign firm as a continuation of the U.S. firm for U.S. tax purposes. All that is required is to drop the operative rule of section 7874(a) as surplusage and to change the specified fraction in section 7874(b) from "80 percent" to "more than 50 percent." This is a simple application of commercial and economic common sense: In a world without tax advantages bestowed for thinking backwards, minnows do not swallow whales, or catfish swallow dolphins. The idea to reorder which is the acquirer and which the target in reverse acquisitions is completely noncontroversial in the domestic context for this reason, and its extension to the international arena not only helps to protect the U.S. tax base but ends a policy that rewards tax perversity over commercial reality.

The second component, which has very recently gained traction among some members of Congress, is to lower the excessively generous ceiling that section 163(j) sets on the quantum of U.S. corporate tax base erosion that we will tolerate regarding U.S. *domestic* earnings. Martin A. Sullivan recently published a description of 10 different proposals to bolster section 163(j) that have been offered to Congress since 2002.⁴⁴ Congress should choose one already and just do it.

A bulked-up section 163(j) would not be limited to inversion cases, nor should it be. It would apply whenever the United States is the source country rather than the residence in a cross-border relationship, and it would ensure that the source country income that economically is generated here is taxed here. For those policymakers who look over their shoulders at international norms, the theme that source countries (in an economic or commercial sense) are systematic losers to stateless income stratagems is the reason behind the OECD's BEPS project, and is a major reason for the thin capitalization statutes that many countries with territorial tax systems have adopted.⁴⁵ Protecting one's source country tax base from easy depredations by foreign investors, where the income side may be taxed nowhere, and certainly not where it economically was earned, is what functional governments do.

Section 163(j) is intended to prohibit easy domestic base erosion through internal leverage. It has been suggested that the same principle should be extended to other deductible payments made by a U.S. company to its foreign parent, such as royalties. The idea is intuitively attractive but conceptually is more difficult than it seems at first blush.⁴⁶ Moreover, such an extension is not consistent with world norms (or arguably with some of the positions staked out by Treasury in negotiations over the BEPS action plans), when arm's-length transfer pricing requirements are still the operative instrument for limiting excessive zeal in this area. For both reasons, I would limit our ambitions today to section 163(j) intragroup interest expense cases.

The final necessary component of any legislative response to inversion transactions is an anti-hopscotch rule. Here the idea is to recognize that the existing offshore cash held by CFCs of U.S. firms was accumulated under an explicit premise that it would one day be taxed by the United States, when the cash was directly made available to the U.S. group through a dividend, or indirectly through a

⁴⁴Sullivan, *supra* note 39.

⁴⁵Kleinbard, "The Lessons of Stateless Income," *supra* note 5, at 140-144.

⁴⁶*Id.*

loan to a U.S. affiliate, an investment in U.S. tangible assets, etc. Hopscotch low-interest loans that skip over a CFC's U.S. parent to go directly from the CFC to a new (or old, for that matter) foreign ultimate public company can be used to put value directly into the hands of former shareholders of the U.S. firm, or perhaps even into the CFC's immediate U.S. parent (through a downstream infusion from the new foreign ultimate parent); those loans can also be used to finance the upside-down merger itself. All these fit badly with the larger apparatus of subpart F. (With some care, the hopscotch loan from the CFC to the ultimate foreign parent can in turn be used to fund loans from the foreign parent to the U.S. group, to facilitate earnings stripping as well.) And because under section 482 intragroup loans can bear a low rate of interest, over time the effect is to drain untaxed earnings out from the subpart F net, as higher returns on the cash so lent accumulate outside the U.S. subgroup.

Like earnings stripping, the hopscotch loan phenomenon is not necessarily limited to true inversion cases, and neither should be the response. Again, the idea should be that whenever a U.S. firm has low-taxed offshore earnings, the indirect distribution of those earnings to or for the benefit of U.S. shareholders or the U.S. immediate parent should be tested under section 956 principles.

Section 956 therefore should be extended to address the problem of hopscotch trades. Legislation should include as section 956 income of a U.S. shareholder its CFC's loans to, or purchases of stock from, non-U.S. persons that either (1) control the U.S. shareholder or (2) are not U.S. corporations and are not themselves CFCs as to the U.S. shareholder but are controlled by the controlling non-U.S. shareholder of the U.S. shareholder. The second thought is meant to pick up the new entirely foreign chain of companies that join the U.S. chain in the merger. This rule would apply even to a non-inverted group (that is, a bona fide acquisition by a foreign company of a smaller U.S. target). It also would not change the current reach of section 956 within the U.S. subgroup of CFCs, so that loans from one CFC to another would not trigger 956.

Again, the solution is designed to be surgical, and to address a problem that was brought to the fore by inversions, but which ultimately is a fault in the code's architecture that logically should not be so limited. As a result, and like the bulking up of section 163(j), it is not intended as a punishment for inverting so much as it is the protection of the U.S. tax base through preserving the premises underlying current law.

In May 2014 the Joint Committee on Taxation staff estimated that a bill incorporating only the first of these three suggestions (the revision to section 7874's threshold from 80 percent to 50 percent) would raise about \$19.5 billion in revenues, compared with current law.⁴⁷ This estimate was delivered before the pace of inversion transactions intensified even further and variants like "spinversions" were widely discussed. I believe that legislation incorporating not only this proposal but also lowering the section 163(j) ceiling and an anti-hopscotch rule would, if analyzed today, carry with it a much higher revenue estimate.

These three proposals are targeted, economically and commercially neutral, and consistent with both current law and the probable shape of any future reform legislation. I would not go further, as for example by rethinking the definition of corporate residence, because such an initiative is not necessary today, and because the topic more fairly does belong in a larger conversation about a new international corporate tax system (similarly, broaden anti-deontra/legislation in respect of controlled foreign corporations properly belongs in comprehensive reform legislation). I have views as to whether this targeted legislation should be mildly retroactive or fully prospective, and temporary or nominally permanent, but these questions are politically charged, and at this point will be resolved through entirely political negotiations.

⁴⁷Memorandum dated May 23, 2014, from JCT Chief of Staff Thomas Barthold to Karen McAfee.

Chairman BRADY. Thank you all for your excellent testimony. We will now proceed to the question-and-answer session. Let me begin.

Professor Hanlon, Ranking Member Levin made, I think, a common analogy. His point is we need to close the barn door before more American companies leave. What I am interested in is what is fueling the fire that is driving these American companies out?

Your testimony laid out an entire range of events going around the world, and combined with our uncompetitive—A, have you ever seen a confluence of events that drives investment and U.S. jobs overseas, grabs our U.S. revenue, and makes us less competitive? Have you ever seen a confluence like this ever occur?

And two, what is your thought on the urgency for Congress to act in this area?

Ms. HANLON. That is a good question. I think the pressure has just been building over time. So it—in terms of a confluence of events, I think just increasingly, as the rest of the world changes, the pressure has been building on the U.S. and we haven't really done anything to change our tax code at all.

So, the way it stands right now, we are just so out of line with the rest of the world that I think that is what is driving companies to leave and try to seek out a better environment. And I think that is what drives them to do the tax planning that they do. They need to be competitive in these foreign jurisdictions. And I wouldn't expect any different behavior from them.

Chairman BRADY. To the issue of urgency, how long does Congress stand by?

Ms. HANLON. You know, I think it is already too late in some sense. But on the other hand, you wouldn't want to rush and make a policy even worse, so you want to make sure that you think it through. But there are some things that are obvious to do, and that is lower the corporate tax rate.

Chairman BRADY. Yes. So rather than a Band-Aid approach, go after the real solution in this.

Ms. HANLON. That is what I would recommend.

Chairman BRADY. Mr. Wiacek, you talked about the BEPS project. More importantly, what happens when companies move overseas, what the—sort of that cascading effect here at home.

So what is—in this global environment, what is the threat of job loss, locally, when we see these companies invert or leave?

Mr. WIACEK. Well, you know, I agree with Ed that tax is not the only factor in competition, and that we can be out-competed because a foreign company invents something we wish we had, or our management is slow, or the foreign company operates under lax environmental regulations or with low labor prices. But I don't understand how anyone can think that tax isn't part of the competition.

You compete, ultimately, with your bottom line, your after-tax cashflow. And if one company is taxed at 35 percent, and another company is taxed at 15 percent, or if you start with 35 but then plan to get it down, the other guy starts at 15 and also plans to get it down. It is the money that is left over that you can invest in wages and jobs, and invest in the future, and sponsor ball teams in your local community. And if the money you have left over is less, all those things are less.

And, moreover, the way you determine the value of your company is by multiplying your after-tax cashflow, as one measure. That is what determines the value of your stock. So the foreign guy's stock is worth more, so he has a currency that is very valuable. And your company is worth less. That is exactly what happened to Anheuser. And you get taken over.

Chairman BRADY. Mr. Wiacek, can I ask—because I am really piqued by the point you made in both your written and your oral testimony, that when global companies leave, there is an impact on local communities that maybe you don't think about from the vendors and the small businesses—can you talk a little about that?

Mr. WIACEK. Well, sure, because I think one of the reasons I was invited is I am the practitioner. So, you know, I have been to Akron, I have been to what was world headquarters and isn't any more.

And Congressman Levin, I am from Detroit, you know. I have been to the old site of the Dodge Main plant that is no longer. And we know what happens. I would use Detroit as an example, because it is my hometown. There are a lot of factors besides tax, but just look at Detroit. It is devastated. And you know, I am going to choke up, it is so devastated.

So what happens? What happens to all the local vendors? Well, in Michigan, the whole economy was based on the auto industry. At one time we were—we had all big three. They were three of the five largest corporations in the world. And Michigan was an unbelievable state. It had more recreation and more tool and die companies and more suppliers than anybody. And those places are all gone.

And I use the past, because that is not what is—those are not the companies that are going to be affected going forward. But we can't lose another round of companies. So maybe we are not going to be big in the auto industry any more or not, but we are big in tech now, and we are big in pharma now, and we are big in branded products, like Starbucks. And we can't lose those companies, too. And they are all under threat.

And everybody just talks about inversions all the time. I didn't even mention inversions, because if you pick up the Wall Street Journal each day—there was another China acquisition today. There was another acquisition by Brazil yesterday. There is continuous acquisitions of our companies that have nothing to do with inversion, and in some cases have nothing to do with tax. It is just that we are here before the Ways and Means Committee, so we are talking about the tax component of it.

But we better figure out for our communities and our country what is happening and why we are losing. And one of the reasons we are losing is that we have a non-competitive tax system.

Chairman BRADY. Good. Thank you, Mr. Wiacek.

Final question, Professor Grinberg, you made the point the BEPS project—developments—many countries are coming down hard on American companies. They are not going after their own companies, they are coming after ours, both in a revenue grab, a jobs grab, and an investment grab.

Some argue that the answer is to impose tougher rules on American companies. I believe—I believe Republicans believe Congress

should try to leapfrog our trading partners and economic competitors by fixing our tax code in a way that helps American workers and companies compete. Can you give us your insight?

Mr. GRINBERG. Thank you—

Chairman BRADY. Should we be taking—should we be solving the problem, addressing the fire that is driving these companies either overseas or to be targets of foreign acquisitions?

Mr. GRINBERG. Thank you, Mr. Chairman. I couldn't agree more. I think that if we just talk about inversions, we are talking about the tip of an iceberg. And we, you know, need to understand that they are symptoms of much deeper problems, that the EU state aid investigations also help you understand the direction the rest of the world is headed, which is to engage in much more significant, source-country taxation, which our countries—our companies will be exposed to, to the extent that we remain in the system that we have today.

My view is that the right way to proceed is to think about a much, much lower corporate tax, and move to dividend exemption as a minimum, while also keeping in mind that we have a world that is moving away from residence country taxation, and towards source country taxation, and away from income taxation, and toward consumption taxation. And so what that means for the United States is that we should think seriously about moving towards a system that defines the U.S. source base that we wish to defend, and then taxing exclusively on that basis, which would include jettisoning the concept of corporate residence as a basis on which we tax.

Now, that would be a big leapfrog. But the first step is just to very—if you want to do a smaller step, the very, very first leapfrog step is just to lower our corporate tax rate so that it is competitive with the, you know, countries that Michelle mentioned, which are our true competitors, and meanwhile, move to a true dividend exemption system. So—

Chairman BRADY. Great. Thank you, Professor. I now recognize the distinguished ranking member, Mr. Levin, for any questions.

Mr. LEVIN. Thanks. Hi, Mr. Wiacek, a special hello. I worked at Dodge Main some years ago. And I think I and others share your concern.

So let me just say a word, Mr. Chairman, about fueling the fire. You just don't let it keep burning and not address, where you can right away, one of the causes. And when you say, "When we address inversions we are not getting at the basic problem, we are addressing symptoms," I think inversions are more than symptoms. But I think we learn you also need to address symptoms. Otherwise, the basic problem festers and grows.

And no one is talking about addressing only inversions. We need to sit down—I think your testimony shows how important it is that we address taxation broadly, comprehensively. We aren't going to do it right now, if we are realistic. And to allow these inversions to continue without taking further steps—the Administration has already done what it thinks it can do. But the Majority here is relating to that doing nothing.

And then there is the earnings stripping issue. And what these companies are doing when they invert, they essentially then borrow

money and they deduct the interest paid to this thing overseas that they helped create. And so they lower the taxes they pay in the United States.

So, it doesn't make any sense to let the fire burn—whatever imagery you want to do—or let more and more horses run out of the barn, saying, “We are going to close the door later.”

So I think your testimony shows we aren't going to do this tomorrow. Mr. Grinberg, what you suggested is really, really basic.

So let me just ask Mr. Kleinbard to comment. You talked about competition and also BEPS, what it meant, and what is going on. Just say a few more words as to how you think we should look at what is happening in Europe. It is clearly a problem, but how do we address it?

Mr. KLEINBARD. Sure. The first point to keep in mind is that BEPS was a project of the G20 countries and, as such, represents the highest levels of agreement among the major countries of the world. The very foundations of the territorial tax systems that the other witnesses have urged depends on figuring out where income, in fact, is earned. And BEPS, at its heart, was trying to do that, trying to get to a better set of tools to figure out where income is earned. There is no source taxation without that.

When it comes to state aid, I take a different view than does Itai. I don't see the state aid cases as the EC, the European Commission, substituting its tax judgement for that of Luxembourg or Ireland. I see, instead, the European Commission asking the question, “Were these bona fide tax agreements at all that Luxembourg entered into?”

And there, for example, the answer is clearly no. One man issued every ruling. One man issued a dozen rulings a day. Those rulings were scarcely read, much less negotiated. And those rulings, the way I see the EC, the EC is simply saying, “Maybe those rulings are just shams. They were devices used to deliver some kind of tax subsidy through the mechanism of an advanced pricing agreement in order to hide the fact that it was state aid, not that these were, in fact, tax agreements at all.”

Mr. LEVIN. Thank you.

Chairman BRADY. Thank you. Due to the scheduling constraints for our Members, and in the interest of allowing as many Members as possible to ask questions during today's hearing, without objection we will reduce question time for each Member to three minutes. Members who are—

Mr. LEVIN. Mr. Chairman, you and I discussed this, and I just want it to be clear that this is not a precedent for how we are going to handle—

Chairman BRADY. No, sir. You are exactly right. Thanks for making that—

Mr. LEVIN. That should be utterly clear. You have a special need on your side.

My own judgement is that this needs to be just the beginning of our discussion of international tax. And we need to sit down on a bipartisan basis and really dig into these issues. And so I had real qualms about limiting it to three minutes. As long as it is not a precedent, and let it be the precedent today that we are going to

really dig into these issues deeply and effectively, and on a bipartisan basis.

Chairman BRADY. Agreed. And I will recognize Mr. Johnson for questioning.

Mr. JOHNSON. Thank you, Mr. Chairman. As you know, this Committee has been looking into tax reform for some time.

And let me ask you, Ms. Hanlon, please, do recent international developments make fixing our broken tax code more urgent than it was five years ago?

Ms. HANLON. Yes.

Mr. JOHNSON. That is a good answer. Secondly, do these international developments just impact big companies, or does this also affect Main Street and American jobs?

Ms. HANLON. I think what you have heard today suggests—and I think it is true—that it impacts big companies and Main Street and American jobs. It is very hard to separate those two things, because they are so intertwined. So I think it affects everybody, all of us.

Mr. JOHNSON. It affects you and me, too, doesn't it? Okay. So the longer we wait to do reform, the greater impact on jobs, right?

Thank you, Mr. Chairman. I yield back.

Chairman BRADY. Thank you, Mr. Johnson. I would like to take a moment of personal privilege. We are honored to have the former chairman of the Ways and Means Committee, the Honorable Bill Thomas of California, joining us today. Chairman Thomas, would you stand and be recognized? Thank you so much for joining us..

[Applause.]

Chairman BRADY. You look a little like the guy in the portrait, right in the middle of the wall over there. Thank you, Chairman.

Mr. Rangel, you are recognized.

Mr. RANGEL. I am always encouraged when there is words like "bipartisanship." And this situation is getting so serious that I would encourage you—there he goes—well, so much for bipartisanship.

[Laughter.]

Mr. RANGEL. But it would seem to me that we ought to get together, as Members of the Committee, and decide what it is that we would want to do without the hearings. Bring in the experts, ask the questions, and then decide that we have to go to our leadership and say, "This is important." Hearings are good, but most of the time we have already made up our minds of what we want to do. And there is no press here.

So I do hope that there would be informal discussions as to how we can help our country out and avoid people saying that, under this President, nothing meaningful will be done. Because the way the presidential elections are going, it is very possible that someone could get elected that the Congress could say that, "We are not going to do anything that she wants done." And if the Congress is going to take that position with the executive, it doesn't really leave much hope for those corporations that want to make us competitive by going where they can be the most productive.

I was very interested, Mr. Wiacek—and with all of your experience as a tax lawyer, you sounded like someone from the community, you sounded like the frustrations that we hear in both par-

ties. You sounded like someone that says, “America isn’t doing what we expect her to do.” And it would seem to me that if the United States Congress had that much feeling about it, that we could do something to alleviate the losses that we are suffering, not only financially, but in terms of the hopes and aspirations of so many Americans.

Now, it has to be true that when we have this extremely high 35 percent corporate tax, that a lot of corporations, domestic corporations, are paying it, but very few international corporations are paying such a tax. I think Mr.—Professor Kleinbard said that Pfizer pays nine percent.

Isn’t it abundantly clear that corporations don’t pay the same taxes?

Mr. WIACEK. Well, it is not abundantly clear. And the—everyone starts with a certain corporate rate and does their planning and seeks to reduce it. So we can either compare our headline or our statutory rates to our effective rates, but we are being out-competed on the tax code.

Mr. RANGEL. I am saying these multinational corporations are leaving our jurisdiction and avoiding tax liability so they don’t pay the 35 percent. Isn’t that true?

Mr. WIACEK. They—our corporations do seek—

Chairman BRADY. I am sorry, Mr. Wiacek, all time has expired.

Mr. Nunes, you are recognized—

Mr. RANGEL. What are you talking about?

Mr. NUNES. Thank you, Mr. Chairman.

Mr. RANGEL. I thought you said we had three minutes.

Mr. NUNES. Ms. Hanlon, I have a question for you. I have introduced the American Business Competitiveness Act, ABC Act, which is based on the X-tax that was developed by David Bradford and others. As you are aware, it does away with subpart chapter F. It taxes amounts effectively connected with businesses in the United States—be a five percent toll.

In the U.S. we continue to see the growing trend of inversions. For example, in my home state of California, biopharmaceutical companies have been the target of foreign acquisitions in recent years. Since 2010, almost 70 percent of U.S. and foreign biopharmaceutical company acquisitions have been by foreign companies.

So, in your expert opinion, Professor, could you tell the committee how the X-tax cashflow system that I have proposed—how that would impact those types of acquisitions switching to a territorial system, like my plan does?

Ms. HANLON. Well, I think, to some degree, because we haven’t run the experiment, we can’t say exactly how it would affect it. But I think your question kind of gets at the spirit of what was said a little bit earlier. And I think it is very important to think broadly when we think about tax reform.

There are many options that we could choose, and we could think about small—“small” moves, like just dropping the corporate rate, which I think all four of us agree needs to be done, or we could think about something bigger. And I think the X-tax is a good option that we should consider and think about all the effects that it would have.

So, I agree that this is something we should think about, and not only limit our view to small changes in the system, but also think a little bit more broadly about other things we could do to reform the tax system.

Mr. NUNES. Well, thank you, Professor.

I would like to—Mr. Grinberg, would you like to—are you familiar with the X-tax system?

Mr. GRINBERG. Sure.

Mr. NUNES. Oh, your mike, sir.

Mr. GRINBERG. Thank you, Mr. Congressman. So the thing about moving to a consumption tax rather than an income tax, is that—which an X-tax is—is that it is simply a much more pro-growth system than an income tax. An income tax creates distortions that a consumption tax does not.

The United States is actually a reasonably low-tax country, we are just a high income tax country. There is no reason we need to live with the distortions that the income tax system creates. We have alternatives available to us.

And so, I think it is correct to study consumption tax reform options that can help the United States be a more competitive economy while remaining, you know, relatively distributionally similar. So—

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

Chairman BRADY. Thank you. Dr. McDermott, you are recognized.

Mr. MCDERMOTT. Thank you, Mr. Chairman. A very eminent philosopher once said, “Those who fail to learn from history are doomed to repeat it.” Now, that is a very fancy way of saying what I learned in Chicago as a kid: The fix is in.

This is a sham hearing. It is not going anywhere.

The Speaker, before he got to be Speaker, when shown the OCED [sic] BEPS program said, “Ultimately, the solution is to bring our tax code into the 21st century, allowing companies to bring back their earnings without penalty.” Now, if that is the goal, to bring back their money from overseas without penalties of any sort, we ought to look at the last time we did that.

Not many Members on this Committee were here in 2004, when we provided a repatriation holiday. This was—allowed companies to bring back their offshore profits at a lower tax rate than that 35 percent we always hear about, which is a sham in itself. The effective rate is about 16 percent for most corporations in this country.

But never mind. They brought their money back. And they promised that they were going to use it to create jobs, and they were going to do all kinds of great things for this country. The 15 companies that benefitted the most from that 2004 tax break cut more than 20,000 jobs. They brought back all that dough from overseas at low rates that we gave them. We said, “Oh, bring your money back and invest in America.” They brought it back, and they sent it to the stockholders in the next afternoon. That is what happens when you get this kind of thing.

And we—although we heard about the other thing, about the fix that you really don’t understand. These companies, they sell some-

thing in Germany. Do they pay the German tax rate? Do they, Mr. Kleinbard?

Mr. KLEINBARD. They do only if they are poorly advised.

[Laughter.]

Mr. MCDERMOTT. Yes. If they are well advised, they do it in the Cayman Islands.

Mr. KLEINBARD. In the end, right, the income is—

Mr. MCDERMOTT. Or Bermuda.

Mr. KLEINBARD. Yes, sir.

Mr. MCDERMOTT. Or The Netherlands, or Luxembourg. Any place to get one of those—or Ireland, even. I mean the Irish are not—you know, we are not very smart, but we are smart enough to know if we have a low-enough tax rate, we can draw a lot of stuff if that isn't taxed in France and isn't taxed in Berlin and isn't taxed all over the world.

This tax structure is not going to be solved by a hearing where people have three minutes to talk about it. This has got to be—you have—we had the Senate Member over today to the Democratic study group who said, "Nothing is going to happen in the Senate on taxes." So whatever you talk about today is just a sham. This is not real tax reform. It took six years under Reagan.

Chairman BRADY. Thank you. Mr. Tiberi, you are recognized.

Mr. TIBERI. So much for bipartisanship. Mr. Wiacek, in your written testimony you talk about examples in communities of corporate headquarters going overseas, and the impact. And one of them is in Ohio that you mentioned, my home state, Bridgestone, Firestone.

In Columbus we are really lucky to have a number of corporate headquarters, both domestic and international companies, and many of them are—most of them are involved in many other ways, in addition to just having a lot of jobs. In fact, one company, AllBrands, has seen the CEO in the company give tens of millions of dollars to Ohio State to create a state-of-the-art medical center. And I think it is safe to say that if they were headquartered in Dublin, Ireland, they wouldn't do that.

My question to you is can you go through the ripple effect that is created in communities? We often solely talk about jobs, which are really important, but the ripple effect that is created when a corporation is moved overseas, not just in terms of jobs, but what it does in a community, the investment that many employees and executives make in many different things, and the impact that has. And, in addition to that, how recent developments in the BEPS project and what foreign governments are doing, unilaterally, to heighten that impact.

Mr. WIACEK. Sure, and let me take BEPS first, just for a moment, because Ed made the comment that attacking BEPS is premature. And that is what got us to the place we are now. We thought that it was just advisory, and that we would get a crack at it because we have to adopt each of the proposals, country by country. But what we forget, while we wait about—tax reform people are asking about—is the barn door open? Is the fire burning?

So we are not in control of international taxation. Inherent in the definition of "international" is there is at least one other country

involved, sometimes many. And they are galloping forward, and they are moving on. And BEPS is out of the barn and running.

And BEPS—look, if BEPS works, and we have a level playing field, that is actually all we want, as a competitive manner. And I don't care whether the rate is the German rate of 15 percent versus the U.S. effective rate of 16 percent or—just so everybody plays by the same rules. But that is not what is going to happen with BEPS, or at least not for 10 or 15 or 20 years, because the different other countries are not going to adopt all of the proposals. Each country is going to adopt the proposals that is best for it. Each country is going to adopt the proposals in its own language.

Someone talked about the privacy—oh, Ed did. And he said, “Why shouldn't we give all of our tax returns to every country?” Well, Germany already doesn't think it is a good idea, either, and has said it is not going to do it. And France has already said, “What the heck?”

So this thing is just going to be—the whole international system is getting rewritten right now in Paris and Brussels. And we better catch up, because we would like to put a stamp on that. And they are not writing it in a way that is favorable to us.

And I am sorry I didn't get to your community question, and maybe I will get an opportunity.

Chairman BRADY.

Thank you, Mr. Doggett, you are recognized.

Mr. DOGGETT. Thank you, Mr. Chairman, and thanks to our witnesses.

I think if this Committee had any genuine interest in addressing those companies that are dodging their taxes by declaring themselves un-American, we would have already approved the anti-inversion legislation that has been pending here for years. We would have approved a tax that is, in concept, the same as what we do for wealthy individuals who renounce their citizenship, and say, “Your earnings may have been deferred, but they are not tax free,” and impose that tax. And finally, we would be asking the United States Treasury Department to use its full authority to stop the Pfizer inversion and the other runaway inversions that are occurring.

Instead, what we have is the call for an international tax reform that is nothing more than an excuse for discrimination. If Star Wars is competing down the street from Austin Java, it is Star Wars that has got the lowest tax rate right now through all the schemes that it has set up on its intellectual property and its off-shore subsidiaries. And what this Committee is saying, “Cut their taxes some more, but don't do anything for Austin Java.”

It says to Pfizer that is up here, whining about the fact that it has to pay maybe a nickel, maybe even as much as \$.07 or \$.08 on its worldwide earnings, we need to cut their taxes a little more, but Davila Pharmacy and the other community pharmacies around the country, they don't get their taxes cut at all.

It says to Burger King, “It is okay to go run off to Canada to invert. We are going to cut your taxes more. But we are not going to do anything with Estella's down the street that is a local, domestic business that is competing.”

And the committee's determination to discriminate against domestic businesses is so extreme that last week even the Business Roundtable, that has as its members so many of these multinationals, rejected this approach with its chairman saying that tax reform cannot be piecemeal, that "You've got to have revenue on the table, lower tax rates, and simplification in order to have a compromise for all."

I agree with a pro-growth, job creation tax policy, but it can't discriminate against American businesses. We aren't talking about a compromise here with the testimony today. We are talking about continuing to have an uneven playing field for our businesses, and to tilt it a little more through further so-called international tax reform.

Specifically, I would ask you, Mr. Kleinbard, what you think about the so-called innovation box, or giveaway box, or whatever, and whether Pfizer needs additional tax breaks.

Mr. KLEINBARD. In 11 seconds, I am opposed.

[Laughter.]

Mr. DOGGETT. Good.

Mr. KLEINBARD. It simply rewards people today for research they did years in the past.

Chairman BRADY. Well done.

Mr. Reichert.

Thank you for sticking to the time, on the dot.

Mr. DOGGETT. Mr. Chairman, may I just ask, as you go to the next witness, your consent, unanimous consent—

Chairman BRADY. Without objection.

Mr. DOGGETT [continuing]. To put in the letter that you received from the financial accountability and corporate transparency group?

Chairman BRADY. You bet, without objection.

[The information follows:]



February 24, 2016

Chairman Kevin Brady
Committee on Ways and Means
United States House of Representatives

Ranking Member Sander Levin
Committee on Ways and Means
United States House of Representatives

Committee Members
Committee on Ways and Means
United States House of Representatives
Submitted via email to: waysandmeans.submissions@mail.house.gov

Re: February 24, 2016 Hearing on International Tax Reform

Dear Chairman Brady, Ranking Member Levin, and Honorable Members of the House Ways and Means Committee,

The undersigned members of the Financial Accountability and Corporate Transparency Coalition (FACT) Coalition—along with the Coalition itself—urge you to close various international corporate tax loopholes that incentivize profit shifting and other tax avoidance maneuvers that force small businesses and average taxpayers to pick up the tab for the cost of government services.

The FACT Coalition is a broad and diverse coalition that unites more than 100 civil society representatives from small business, labor, investor, government watchdog, faith-based, human rights, anti-corruption, public-interest, and international development organizations from across the ideological spectrum. We seek an honest and fair international tax code, greater transparency in corporate ownership and operations, and commonsense policies to combat the facilitation of money laundering and other criminal activity by the legitimate financial system. The FACT Coalition was founded specifically to advocate for measures to halt multinational corporations' ability to avoid paying their fair share of U.S. taxes through the abuse of offshore tax havens and corporate tax loopholes.

It's clear that any proposal for bipartisan tax reform should restore honesty to the tax code. Currently, the tax code is riddled with loopholes that were systematically inserted by special interests resulting in the ability for large, multinational corporations to shift their tax responsibilities to small businesses, domestic businesses, and normal taxpayers. In addition to harming vulnerable communities across the country, these offshore loopholes help facilitate the outflow of trillions of dollars from developing countries—exacerbating global poverty and inequality and increasing national security

risks. We must correct these systemic inequities where certain players manipulate our tax laws to their own advantage.

Because of the current system of deferral, where taxes may be indefinitely put off until profits are “brought back” to the U.S. in the form of dividends or other shareholder payments, multinational corporations are able to play games with their accounting books and transfer profits between entities, usually to companies located in low or no tax jurisdictions.

This type of corporate tax haven abuse costs the federal government \$111 billion in lost revenue every year.¹ In total, more than \$2 trillion in profits are booked offshore.² Often, these “offshore” profits are being attributed to an entity that consists of nothing more than a P.O. Box in a tax haven country—a very low tax jurisdiction—where the company does not have an actual physical presence. The most illustrative example of this can be found in the fact that profits reported to the Internal Revenue Service (IRS) that reportedly were made by subsidiaries located in the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, and Luxembourg were many times greater than the entire Gross Domestic Product (GDP) of those nations, sometimes more than 10 times greater.³

There are many well-known examples of huge, profitable multinational corporations that have effectively used tax haven profit shifting and other accounting gimmicks to shave billions of dollars off of their tax bills. Take for example:

- **General Electric (GE).** By using tax havens, GE paid an effective federal tax rate of *negative* 7.3 percent between 2008 and 2014, while booking billions in profits.⁴
- **Microsoft.** With subsidiaries in five tax havens, Microsoft reported \$108.3 billion in overseas profits according to its 2014 filings, allowing it to avoid almost \$34.5 billion in taxes in the process.⁵
- **Apple.** With subsidies in Ireland, Apple has managed to avoid paying the over \$60 billion it owes in taxes on the \$200 billion it currently holds offshore.⁶
- **Bank of America (BofA).** BofA reported \$17.2 billion in offshore profits in 2014, using 21 subsidiaries, allowing it to avoid a \$4.5 billion tax bill.⁷

¹ Clausing, Kimberly A., “The Effect of Profit Shifting on the Corporate Tax Base”, *Tax Notes*, (Jan. 25, 2016), <http://www.taxanalysts.com/www/features.nsf/Features/622F036AA4CAD8DF85257F5D006799D2?OpenDocument> (accessed Feb. 22, 2016).

² Drawbaugh, Kevin, and Patrick Temple-West, “Untaxed U.S. Corporate Profits Held Overseas Top \$2.1 Trillion: Study”, *Reuters* (Apr. 8, 2014), <http://reut.rs/1gdTGhp>.

³ *Citizens for Tax Justice and U.S. PIRG Education Fund*, “Offshore Shell Games 2015: The Use of Offshore Tax Havens by Fortune 500 Companies” (Offshore Shell Games), (October 2015), <http://ctj.org/pdf/offshoreshell2015.pdf>, at 14.

⁴ Gardner, Matt, “Imagination at Work? GE Once Again Pays Less Than 1% in Federal Taxes”. *Tax Justice Blog: A Project Of Citizens for Tax Justice and the Institute on Taxation and Economic Policy*, (Mar. 3, 2015), <http://bit.ly/1CHFJ3l>.

⁵ *Citizens for Tax Justice*, “Ten Corporations Would Save \$97 Billion in Taxes Under ‘Transition Tax’ on Offshore Profits”, (Feb. 16, 2016), <http://ctj.org/pdf/obama14guys2016.pdf>.

⁶ *Id.*

⁷ *Id.*

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There are a number of provisions in the tax code that exacerbate the problems created by allowing companies to defer taxes on their foreign profits. For example, the so-called “check-the-box” provisions where, by checking a box, a company can make one of its foreign affiliates a “disregarded entity” for tax purposes, enabling income shifting from a subsidiary in a high tax country to one in a low tax country.⁸

Another issue occurs because of a once “temporary” tax break—unfortunately made permanent in December 2015—that had been contained in the package of credits referred to as the “extenders” called the “active financing exemption.” Though U.S. companies generally cannot defer paying taxes on the foreign-made income of a subsidiary that is considered “passive,” such as interest, dividends, rents, and royalties, under active financing a company may do so if it is related to financing of investments, broadly defined.⁹ Another costly loophole included in the extender package is the “Controlled Foreign Corporation (CFC) Look-Through Rule,” which was extended in December for five years and which allows U.S. multinational corporations to defer tax liabilities on income generated by one of its foreign subsidiaries from sources of income such as royalties, interest, or dividends.

Another important tax avoidance strategy is through an inversion, where a domestic company purchases a foreign firm that’s usually much smaller and reincorporates, changing its corporate address to the country where the other firm is located. The new, combined “foreign” firm is typically located in a very low tax jurisdiction. These inversions are merely paper transactions and usually there is no change in the formerly domestic company’s operations; management and control of the company continues in the U.S.

These tax maneuvers have been on a steady uptick in recent years.¹⁰ For the past couple of years, the news has been filled with big name American companies considering or completing inversions such as Pfizer, Johnson Controls, Burger King, and Walgreens. The Treasury Department’s actions on inversions in 2014¹¹ and 2015¹² were important first steps, but more has to be done. Without specific, meaningful legislation to address inversions head on, there will continue to be an incentive to shift companies, at least on paper, overseas.

A related accounting gimmick that flows from inversions is known as “earnings-stripping.” This occurs when companies load the American side of the company with debt owed to the foreign entity. The interest payments on the debt are tax deductible, reducing its U.S. profits and thus eliminating any tax that would otherwise be paid.

The FACT Coalition believes that members of the House Ways and Means Committee have a unique opportunity to comprehensively address these international tax loopholes that are draining our nation of much needed revenue and placing large and small businesses on unequal footing. Below, we offer a series of recommendations that would

⁸ Scott, Jeremy, “Check the Box for Tax Avoidance”, *Forbes*, (Feb. 19, 2014), <http://onforb.es/1yj9hHY>.

⁹ *CNN Money*, “America’s Debt: Wall Street’s \$11 Billion Windfall In the Fiscal Cliff Deal”, (Jan. 22, 2013), <http://cnnmon.ie/1kVYRRN>.

¹⁰ *Bloomberg News*, “Tracking Tax Runaways”, (Updated on Apr. 13, 2015), <http://bloom.bg/1ohNIYz>.

¹¹ *U.S. Department of the Treasury*, “Fact Sheet: Actions to Rein In Corporate Tax Inversions”, (Sept. 22, 2014), <http://1.usa.gov/1oeem02>.

¹² *U.S. Department of the Treasury*, “Fact Sheet: Additional Treasury Actions to Rein in Corporate Tax Inversions”, (Nov. 19, 2015), <https://www.treasury.gov/press-center/press-releases/Pages/j0281.aspx>.

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eliminate the most egregious loopholes, and introduce greater fairness and transparency in the system.

The most comprehensive solution to tax avoidance by multinational corporations is to simply end deferral. Though companies contend that their profits are “trapped” overseas, in reality much of those dollars booked as “foreign-made profits” are already invested through American banks.¹³ The FACT Coalition believes that instead of indefinitely deferring taxes on these profits, these taxes should be paid when the income is earned while keeping in place the foreign tax credits received for taxes paid to foreign governments. This could create more than \$900 billion in new revenue according to an analysis of estimates from the Joint Committee on Taxation and the Treasury Department.¹⁴

Other wide-ranging tax avoidance schemes could be stopped by incorporating elements of broad reform legislation such as the Stop Tax Haven Abuse Act (S. 174, H.R. 297). This bill does many laudable things such as ending profit-shifting abuses and reducing the incentive for corporations to license intellectual property (for example, patents and trademarks) to shell companies in tax haven countries. It does that by:

- Removing the deduction of interest expenses related to deferred income;
- Determining foreign tax credits on a pooled basis to stop companies from manipulating foreign tax credits to avoid taxes;
- Requiring multinational companies to report employees, revenues, and tax payments on a country-by-country basis;
- Ending the so-called “check-the-box” rules for foreign entities.
- Eliminating the “Controlled Foreign Corporation (CFC) Look-Through Rule”;
- Ending the “active financing exception” to subpart F of the tax code;
- Preventing companies that are managed and controlled in the U.S. from claiming foreign status;
- Equipping the Department of Treasury with the enforcement power it needs to stop tax haven countries and their financial institutions from impeding tax collection in the United States; and
- Strongly implementing the Foreign Account Tax Compliance Act (FATCA).

Any international tax reform solution should also address the problem of inversions. It should do that by treating as domestic for tax purposes any formerly American company that either retains a majority of the same U.S. shareholders after reincorporation or that is managed and controlled in the U.S. without significant foreign operations. (See the Stop Corporate Inversions Act, S. 198, H.R. 415.)

Congress also should prohibit the awarding of federal contracts to an American company that has inverted, since it is gross abuse of tax dollars to reward companies that desert our nation for the purpose of avoiding paying their fair share of the taxes—the same taxes that fund government contracts. There have already been bipartisan amendments to some appropriations bills that barred companies reincorporated in

¹³ *Center for American Progress*, “Offshore Corporate Profits: The Only Thing ‘Trapped’ Is Tax Revenue”, (Jan. 9, 2014), <http://ampr.gs/1RrEUt>.

¹⁴ *Offshore Shell Games*, at 18.

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Bermuda or the Caymans from receiving federal contracts. The time has come to employ this policy across-the-board for the entire federal government, and apply these restrictions to all companies that have reincorporated in tax havens.

Congress must also avoid embracing changes to the tax code that provide false "solutions" like a shift to a territorial tax system. Such a system would truly bleed government coffers dry since it would only further incentivize multinational corporations to shift profits overseas and engage in a "race to zero."

Similarly, Congress should reject patent or innovation box proposals, which would go against the entire premise of international tax reform by creating yet another costly, unnecessary and ineffective loophole for companies to take advantage of.¹⁵

Another shortsighted change would be a "repatriation holiday" that has been proven to be a revenue loser in the long run.¹⁶ Allowing corporations that have hoarded profits on the books of foreign subsidiaries to repatriate taxes at a lower rate would be a reward for wrongful behavior. In 2011 a Senate report analyzing a tax repatriation holiday in 2004 found that much of the profits that multinational corporations were supposedly holding offshore were actually sitting in U.S. bank accounts and other assets, undercutting the very premise of "bringing the money back."¹⁷ Moreover, the vast majority of the repatriated taxes came from only a handful of firms, the money was doled out in dividends versus being reinvested in the economy, and companies that chose to take the "holiday" ended up cutting jobs rather than expanding their workforces.¹⁸

A related idea that also would create a loss of revenue when compared to immediate taxation at the full statutory rate, would be a "deemed repatriation." This differs from a "holiday" because companies are required to repatriate profits but they are still given a break on the tax rate, thus extending the incentive for companies to continue to play accounting games and shift profits to overseas subsidiaries. The American people should not have to settle for discounted tax revenue at the expense of further incentivizing activities by multinationals that disadvantage responsible small business owners and ordinary taxpayers.

For questions on these comments, please contact Clark Gascoigne, Interim Director of the FACT Coalition, at cgascoigne@thefactcoalition.org.

Thank you for considering our views.

Sincerely,

American Sustainable Business Council

¹⁵ *Citizens for Tax Justice*, "A 'Patent Box' Would Be a Huge Step Back for Corporate Tax Reform", (June 4, 2015) <http://ctj.org/pdf/patentboxstepback.pdf>

¹⁶ Letter from U.S. Joint Committee on Taxation to U.S. Senator Orrin Hatch, Chairman of Senate Finance Committee, (June 6, 2014), <http://1.usa.gov/1Dtqqq>.

¹⁷ Permanent Subcommittee on Investigations, "Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals", *Majority Staff Report for the Permanent Subcommittee on Investigations of the U.S. Senate Committee on Homeland Security and Governmental Affairs*, (Oct. 11, 2011), <http://1.usa.gov/1cjhqlj>.

¹⁸ *Id.*

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Chairman BRADY. Mr. Reichert, you are recognized.

Mr. REICHERT. Mr. Chairman, could I ask the clock be set at three minutes, that—

Chairman BRADY. Yes. Yes, sir.

[Laughter.]

Mr. REICHERT. My time was ticking away there. Thank you. Thank you, Mr. Chairman.

I usually stick to a script, and I am going to go off the map a little bit here. I am just getting frustrated by hearing some of the comments today.

I have—I look like I have been in Congress 40 years, but I have just been here—this is my twelfth year. So I was a cop before this, and cops are all about getting stuff done, right? I just want—you know, I think Mr.—is it Wiacek? I want to—Wiacek?

Mr. WIACEK. Wiacek.

Mr. REICHERT. Thank you. You know, I thank all three—all four witnesses. You have provided some great testimony here today for us to be educated. However, I think that, Mr. Wiacek, you have really touched, you know, me in a personal way. I think I can—I mean I can see your emotion, your passion. Even though we are talking about tax reform, which is not—you know, how can you get excited and passionate about—unless you start talking about what it does to people in America.

And the anger that we see in America today is all about what is happening right here in this Committee, the lack of bipartisanship, some of the comments made here to me are depressing, disgusting, and absolutely uncalled for. We have been working on tax reform for the past eight years that I have been on this Committee. Through Dave Camp and through Mr. Brady, and even when the other side was in the Majority, there was some attempt. But we have got to work together.

And in the last minute and 30 seconds, I want Mr. Wiacek to continue on—with his conversation on how this affects all businesses across America, and what your solutions are. Just list them right off, you know, 1 through 10. Whatever you have got, man, I am ready to write them down.

And, you know, I don't know how we can say that companies are only paying six and seven percent. I am talking to companies that are paying 50 percent.

Mr. Wiacek, please.

Mr. WIACEK. So I appreciate, by the way, the competition between the international company that sits next to the local company, and what does the local restaurant pay versus the Burger King. But if we don't get the international side right, Burger King is going to not only be in Canada, it is going to be run by the Canadians, and you are still going to have the tax competition, because now the Canadian company is not taxed on its U.S. income, it is a territorial system, it is going to have a lower rate.

And someone talked about the German—don't even pay the German tax. The German tax is only 15 percent, by the way. And our tax is 16 percent, even if we take into account all the planning or the so-called—so what is going to happen if we don't solve the international side is we are going to lose more and more of the companies. And then the company that is reducing its taxes isn't

even American, it is a foreign company that sits next to your domestic company. So these things are very hard.

And wow, in 12 seconds what would be my list of things that we should do? Can I follow up with a supplementary thing to you or something?

Mr. REICHERT. Yes, you can.

Mr. WIACEK. Because it is a very difficult topic.

Mr. REICHERT. Please do, thank you. Thank you.

Chairman BRADY. Thank you—

Mr. REICHERT. Mr. Chairman, I yield back.

Mr. WIACEK. But we do need to get on with it.

Mr. THOMPSON. Thank you, Mr. Chairman, and thank you, witnesses, for being here.

Could each one of you witnesses just tell me—do you believe that tax cuts, either international, domestic, or otherwise, tax cuts should be revenue-neutral? Just a yes or no.

Ms. HANLON. I don't think they necessarily have to be.

Mr. WIACEK. No.

Mr. GRINBERG. I don't think corporate tax reform should be revenue-neutral, necessarily.

Mr. KLEINBARD. I think that the United States needs more tax revenues than it is currently collecting. I think that the business tax system can be reformed in a revenue-neutral way to still be more efficient—

Mr. THOMPSON. I am a little perplexed, because the idea that we would not push policy here that is revenue-neutral—at some point you have got to—you know, you have got to pay the piper. And I don't think it is good public policy to say we are going to do all this stuff and then, you know, somebody else figure out how to pay for it. Or, as one prominent Republican has been saying, "We will let Mexico pay for it." It just doesn't work. You have got to pay the bills.

Mr. Kleinbard, the chairman stated when he—in his opening remarks that there is all this U.S. money stranded overseas. And we have heard time and time again that it stifles investments in this country. Is that accurate? Are there examples of ways to still invest in this country, still pay dividends in this country, notwithstanding the fact that you have some of your capital invested overseas?

Mr. KLEINBARD. Sure. It is not a great idea to have a system in which firms are encouraged just to keep large quantities of cash in their offshore subsidiaries. But the consequences of that have been vastly overstated.

It is simply not the fact that that money is buried in a backyard in Zug. That money, to the extent that it is invested in dollar assets, is in the U.S. economy. As my example of Apple, which just borrowed \$12 billion in the U.S. capital markets demonstrates, it is possible to get to the tax equivalent of a tax-free repatriation of those funds. The money can be invested anywhere in the United States, except the pockets of the shareholders of that company.

So the idea that the money is trapped overseas is false. It is not a desirable tax system, there are inefficiencies, but it is not the case that we have the kind of trapped money that is sometimes described.

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

Chairman BRADY. Thank you.

Dr. Boustany, you are recognized.

Mr. BOUSTANY. Thank you, Mr. Chairman. I am angry too. I want to express the same anger my colleague just expressed.

This is an urgent problem. It is an urgent problem. We have to impart the urgency, not only to people in this room, but beyond, to the American people, as to what is happening to American business.

Look, we throw around the terms “EU,” “state aid,” “inversions,” “OECD,” “BEPS,” “action items.” We all know what those things mean, but people across this country don’t have a clue. But I think they do understand what happens when a multinational U.S. company that started here and grew here leaves from middle America and goes to Dublin, or it goes to Tokyo. They understand that.

What they don’t understand are what are the second-order and third-order effects of that. What happens to the suppliers and the other companies, small businesses, LLCs, private companies, that are part of the supply chain? What happens beyond that to local establishments, whether they are restaurants or whatever?

We need to make that case and impart that sense of urgency throughout this country, because American business is under assault. And it is not just American multinationals, it is all of American business. And we need to start talking in those terms. This tax code is broken.

Now, we need data from you guys. So, Mr. Wiacek, I am just curious. Do we have any hard data on these second-order, third-order, fourth-order effects in communities across this country as a result of what is happening with this very hostile environment that is leading to inversions at an alarming rate, and leading to mergers and acquisitions where U.S. companies are leaving or they can’t compete?

What are those second-order, third-order, fourth-order effects? How does it affect the local hospital, the—you know, a real estate agency? We need that data. Is there data available?

Mr. WIACEK. All right, so let us get it to you. There is such data, and there is data that is even more neutral, not what happens when the company leaves, or whether you fight the inversion fight, or why they left, or—but just what a Procter and Gamble means for Ohio. And you can just trace that through every supplier and every restaurant, and how much revenue comes from the tax imposed on the wages of the employees.

And you know, a lot of you represent districts that have a city like the size of Akron or the size of Cincinnati or something. Just think what happens if you don’t have that company. That is why I started with St. Louis. I mean the parks of St. Louis, the ball fields of St. Louis, all this stuff that the Busch family has done for that city—I am sure they will still be generous, but it is different.

But you are right, I came up with—

Mr. BOUSTANY. Our committee needs that data.

Mr. WIACEK. Need data.

Mr. BOUSTANY. We have to all go out and make that case. It is not just us on this dais here, or you guys. It is everybody out there. We have to make that case about this urgency.

And I am sick and tired of the punitive measures being promoted on the other side against American business. We have capital that is locked out of here. Yes, they are doing it to get lower tax rates. Tax competition is real, it is part of economic competition. We have to win for the American worker, for the American people. It is time to act now. I yield back.

Chairman BRADY. Thank you.

Mr. Blumenauer, you are recognized.

Mr. BLUMENAUER. Thank you. But I think it is important for us to think about how we act now, and for whom we act. There is no question that our broken corporate tax system has some—I represent some people—I don't know 50 percent that Mr. Reichert is talking about, but I represent some people who pay nearly the full statutory rate. They do business here, they manufacture here, they have assets. But that is not the average, and there are wild exceptions where people take advantage of it.

I loved the article in the New York Times this weekend about Wales, where the local businesses started to say, "We are not going to take it any more." The Starbucks pays no tax to the Great Britain. They finally were shamed into voluntarily coughing up a few hundred million, after having billions of dollars through these techniques that are legal, sort of. But the long-term impact for the people in that village is that they are paying the price in Great Britain.

This is not just something that is a concern of people on this Committee. There are problems of equity throughout the developed world, where people are concerned about stateless income, they are concerned about a lack of equity.

One of the things—to my friend from Louisiana—that we ought to do, we ought to have full transparency. It shouldn't be so hard to know what rates corporations are actually paying. It shouldn't be some proprietary secret about the double Dutch whatever it is that enables them to park huge amounts of corporate profits in a handful of jurisdictions where they don't really do business. Let's be transparent. Let's find out where the money is made, what amount is paid, and allow this Committee and the American public to make some judgements.

Now, I don't think we are going to have massive corporate reform on a—by—without making it revenue-neutral. We are going to need probably another revenue source. All these countries you are talking about that have different corporate systems have a value-added tax. Ted Cruz notwithstanding, I don't think we are going to have a national sales tax here any time soon. Part of the solution is a carbon tax to help buy this down. But part of it is transparency now, understanding how it works.

Part of the system is for us to stop making the code more complex, and dealing with little ancillary questions. Rather than looking at impacts for the people we represent, look at how we are going to pay the bill. Looking at other mechanisms to provide the resources Americans need, and to do so in a way that is simpler and less convoluted. And I think it would start with a little transparency that maybe we can help promote. Thank you, Mr. Chairman.

Chairman BRADY. Thank you.

Mr. Roskam.

Mr. ROSKAM. Mr. Chairman, you have convened a really interesting discussion today. And if you step back and just listen to it, there are some themes. And the one theme is nobody is defending the status quo. There is no voice here on the dais among the witnesses—nobody is saying, “Oh, it is great, just leave it alone.” That is really interesting. Everybody is communicating a sense of urgency about this.

I am from suburban Chicago. I get in and out a lot of companies in my district. And not unlike the Detroit situation—Chicago is not Detroit, thanks be to God, but there is a lot of issues as it relates to tool and die manufacturers, precision tool manufacturers that are selling into these other markets, and it really does matter where worldwide American headquarters are doing business, and so forth.

And so, I think, you know, some of the differences between us—some friends on the other side of the aisle will ascribe a bad motive to a worldwide American company. We tend not to ascribe the bad motive. But, you know, when it comes down to it, who cares? They are either staying or they are leaving. They are sort of doing a jail break like Walgreen’s tried to do. They would have done it, if they could have done it, but they were under so much pressure and they have so much federal business in their drug stuff, they couldn’t do it. But if they were some other company, they would have been gone right now.

So, Ms. Hanlon, question for you. You sort of mentioned this interplay between the inversion discussion, the tax rate discussion. Can you just educate us here on how those things play out together? They are not the same thing. How would you counsel us, moving forward? And what would be a couple of steps, if we were to gather around to try and move forward quickly? What would you counsel us?

Ms. HANLON. Again, I think the number-one thing that, again, all of us agree on this panel is to reduce the corporate statutory tax rate. And it matters. The evidence in the academic research is very clear. That statutory tax rate matters. So I think the number-one thing to do is get that rate down.

Then, I think, consider some version of a territorial tax system. If you want to think more broadly, a consumption tax or some of the other options available to us are also worthwhile things to think about and may have a lot of benefits. But the—again, the number-one thing to do, if you want to act quickly, is to get that corporate tax rate down and reduce the pressure on the U.S. companies.

Chairman BRADY. Thank you. To balance out the questioning, we will be going to two-to-one in the questioning.

So, Dr. Price, you are recognized. Then we will—

Mr. PRICE. Thank you, Mr. Chairman. I too want to thank the witnesses for their testimony and, Mr. Wiacek, for your clear passion on this issue. What you demonstrate is that these issues are real to people, they affect real folks in real communities and our constituents across this great land.

Mr. Chairman, I don’t know if you noticed, but there was an earthquake that happened in this room about a half-an-hour ago

or 20 minutes ago. It is when Dr. McDermott said, "If you lower the tax rate enough you will draw a lot of stuff in." That is a great recognition of what needs to happen. We need to be drawing folks in, we need to be encouraging folks to start businesses and expand businesses. And I just appreciate the fact that—my friend on the other side of the aisle recognizing that we need to lower the tax rate enough.

Some folks have even been candid on the other side. One said, "More tax revenue than currently collecting" is what we need. It is important for people to appreciate we collect more revenue to the Federal Government now than ever in the history of the country. Ever. This is the greatest amount of money that has ever been collected by the Federal Government.

So we can collect more, and the way you do that is through growth. And what we have done in our economy is actually decrease growth. Our growth rate is now 30 percent to 35 percent lower than it has been in the history of the country.

And then you got some peculiar comments on the other side: "We will force them to do it. We will stop those inversions because we will force those companies to not invert." Well, there is a good way to promote a commonality of theme with the business community.

Mr. Wiacek, I want to touch on—I am going to get wonky here for a second on the BEPS project, the base erosion of profit shifting. This appears to me to be a revenue grab by foreign countries of American companies. And one of the ways they are going to do that is to require that this "sensitive company data," that has been belittled by another member of the panel, will be required to be given to the countries.

I ask you. Is—what are the examples of this sensitive data? What data are they seeking? And what should the United States Government be doing to protect United States companies doing business overseas to make it so that they don't have to give away this kind of information that would make them non-competitive?

Mr. WIACEK. Well, in fairness to BEPS, I think it starts with a good motive, which is the motive we all have here, which is to admit the system is broken, and not just here, but across the world. The reason the system is broken is there is not a level playing field, and the systems aren't working well together.

We wouldn't need to lower the 35 percent rate if this Committee or this Congress could ensure that everybody else was paying it. So we could get 35 percent from Pfizer if Britain gets 35 percent from Glaxo. We could get 35 percent from Microsoft if Germany would get 35 percent from SAP. But when that is not what is happening, they are eating our lunch.

So BEPS was kind of a think tank, do-good effort to fix this. And in a lot of ways, it is fixing it. But the view in Europe of what is the right fix is not always in our interest.

Now, you talk about the—

Mr. PRICE. I will follow up with you.

Mr. WIACEK. I am sorry.

Mr. PRICE. Thank you.

Chairman BRADY. Thank you, Mr. Wiacek, Dr. Price.

Mr. Kind, you are recognized.

Mr. KIND. Thank you, Mr. Chairman. Mr. Chairman, the complexity of this topic, I think, really does call for additional hearings. So hopefully, we will take some time to walk through all this. But we appreciate the testimony that we are hearing today.

Let me just ask all of you on the panel just a simple proposition on whether or not, no matter what we end up doing, if anything, on international tax reform, it should at least be revenue-neutral.

And the reason I say that is because I asked the Congressional Budget Office to get me some numbers recently. If we had paid for the extension of the Bush tax cuts a few years ago, and if we had paid for the tax package that was reported out last December, our budget deficit this year would be \$34 billion, not \$544 billion, as it is. And there is a propensity around this place to enact tax reform without paying for it. And that makes it very difficult, addressing the aging population that we have in this country today.

So let's just go right down the line. And I would like to hear each of your opinion on whether or not we should be paying for any changes in the international tax code.

Ms. HANLON. There's ways that you could pay for it or cover the cost, but I don't think the reform necessarily needs to be revenue-neutral.

Mr. KIND. Okay.

Mr. WIACEK. I think, if you have the courage or the will or the way to raise additional money, that would be good. But if the great becomes the enemy of the good while BEPS proceeds and the rest of the world proceeds without us, and state aid proceeds, and our companies are leaving or something, that is a problem. Because we can wait around for a long time to get this right.

And the fact of the matter is, on international taxation, you folks are not in control. This is multilateral. This—my main message: this is happening without you.

Mr. KIND. All right. So you are kind of fudging on that. I understand the complexity—

Mr. WIACEK. Well, okay. I didn't mean it to be a fudge, I meant it to be an answer.

Mr. GRINBERG. So I worry a lot about opportunity for future generations. And for that reason, because I think the real consequences to not acting, I believe in revenue-losing corporate tax reform. And I think you can get the revenue other places.

I think that there are lots of opportunities—if you need to get revenue, why would you do it here? Even the OECD, you know, says that the corporate tax is the least pro-growth tax out there, it is the most damaging tax that exists. They, in fact, recommend and note that every country—every other country is going towards a consumption tax.

So, you know, we should think about doing some—if we need revenue, not from this spot—

Mr. KIND. Mr. Kleinbard.

Mr. KLEINBARD. We need revenue. Business tax reform should be revenue-neutral within business tax reform. There is plenty of revenue within business tax reform to do it in a revenue-neutral way. And the United States today is the lowest-taxed major economy in the world. The lowest-taxed major economy in the world.

Mr. KIND. All right, thank you. Thank you, Mr. Chairman.

Chairman BRADY. Thank you. And, Mr. Kind, just to clarify from my standpoint, what I believe is that within dynamic, real-life scoring, overall tax reform can be revenue-neutral. But we are not going to leave growth on the table if we are off a dime a two. We are looking for jobs, we are looking for opportunity. We are looking to leapfrog and go to the lead pack of where our competitors are at.

Mr. Smith, you are recognized.

Mr. SMITH of Nebraska. Thank you, Mr. Chairman. And thank you for the opportunity to have a dialogue here.

I will say that sometimes it can be a little frustrating, hearing some of the pessimism and why not to do something, and when we know that we have got an incredible problem with our current tax code. And I want to do what I can to move the ball down the field. And I think the importance of international tax reform is incredibly high.

Regardless of the fact that a lot of folks in my district, you know, they pay under the individual rate, many will face a tax rate as high as 47.9 percent. So we can hear about some of the single-digit effective tax rates and—or maybe even zero effective tax rate. But we need to do our job in addressing the problems that we know exist. And I would hope that, as we move the ball down the field, that we can actually help even small businesses through the corporate tax reform, international tax reform, and those items that any reasonable person would acknowledge need some correction.

Can any of you elaborate on how perhaps a small business, who does pay through the individual rate, individual code, would benefit from international tax reform? Go ahead, Ms. Hanlon.

Ms. HANLON. You know, first, I guess I would like to clarify a couple things. It is very common for people to say, “Oh, individuals pay the 39 percent rate.” But the IRS statistics would tell you that most of the evasion happens at the individual level, and for cash-basis small businesses. So it gets a little tiring to me to hear us all going after multinational corporations when the data actually would tell you that the tax evasion is stronger on the individual side, and for cash-basis small businesses. It is not like they are all paying the 39 percent rate.

Sorry, what was your question, again?

Mr. SMITH of Nebraska. That is okay. And in terms of positive impact on small businesses, but—

Ms. HANLON. Oh, yes. I think we have heard a lot about that. There is—it affects jobs, it affects all of us.

Mr. SMITH of Nebraska. Mr. Grinberg.

Mr. GRINBERG. So, you know, I think you are right to worry about Main Street. Still the largest producer of jobs in the United States. The thing about Main Street is it often supplies corporate America, and that is important.

As you think—if you think really broadly, if you go to a system that goes all the way towards moving away from, you know, income taxation as the base, there are real advantages for small business, too, of consumption taxation.

Mr. SMITH of Nebraska. Thank you. Thank you, Mr. Chairman. I yield back.

Chairman BRADY. Thank you.

Mr. Paulsen.

Mr. PAULSEN. Thank you, Mr. Chairman. And just to follow up a little bit on that, you know, a lot of time when we have a conversation on this issue it is always being focused on the larger American job creators that are often the target, right, of these foreign takeovers, or that are forced to relocate their headquarters, just so they can remain competitive. And what often gets lost in that conversation, though, is the Main Street businesses, and that concept, and the ripple effect, the cascading effect.

And I am glad that we had some testimony—Mr. Wiacek, you mentioned it, you have that in the written testimony, as well—the effect that these takeovers and these acquisitions have on the small business community that either supply those large companies, or they provide goods and services to their employees.

And, you know, for me—and Minnesota has had some instances of the inversion issue—but consider, as an example, I mean, if you have a Minnesotan who loses her job when a company is actually forced to move their headquarters to another country because they have a lower corporate tax rate, more competitive international tax system, just because she ends up not going to work for the day, she is not going to stop on her way necessarily to the local Dunn Brothers coffee shop to get her coffee and her muffin. That might be a \$5 expenditure.

She may not be stopping after work to pick up her dry cleaning at the Pilgrim Dry Cleaners. So that might be \$25 right there, at the local dry cleaners. She is probably not going to be picking up her children from the New Horizon Day Care facility, which in Minnesota could be about \$60, \$64 a day. And then she may not be dropping off her husband to pick up the car that was left for an oil change overnight at Bobby and Steve's Auto World. And that could be \$40.

And then, finally, maybe on the way home she is not going to stop at the Cub Foods to purchase extra groceries that would be used either for dinner—or they may not be going out to dinner for \$20.

So you add up that money, and it is about \$154, maybe just in that one day, you know, a very busy day. And, obviously, if you are to spread those activities out, even over the course of a few days, and then multiply it by hundreds of other employees that may be negatively impacted by losing their job from a large headquartered company, we are talking about lots of other Main Street Minnesota small businesses in the supply chain missing out on hundreds of thousands of dollars every week.

And even in an economy like Minnesota, that is actually doing pretty well. This would be a really big hit. And while this is only a hypothetical example, I think the whole issue of inversions and acquisitions and companies relocating overseas is very real, and your testimony absolutely describes that.

You know, you think about 51 U.S. or American companies moving or being reincorporated outside the United States since 1982, but 20 of those have happened just since 2012. We have had three more announcements just in the first month of this year. And our tax code has not kept pace with the modern economy. So it not only about keeping the headquarters that provide these good-paying

jobs, but for me it is about the Dunn Brothers, the Bobby's—and Steve Auto World, and others that rarely come up in these conversations that I think we need to focus on and keep the attention on.

So I want to compliment the chairman for the hearing, and make sure we don't leave job growth on the table as we move forward. And thank you for your testimony today.

Chairman BRADY. Thank you.

Mr. Pascrell, you are recognized.

Mr. PASCARELL. Thank you, Mr. Chairman. Thank the panelists, each and every one of them.

Mr. Kleinbard, you wrote an article in 2014 in the special report on tax notes which I find very intriguing, because it really contradicts a lot of what I have heard today, not from you, but from other panelists, concerning competitiveness.

So, in other words, this whole thing could be summed up, this discussion about whether we want to make Americans able to fit into a competitive system, is if those of us who question the direction we are going in, we don't want competitiveness, we don't want our businesses to compete, which is false, which is false.

You pointed out in that article very decisively—in fact, you used an example—what happened in 2013 to the Mylan Company, M-y-l-a-n. You derived about—that company derived about 57 percent of its worldwide revenues—essentially, gross receipts—from the United States. Yet, as—told investors that its worldwide effective tax rate was 16.2 percent. That is interesting. I find that interesting.

So, if it had faithfully complied with the SEC rulings that it identify its tax footnote, the United States tax cost of repatriating its offshore cash, but they didn't do it [sic]. They didn't do it.

So, I agree, competitiveness has nothing to do with what we are talking about. Working Americans across the country do not have the benefit of hiring consultants and shifting their earned income and assets around the world to find the lowest tax rate. That is what we are talking about, no matter how you slice it. Yet many multinational corporations do just that. And we are aiding and abetting this behavior with our lack of action on an outdated and overly complex tax code.

And when that happens, here is what happens. Like if I don't pay my taxes, my property taxes, regardless of what—every state is different. In Patterson, New Jersey, and the next guy down the block doesn't pay his property taxes, or there is foreclosures and people can't pay their taxes, somebody has got to pick up the slack. And that is what we are talking about here.

So you could put it any way you want, about how this present system, which we all agree should be changed, needs to change in order to benefit corporations. I want you to know that this is a very important bottom line that we are talking about.

And I would ask you the question—not going to have a chance to answer it—you pointed out that the international reform is needed, but that today a good portion of our tax revenue is flowing out of the United States. So discretionary spending has fallen to its lowest level since 1940. Here is what we are trying to do, Mr. Chairman.

Chairman BRADY. Quickly.

Mr. PASCARELL. Thank you for your indulgence.

Chairman BRADY. Sure.

Mr. PASCARELL. Here is what we are trying to do. We are trying to squeeze that discretionary money even further by making cuts here and cuts there, and trying to communicate to the American public, mind you, that the problem is that our corporations can't compete because of the tax system. And that is not the basis of the problem.

Chairman BRADY. Thank you, Mr. Pascrell.

Mr. Marchant, you are recognized.

Mr. PASCARELL. You are welcome.

Mr. MARCHANT. Thank you, Mr. Chairman. I represent a district that has a lot of multinational corporations, but a lot of very large corporations that operate in the United States. When I visit with them, this whole issue about tax reform is beginning to be a very sensitive subject because they have shareholders. Their shareholders are intelligent shareholders. They have boards of directors. They have hired very high-powered law firms and very good tax counsel. And in every case they are being told by all four of those levels that they need to do something about their taxes to either maintain profits or to enhance profits. That is, by the way, the job of the CEO, the CFO, the board, for shareholders.

So, we as a Congress owe it to the businesses of the United States to either simplify the tax code or lower the tax rate, where they do not have this constant internal conflict going on inside of their board rooms.

And people think, well, these are big corporations. Why should we feel sorry for them? Well, because they are a representative of the shareholders. They are broadly held. And I don't believe—I believe that the pressure on these companies is going to increase daily. And all of the Wall Street Journal, all of the stories, all they are going to do is begin to apply an additional layer of pressure.

So I don't think we have just years to ponder this and think about it. I think that just because of the way our system is set up, we must act. Will it be revenue-neutral? It certainly has to take a strong factor of growth into it.

As far as the money overseas—and I found Mr. Kleinbard's answer correct—these companies can access that money, basically, by going to the capital markets over here, or the bond market, and paying that. But that in itself is reducing the revenue to the Treasury, because they are then having to pay interest on that, which is then deductible, and it lowers their bottom line. And, in fact, the profits of those corporations are being penalized.

So, in my view, we don't have, you know—we don't have a long time to ponder this. We have got to determine an effective way for those corporations to get the money back here, effectively. And we have got to figure out a way for our presidents and directors of these corporations to walk into their board rooms and say to their shareholders and directors, "No, we need to stay here, here is how we can do it," and not invert. Thank you, Mr. Chairman.

Chairman BRADY. Thank you.

Mrs. Black, you are recognized.

Mrs. BLACK. Thank you, Mr. Chairman. I appreciate the panel being here today. This is such an important conversation that we absolutely have to have. And I know that some may say these hearings aren't worthwhile, but I will say for me they are very worthwhile. And I know they are for the people here in this audience and those that are watching, as well.

So, Professor Grinberg, I want to go to you, because in your testimony you specifically mention how continuing to make these mistakes in the global tax environment will be extremely costly, in terms of employment and opportunity, and especially for those younger generations.

I hear from the younger folks in my district all the time how difficult it is to find a job, or how few opportunities they have. And if we continue down this path of preventing our U.S. companies from competing globally, how will this impact, not just today, in what I am hearing from the younger generation, but also looking out—my grandchildren and even my children, but my—more importantly, my grandchildren 10 years or 20 years down the road.

Can you just look out and tell me what you think this is going to look like, if we continue down this road without making any changes?

Mr. GRINBERG. Thank you, Congresswoman. It is an important question. The international tax environment is changing very rapidly. And I believe that the BEPS project will succeed, at least in requiring that in order to shift income to lower tax jurisdictions you must also shift jobs into that jurisdiction.

And as many people on both sides of this aisle have said and acknowledged, you know, we don't blame corporations for trying to get to a lower rate. And so, what will happen, unless we act to produce a competitive system that leapfrogs us at least to the middle of the pack, is that over time there will be corporations that migrate offshore, or incorporate offshore to start. And more and more of their high-skilled, high-quality opportunities will be staffed abroad, as they have headquarters abroad and as the leadership of those companies just make decisions about where they want to have, you know, small and medium business suppliers, for example. They will be in Europe, not in the United States.

And, as a result, I really do fear that there will be fewer opportunities for younger people in the U.S. That will be a slow process. It is not like something that happens overnight. But if you think out a ways, you have to hope that the United States can move to a competitive system so as to make sure that, you know, future generations have the kind of opportunities that prior generations have had.

Mrs. BLACK. And I know my time is going to run out, I have eight seconds left. This not only goes to jobs, but it also goes to growing our economy, and where we are with \$19 trillion in debt. And if we don't have jobs and we don't have the economy moving along, we are going to sink.

So thank you so much for being here today, and I appreciate the opportunity to ask you that question.

Chairman BRADY. Thank you. Mr. Davis, you are recognized.

Mr. DAVIS. Thank you very much, Mr. Chairman.

Professor Kleinbard, I represent downtown Chicago. So it is obvious that I have a number of multinational corporations. My question and my interest and my issue—how do I keep them—help keep them competitive with their global competition, and yet exact from them a fair share of the cost of doing business that will help to keep our economy solvent and growing? I think that is also the question Mr. Pascrell was really asking—you didn't get a chance to answer.

Mr. KLEINBARD. First step is lower the domestic U.S. corporate tax rate. If you think that people in your various districts are overburdened by taxes, first step is to lower the domestic corporate tax rate. We all agree on that. The second step is to protect the corporate tax base so that foreign companies can't strip income out and enjoy a low-tax paradise inside the United States available only to them.

People are not inverting because of the headline tax rates. Companies today invert for two reasons only: one is to get their hands on the offshore cash, tax free; the other is to set up the earnings stripping game, so that they can turn the United States of America, domestic income, into tax haven income. Those are easily fixed. Those last two points are easily remedied. Those, in turn, protect the base from depredation. Then, going forward, you want a medium rate, U.S. tax, with fewer tax expenditures, with fewer special deals.

Right now we have—through accelerated depreciation we actually end up paying U.S. companies to make investment in capital equipment when that equipment is debt-financed. We need to, therefore, have fewer tax expenditures. We need to scale back interest deductions to make the system more neutral, and we have to reduce the rate. And then the United States of America is the competitive environment.

What the Congress needs to focus on is what Congress can control, which is the business environment in which Americans operate. And it is very odd to me that in this hearing we talk so much about the poor little multinationals and not nearly enough about what to do domestically for American companies and American citizens.

Mr. DAVIS. Thank you very much. Thank you, Mr. Chairman.

Chairman BRADY. Thank you. Mr. Reed.

Mr. REED. Thank you, Mr. Chairman, and thank you to our panelists.

Echoing on that comment, as I go into this, obviously, the focus of this hearing is talking about the corporate international tax reform. So I share the concerns of making sure that, when we talk about our pass-throughs and our individuals, I think there is a commonality across the aisle here that the tax code is broken for everybody. But what we are talking about today is international competitiveness, and how we are going to potentially take on this issue, going forward. So I want to make a note that I am committed to making sure that we stand with the individual tax reform, also.

Also, no one has talked about—this has been 30 years, essentially, since the last time we did tax reform. So if what we are trying to do here today is to get to the middle of the pack, to catch

up to other folks, are we going to get to the middle of the pack and then have to wait 30 years to become way behind in order to catch up again? Are we going to be that nimble, as you said, Mr. Grinberg, that the environment internationally is happening rapidly, it is changing rapidly?

So my real question to you is give me your best recommendation as to how we get ahead of the pack, how we make the American market competitive. And I am going to focus first of all, Mr. Grinberg, on Mr. Wiacek and Ms. Hanlon, because Mr. Wiacek is a practitioner. He is talking to the people in the field.

What is it that would put us ahead of the pack, and potentially keep us at the head of the pack for competitiveness for the next 20 to 30 years? Because, God forbid, we are not going to get to reform for another 30, 25 years down the road. Mr. Wiacek.

Mr. WIACEK. Well, if we want to have a real revolution here, the corporate income tax is just a bad way to raise money, or to contribute to the fisc. And if we really wanted to unleash American business domestically and internationally, we might consider eliminating the corporate income tax.

Now, that is just not going to happen, and you would, obviously, need to still have discretionary spending, and still take care of everybody, and you might have to replace it with a VAT or some other form of consumption tax—

Mr. REED. So a consumption-based tax. Ms. Hanlon.

Ms. HANLON. I mean I think I agree with this, and with the statements we have already said, in a sense, is there are a lot of things we could consider and a lot of things we could do that are bigger than just reforming the corporate tax system that we have today.

And I think the statements that were made before, that the corporate tax system—corporate taxes, in general, are bad for growth, is true.

Mr. REED. Because this is my concern. If we are not going to think big—we are here to think big. I came here to Washington to fix problems. I came here to move the needle. And if all we are going to do is go to the middle of the pack, how much complexity, how much danger is there that, if we do this, and then all of a sudden the system reacts to it, how much loss—how efficient is that?

If we are going to go big, why don't we go big and get it done, as opposed to go to the middle of the pack, everyone adjust, everyone gets more advice, creates different shelters, different structures? Why would we do that? That doesn't seem to make sense to me.

Does anybody understand? Can anyone defend that situation?

Mr. WIACEK. No, and you know that that is not what the rest of the countries are doing. So we keep looking for ways to get to the middle, or get money from the corporate income tax, and the rest of the world is not using the corporate income tax. So we are always going to be disadvantaged, even with a lower rate.

Mr. REED. Appreciate it. With that, I yield back.

Chairman BRADY. Thank you.

Mr. Kelly.

Mr. KELLY. Thank you, Chairman. Thank you all for being here.

It is interesting. And, Mr. Wiacek, I agree with you. I remember the old Detroit. I remember Clark Avenue, when they were building Cadillacs up there. I know Akron very well. I also know Butler, Pennsylvania, Erie, Pennsylvania, where you see all these areas where we had great companies that are now nothing but rusting.

But I want to get to something that is really important, because I think what we talk about—we all agree, and I agree with Mr. Rangel—and I am only going to have three minutes to address this with you?

But seriously, I mean, we all agree on the same thing. But unfortunately, we are not able to fix it. And so it is the old story of while Nero fiddled while Rome burned. And it is to the point now where—there is an old saying. When you are up to your rear end in alligators, that is not the time to worry about who was supposed to drain the swamp. The answer was we were.

So, addressing these things, there is three things, there are three factors, I think, that—why companies invert, or they are foreign takeover targets. The first is a lock-out effect. The second is anti-competitive effect of U.S. statutory rates versus world rates. And the third is the ability for foreign-owned firms to strip the U.S. base. So, as we look at all these, if you don't do them all together—because it is a two-sided coin—there is no answer to his.

And I would just tell you in my business, the automobile business, you either pivot or you perish. You either understand that you live in a global, competitive nature, or you are not going to be part of it any more.

So, absent of fixing all of it, do any of you see anything—it is not any one thing, is it? It is a number of things we have to fix. Is there any who want to weigh in? Does anybody agree that just—if we just fix this inversion thing, and if we really beat the living daylights out of these guys that want to jump ship, we are going to keep them home?

Mr. GRINBERG. Okay, so—thank you, Congressman. I mean my view—when I teach about the inversion rules and talk about proposals about them, I call them the Hotel California rules: you can check out, but you can never leave. And the problem with imposing those kinds of rules is that eventually no one new checks in. And also, you know, if the rule is that you have to be fully taken over by a foreign firm in order to check out, and you are in the Hotel California, that is what you will do.

And so, I think that is the difficulty with just focusing on inversions and not addressing the broader problems that exist in the system by moving to a modern, competitive system that puts us in a position to compete with the rest of the world.

Mr. WIACEK. I think, as I said—and my testimony doesn't mention inversions—I think inversions has unfairly stolen the debate. I testified about companies that are just taken over with no tax planning for competitive reasons. This is about competition. And, as I said, if you pick up the Wall Street Journal, there is a Chinese company buying an American division every day. It has nothing to do with inversions.

So don't let diversions [sic] steal the debate. They are just the tip of the iceberg. And we are losing jobs and companies every day because we are not competitive. And it is—and that is what it is.

Mr. KELLY. I want to stay in touch with you, because you all have great ideas.

Thank you, Mr. Chairman.

Chairman BRADY. Thank you.

Ms. Sánchez, you are recognized.

Ms. SANCHEZ. Thank you, Mr. Chairman, and to our witnesses for joining us here today. While I think that this hearing is important, and it is providing us a chance to delve deeply into some very timely tax issues, I would be remiss if I didn't start my time by urging the committee to take up true comprehensive tax reform, rather than just walling off the international piece.

And that is not to say that many of the issues that have been discussed today aren't important. Things like base erosion, inversions, and a generally outdated system, those are all very important. But you can't do the international piece without—in a vacuum, because a tax code is like a spider web: If you tinker with one part of it, it has ripple effects throughout the whole.

Mr. Kleinbard, in your written testimony you discuss the relative relevance of the U.S. statutory corporate tax rate for multinationals versus the impact the rate has on purely domestic companies. And you started to discuss that a little bit with Mr. Davis's question. But I would like to push on this a little bit.

In your written submission you state that corporate tax rates inside the United States should be our highest priority, and that a lower domestic rate reduces, to some extent, the long-term attractiveness of inversions or stateless income planning.

I agree that competitiveness for all U.S. businesses is extremely important. But equally important, I think, is that fair playing field for domestic companies who also, we forget, employ workers and create jobs here in the United States—domestic companies who, I might add, don't generally have the resources to take advantage of tax planning schemes in order to lower their effective tax rate. And I think it is important to distinguish between what is the statutory rate and what people actually pay as their tax rate.

So, Mr. Kleinbard, if we are attempting to get as close to a level playing field for domestic companies as possible, would international-only reform be the correct route to take?

Mr. KLEINBARD. Well, I think the answer to that is no. When international is understood the way it is being described here, which is fixating on the taxation of foreign direct investment by U.S. firms, that is half of international, much less all of business. The other half of international, again, is that the United States is the largest importer of foreign direct investment in the world.

So if what you want is a level playing field, and you are going to insist that that be understood as meaning only international, well then, the United States is part of international. The United States is a source country, as well as a residence country. It is inbound, as well as outbound. Both parts really ought to be thought of.

And things like the base erosion point, closing off earnings stripping, closing off the excessive interest deductibility, dealing with the so-called hopscotch loans that motivate inversions, those protect the domestic base so that there is a level playing field with wholly domestic competitors.

Ms. SÁNCHEZ. Thank you very much. I yield back.
Chairman BRADY. Thank you.

Mr. Renacci.

Mr. RENACCI. Thank you, Mr. Chairman, and I want to thank the witnesses.

You know, Mr. Kleinbard, you had talked a little bit earlier about all these things we have to do, and then you ended by saying, "and that is how we can be competitive." And I think the answer is that is the issue. These multinational companies are not competitive, which gets back to what Mr. Wiacek said earlier, that the only way we can be competitive is to be able to compete. If I had a business today, and I knew that I could move it and save 17 percent or 22 percent, that is a savings, especially when you are working on a small margin. That is why we have to become more competitive.

You all have said we need to reduce rates. That is an easy answer. We could do that tomorrow. Here is the issue: We are not—this country just doesn't have C corporations, they have pass-throughs. So you just can't reduce rates on corporations when you have pass-throughs. So you would all agree that that is probably the stumbling point between just reducing rates.

Mr. KLEINBARD. No. Sorry, I can't. And I also can't agree with the idea that international firms are not competitive. There is just no evidence, when Pfizer is paying worldwide cash tax at a rate of six-and-a-half percent, where is the competitiveness—

Mr. RENACCI. Have you ever operated a business?

Mr. KLEINBARD. Have I operated a business? Yes. I was one of the executive committee of my law firm at the old days. It is a billion-dollar business.

Mr. RENACCI. I was in a business for almost 28 years. I can tell you that if I could save 14 percent or 22 percent, I—

Mr. KLEINBARD. They are not saving it, that is the point. There is not, in fact, a cash tax savings—

Mr. RENACCI. I don't want—with three minutes, I can't argue with you.

I—go ahead, Mr. Grinberg.

Mr. GRINBERG. I think you are right, that it is important to think about Main Street. And if you are kind of thinking about fundamental, comprehensive tax reform, and you want to leapfrog, then you need to find a way to address everyone's concerns. But if you go down that road, then I think you have to talk about very, very fundamental tax reform. That is why consumption tax looks attractive. A consumption tax looks attractive to Main Street, and it looks attractive to corporate America.

Mr. RENACCI. One thing I do want to agree with, one of my colleagues talked about, you know, we have to get—make sure the American people understand this.

I was thinking back, Mr. Wiacek, when you talked about Firestone. You know, Firestone, on March 18, 1988 the New York Times reported that Bridgestone acquired Firestone the night before. I live 15 miles away from that corporate facility, and I was a firefighter at that time, I was a businessman, I was a CPA, but I never really thought of the impact. Twenty-eight years later, I know what the impact is now.

I don't know if there is any statistics you can bring to the table on Akron in specific, but Akron is a great case study, because we have seen what happens when a major corporation leaves the city, and what it does. So I only have 23 seconds left, and I do want to move on to one other question.

Mr. Grinberg, you also said that it is important to recognize that countries around the world are moving away from residence country taxation towards source country taxation. I agree with that, it shouldn't matter where the residence is, it should matter where the source of the income is. Can you just touch on that?

Mr. GRINBERG. So in three seconds all I can say is I agree. And, you know, I think that is another issue that Congress should consider. Thanks.

Chairman BRADY. Thank you very much.

Mr. Meehan, you are recognized.

Mr. MEEHAN. Here is the bottom line—and this is fascinating testimony, but I feel like, if I was in law school and I wrote the same paper, I would have two professors who would grade it completely differently. And that is one of the frustrations of this.

Mr. Wiacek, you talked—the other thing that concerned me is the inequity of the playing field and what we are doing here in the country. You are suggesting that we have had American-based businesses that have relied on opinions that have been given by other countries, they have made their calculations based on that, and now European countries and others are changing the rules halfway around the game. So how do we respond to that?

But basically, the question is, I get asked by—I have a lot of pharmaceutical companies in my back yard. When they leave, and they go to another country, all of the things that you discussed are part of it, Mr. Wiacek. What do I tell them? When they say to me, "What are you doing about it," what do I say? "Here is the answer."

Mr. WIACEK. So that is why they voted for you instead of me. But, you know, if they all leave, you know, as you go up and down the Garden State Parkway you know it is pharmaceutical central and we are in big, big trouble if that happens.

And you know, there has been this discussion that—there is a vilification of the pharmaceutical and the tech companies for not paying a 35 percent rate. Thank goodness. You know? The 35 percent rate is not competitive. And Ed and everybody—everybody has said we have to lower the rate. I don't think that is the only answer.

Then we move on to what do we do about deficits, do we have consumption tax, what do we do—but just since a lot of them are in your district, there is nothing wrong with the planning they do, just as there was nothing wrong with getting a ruling from The Netherlands as to their business plans and what the tax effect would be in Europe about it.

If we get 16 percent from them, which was the rate proposed from someone on the Democratic side, that is a competitive rate. That is where they should be. If you actually expect everybody—and you are really mad at them if they don't pay the 35 percent rate—if they pay the 35 percent rate, they are toast. They are toast.

Now, I understand that you have a local restaurant that pays the 35 percent rate, or a pass-through that pays the 35 percent—and we have to—you know, we have to figure out how to do that. Heck, I pay 39.6. I work so hard for my clients I don't attend to my own taxes at all, and I just write the damn stuff and grit my teeth like every American.

But we have got to make these companies competitive. And my consistent point is it is urgent, because everyone else is galloping forward and doing it anyway and already. BEPS is out of the barn.

Source-based taxation isn't always the best idea. It is anti-American, because we are the resident country. We invent the stuff, we make the stuff, we sell the stuff. What source-based taxation says, "But I buy the stuff, and I would like to take a big piece of the revenue." And that is—that favors India and Brazil and Mexico and a lot of places that aren't us.

Chairman BRADY. Thank you.

Mr. Neal, you are recognized.

Mr. NEAL. Thank you, Mr. Chairman. Ms. Hanlon, I know that you have taken an interest in innovation box pursuits. And Mr. Boustany and myself, we have focused a proposal on that whole notion of the innovation box. Would you care to comment, and then maybe Mr. Wiacek.

And then I am going to have Mr. Kleinbard, whose book I feverishly read last summer and have been recommending widely to people, tell me why he disagrees with me.

Ms. Hanlon.

Mr. WIACEK. Do you want Ed to go first, or me, or—

Mr. NEAL. No, no, you two go first. He is going to take the—he will do the clean-up spot for us.

Mr. WIACEK. I am not a big fan of the innovation box or the patent box. I understand why it is there, or—it is a little bit, to me, a part of the debate of how much do you want to bite off at any one time. So it bites off the return to—and tries to be—if you are the UK and you put it in, you are not trying to attract all investment, you are trying to attract the investment that is most wealthy, most modern. You are trying to attract technology. That produces the most jobs.

I would bite off more, and I would try to not do the patent box and fix international taxation. Other people here want to bite off the whole thing and fix all taxation. It is just kind of this step along the line for me—

Mr. NEAL. Ms. Hanlon.

Ms. HANLON. I think innovation boxes are, you know, possibly a good alternative.

Again, though, I think we need to reduce the overall corporate tax rate. That would be the best thing we could do. If that is too politically difficult to do, then a patent box becomes even more appealing at that point.

Mr. NEAL. Okay. Mr. Kleinbard.

Mr. KLEINBARD. Mr. Neal, first, I appreciate your kind words about the book. And second, I—

Mr. NEAL. It was—your book, by the way, was very reasonable. Entirely reasonable, when I—

Mr. KLEINBARD. Completely inconsistent with my personality.

[Laughter.]

Mr. NEAL. Go ahead. Finish, please.

Mr. KLEINBARD. So, you know, I hate to—ever to disagree with you, but I am not a fan of patent boxes. I do know that they will be job creators, but those jobs that they create—that it creates will be entirely in the accounting profession, as people devote huge amounts of energy to squeezing all sorts of ordinary course business activity into the patent box.

I wrote, you know, a paper using Starbucks as a case study called, “Through a Latte Darkly.” And in the paper what I discovered was that Starbucks pretends that its so-called Starbucks experience is a separate intangible that it can charge a license for. So when you start down the innovation box road you have that problem.

You also have the problem that you are rewarding for past behavior. We have lots of incentives right now for R&D, like the R&D credit, like the deductability of R&D expenses. I think that those make sense, those ought to be the focus, not the reward for past behavior that the innovation box offers.

Mr. NEAL. I think my time has expired.

Chairman BRADY. It has. Mr. Holding, you are recognized.

Mr. HOLDING. Thank you, Mr. Chairman. It is pretty clear from this hearing that our foreign rivals aren’t stupid, and they have taken steps to attract business, innovation, implementing territorial tax system, lowering corporate rates, and aggressive IP regimes, including innovation boxes and research credits. So all of this serves to show how broken our own system—everything that they are doing highlights a broken part of our own system. And it is my concern, if we don’t do something now, it is the American worker that is going to pay for this.

Professor Hanlon, in your testimony you discussed, as we have said, the implementation of innovation or patent boxes by a number of foreign countries. And then, highlighting this, you touched on a concern of mine with this proposal, which is the OECD’s nexus requirement.

So innovation and research is, especially in the life sciences, very important in North Carolina, and the fact that the life science sector in North Carolina accounts for about \$73 billion in economic activity and employs about 66,000 people across North Carolina. So these are the high-paying, high-value jobs that are making North Carolina a leader in innovative research.

So, Professor Hanlon, could you please describe how the OECD’s nexus requirement, in conjunction with the implementation of foreign patent box regimes, could affect research and development activities as well as jobs here in the U.S.? And if you see any steps that Congress could take to encourage and attract companies to conduct research and development here.

Ms. HANLON. Sure. I think it is a good question. The OECD BEPS requirement for nexus basically will require companies to have economic activity—meaning R&D, generally—in the jurisdiction or in the entity that is going to get the benefits of the innovation box.

So it is a risk, in the sense if we don’t do anything we will plausibly lose R&D jobs. Not just the income from the patents going

forward, but actual R&D jobs will have to move offshore. And I think that is a big risk—

Mr. HOLDING. Because they are complying with OECD BEPS.

Ms. HANLON. Yes, yes. And so that is a big risk. I think there is a lot of things we could do, a wide array of things. Increase the R&D credit. I think making it permanent was a great step, but we could increase those incentives. We could—you know, the government could give more grants, we could do an innovation box. There is lots of things at our disposal that we could think about doing. But it is a risk, I think, if we don't do anything—we don't reduce the corporate tax rate, we don't do any tax reform, we are at a serious risk of losing R&D jobs.

Mr. HOLDING. Right, because the foreign countries are putting in regimes to attract other—to attract these businesses. And for them to take advantage of it they are just simply going to have to move the jobs out of the United States and into the other countries.

So thank you, Mr. Chairman, I yield back.

Chairman BRADY. Thank you. Mr. Smith, you are recognized.

Mr. SMITH of Missouri. Thank you, Mr. Chairman. I want to thank all the witnesses for being here today. This is an extremely important subject, as we all know, to discuss.

But I also want to make a point. I think that inversions are a huge, serious issue that we should all continue to examine. We have seen that. And it is clearly a symptom of our broken tax system in the U.S., and we need reform.

At the same time, I believe that we should be careful not to conflate the issue of inversions with foreign investment in the U.S., which, as we can see, can have a positive impact throughout our country. I can give you a couple examples in my congressional district alone.

In my district, TG Missouri, which is a Japanese company that employs over 1,400 employees, one of the largest employers in our congressional district, has great, high-quality paying jobs. And, in fact, they are expanding. That is a foreign investment. That is different than inversion. But I want to make sure we are clear on that. And I think this Committee needs to be very careful when we are looking at the tax structure and looking at it.

There is also another company that has been mentioned around here that is located in Jefferson County in our district, a \$280 million investment for a bottling company to manufacture aluminum cans, aluminum bottles. There is really only one company that does aluminum bottles; you can figure that out. But that was a foreign investment, and not an inversion. And so we need to look at that when we are looking at the tax structure.

I do have a question, Mr. Grinberg. As things stand today, my constituents in southern Missouri are not all that worried about BEPS and what is going on over in the European Union. They really aren't. They are concerned about getting their crops in the ground and how to just make ends meet, balance their budget, live within their means. But you have been quoted in saying that the U.S. is one of the losers in the BEPS rule. Assuming the U.S. does nothing to step BEPS from being implemented, what is the impact of those families back in Missouri?

Mr. GRINBERG. Thank you, Congressman Smith. So I think it is too late to un-ring the BEPS bells. I think that whatever one thought about the old international tax environment, the new environment puts greater competitive pressures on the United States, and means that we need to very substantially lower our corporate tax rate and move to a dividend exemption system as a first step.

I think that, you know, the families of the people in your district should be concerned about it because it is about opportunities and jobs for future generations of Americans, and they are affected by that.

Mr. SMITH of Missouri. Thank you, Mr. Chairman.

Chairman BRADY. Thank you.

Mr. Rice, you are recognized.

Mr. RICE. Recent polls say 65 percent of American families don't believe that their children will have the same opportunities that they have had. I think the American people do realize this.

And you know, it is perplexing and frustrating to me that the President and Republicans and Democrats and House and Senate Members all talk about this as a huge problem for American competitiveness every day, every day, and yet we can't seem to push anything forward.

Let me ask you all a question, just a hypothetical. You got two companies, one an American company that wants to be patriotic, doesn't want to invert, and wants to pay every dime that it is supposed to pay, and it is paying a 35 percent rate. And then you have got an Irish company that is paying at 13 percent. And they both buy from the same suppliers, sell to the same customers, and they are competing hard every day. What is going to happen? What is the outcome of those two companies, Ms. Hanlon.

Ms. HANLON. I think the Irish company will win.

Mr. RICE. They will either buy the American company, or the American company will go bankrupt, right?

Mr. Wiacek, do you agree with that?

Mr. WIACEK. I do. The Irish company will buy the American—

Mr. RICE. Mr. Grinberg, do you agree with that?

Mr. GRINBERG. I think we should be—

Mr. RICE. Mr. Kleinbard, do you agree with that?

Mr. KLEINBARD. No, for a reason. And the reason is simply that if the Irish company is doing business in the United States, selling to the same U.S. customers, it will be dragged into the U.S. tax net. So you have to compare apples to apples—

Mr. RICE. So three out of four agree that it is a matter of economic survival, it is not a matter of patriotism. If we punish inversions, does that solve that problem, Mr. Wiacek?

Mr. WIACEK. No.

Mr. RICE. Ms. Hanlon.

Ms. HANLON. No.

Mr. RICE. Mr. Grinberg.

Mr. GRINBERG. Again, inversions are a symptom of this broader problem. We need—one of the things that—

Mr. RICE. So it—I am sorry, I got limited time.

Mr. GRINBERG. Yes.

Mr. RICE. It doesn't solve the problem, does it? Okay.

Do all you all favor a consumption tax over corporate tax? I heard the first three. Do you—is that true?

Mr. WIACEK. When we can't lower the corporate income tax or fix our competitiveness problem in the corporate income tax sector because people talk about deficits or discretionary spending and another source and fairness, another source of revenue—I think even Ed agrees, or we all agree that another source of revenue may be necessary.

Fred Goldberg testified before you folks for a——

Mr. RICE. I am sorry, I have got very limited time, I am sorry.

Mr. WIACEK. Okay, I am sorry. But——

Mr. RICE. In general, do you favor, Ms. Hanlon, a consumption tax over corporate tax?

Ms. HANLON. Potentially, yes.

Mr. RICE. For economic growth?

Ms. HANLON. Depending on the details.

Mr. RICE. Mr. Wiacek.

Mr. WIACEK. Potentially, yes.

Mr. GRINBERG. Yes, we should move towards consumption taxation and away from——

Mr. RICE. Mr. Kleinbard.

Mr. KLEINBARD. I actually have a comprehensive tax reform proposal called the dual business enterprise income tax. You will like the fact that——

Mr. RICE. Is that yes or no?

Mr. KLEINBARD [continuing]. That the business component of that functions as a consumption tax, but it is integrated with an income tax at the individual level.

Mr. RICE. Okay. Well, I yield back my last two seconds. Thank you. I am sorry I pushed so hard. I had to get all that out, I am sorry.

Chairman BRADY. I think you set the record for questions today, Mr. Rice.

[Laughter.]

Chairman BRADY. So, Mrs. Noem, you are recognized.

Mrs. NOEM. Well, thank you, Mr. Chairman. And while I am sure everybody is glad to be getting down to the last few Members of Congress, we prefer to think of ourselves as the grand finale.

[Laughter.]

Mrs. NOEM. So, South Dakota is primarily an ag state. It is our number-one industry. And while we don't have a lot of multinational companies located in the state, we are extremely competitive because we do not have a state corporate income tax. We do have some companies that have recently moved in, and it has been because of our tax climate. Babybel Cheese, a French company, has recently set up facilities within the state, and we are glad to have them.

But you know, companies look to locate in our state over other states, because of the environment that we have created. We know that we—they need to be competitive and, if they are going to be in the United States, that we need to make that package as—available to them so they can be successful, as well.

I guess I just wanted to ask you today, since I think virtually every question under the sun has been asked already, is if you

could be a bit visionary for us. Tell me what each of you believes will happen if we do not deal with corporate income tax, international tax reform, in the next 5 to 10 years. What do you envision will happen to the economy in the United States, and American companies that are struggling to survive in this competitive tax environment, globally?

We will start with Ms. Hanlon.

Ms. HANLON. In general, I think we will see a continuation of the trends we have already observed, meaning we will see more companies trying to exit the U.S. We will see more companies being acquired by foreign companies. We will see more cities, perhaps, that look like Akron. So I think it is quite a risk. And I don't think we can sit by and do nothing.

Mrs. NOEM. You spoke specifically in your testimony about companies being forced to invest poorly overseas, rather—could you expand on that a little bit, that they are making poor choices because—not being able to repatriate those funds to the United States. Could you just expand on that a bit?

Ms. HANLON. So it is basically an effect of this locked-out cash. And there is two plausible hypotheses about why it happens. But generally, what we observe is that these companies invest in foreign companies, and they invest in foreign capital expenditures, rather than the U.S. And it is economically rational for them to do that, because they avoid the 35 percent tax. But it is true that these companies with a lot of cash that make these foreign acquisitions, the market return to those acquisitions are lower than, say, returns—

Mrs. NOEM. Right, and you don't—

Ms. HANLON [continuing]. For other kinds—

Mrs. NOEM [continuing]. Want to necessarily leave the cash in their pockets and become a target for takeover, as well.

Ms. HANLON. That is right, that is right.

Mrs. NOEM. Okay. Well, we will move on to the other three. If you could be a little visionary with me and share what you think could happen in the next 5 or 10 years if we do not have any type of international tax reform.

Mr. WIACEK. Well, I hesitate to quote Donald Trump, but I think—

Mrs. NOEM. No, no.

Mr. WIACEK [continuing]. Continue to lose.

Mrs. NOEM. We are going to lose?

Mr. WIACEK. We will continue to lose.

Mrs. NOEM. We won't be great again?

Mr. WIACEK. I don't think it will be a crisis, I don't think you will have one big event where everybody is taken over, but a kind of slow drumbeat of erosion and—

Mrs. NOEM. Steady decline.

Mr. WIACEK [continuing]. Lack of confidence and no jobs for the future and people actually, on survey, worrying that the next generation will not do as well.

Mrs. NOEM. I think I am out of time, but for—I appreciate you being here today.

Chairman BRADY. Thank you.

Mr. Dold for the last question.

Mr. DOLD. Thank you, Mr. Chairman. And I want to thank you all for taking your time and for your testimony.

I think what is interesting, as we have listened to—and again, you have three minutes—so I think what is interesting is kind of this similarity of a lot of the questions, because that is what we are hearing from our constituents.

And then the other thing that I find so interesting is the fact that most of you—in fact, all of you—agree that we need to do something with regard to our corporate rate. And I would be one, as a small business owner, that recognize two-thirds of all new jobs are created by small businesses that are not necessarily C corps.

But I also know, representing a district that has 23 Fortune 1000 companies, that these Fortune 1000 companies support thousands of small local businesses. And what they fear? They fear that they are not competitive, and we have all highlighted that. We are not operating in a competitive environment today. We are in a global economy and, frankly, we are going to get our heads handed to us if we don't step up and do something.

And so, whether it is you are able to manipulate, whether it is you are able to pay an effective rate that may be lower, the long and the short of it is would you all agree that we are currently not in a competitive tax environment here, in the United States? Just quickly.

Ms. Hanlon, are we in a competitive tax environment for our companies here in the U.S.?

Ms. HANLON. No.

Mr. DOLD. Mr. Wiacek.

Mr. WIACEK. No.

Mr. DOLD. Mr. Grinberg.

Mr. GRINBERG. No.

Mr. DOLD. Mr. Kleinbard.

Mr. KLEINBARD. Domestically, no.

Mr. DOLD. Okay. What I inherently hear from folks, from businesses, is that they are terrified. And I represent a district that has a lot of life sciences companies. They are terrified that foreign competitors are going to use our own tax code as a weapon against us, that they are going to be taken over, they are no longer going to be U.S. based.

And therefore, these good, high-paying careers that are spending an enormous amount of resources, that are donating to charities, that are propping up our communities, are no longer going to be there. They are no longer going to be the decision makers. In fact, they are going to be based overseas.

And so, while I do agree that we have to deal with a comprehensive approach, my fear is that we are not prepared to do so in 2016. And if we are waiting, more and more of these businesses are going to become foreign-owned. More and more of these inversions are going to happen.

And what I have also heard from companies—and if there is anyone that agrees—many of them are inverting because they can invest back in the United States easier from a foreign base, if they can, as if they are U.S.-based. Would you agree, Ms. Hanlon, that that is happening?

Ms. HANLON. Yes.

Mr. DOLD. Mr. Wiacek.

Mr. WIACEK. Yes, indeed.

Mr. GRINBERG. We are no longer a good jurisdiction to domicile a global business, and that is a problem.

Mr. DOLD. Mr. Kleinbard.

Mr. KLEINBARD. You have the power to change that with a snap of your fingers. Yes, it is true that when you invert you can get your hands on the offshore cash, but that is because there is a—because you need to repair Section 956 of the code. You have the control over that.

Mr. DOLD. And I welcome your advice and counsel, because that is exactly what we need to do. We need to make sure that American businesses are allowed to be able to compete and win. And if we don't step up and act and act now, we are going to find more of these businesses that are going to have decisions taken away from them, and those decisions will be made overseas, and we will be uncompetitive, making our communities less competitive. And again, opportunities for job growth decline.

Mr. Chairman, my time has expired, but certainly appreciate the opportunity. And I want to thank our witnesses for being here.

Chairman BRADY. Well, thank you, sir. Mr. Young has returned. You are recognized.

Mr. YOUNG. Thank you, Chairman, for this hearing. I thank our witnesses for being here today.

Indiana has a robust life sciences industry. My hope is that it continues to play a very important role in our state's economy, future jobs, and jobs that pay well.

Professor Hanlon, there is widespread agreement that our corporate tax system is in urgent need of reform. Hence our hearing today. The combination of high corporate tax rate and worldwide tax base hinders the competitiveness of U.S. global innovative businesses in the United States as a place to invest. As a result, foreign-parented businesses have a more efficient platform for business growth, acquisitions, and shareholder value than U.S.-parented businesses. We see this playing out in M&A, particularly in the life sciences sector, where intense competition is highly sensitive to these tax rate differentials.

Don't you agree that any tax reform should adopt policies that solve these competitiveness issues, rather than making them worse?

Ms. HANLON. Yes.

Mr. YOUNG. Okay. As a follow-up, Professor, one of the key objectives of international reform is to solve the so-called lockout problem with respect to foreign earnings. All the recent proposals, of course, would do this by making repatriation no longer a taxable event, and adding measures to prevent erosion of the U.S. corporate tax base. While these are common features of recent proposals, the details matter when it comes to their impact on competitiveness.

Don't you agree that replacing deferral with what amounts to an uncompetitive worldwide tax system for intangible income would exacerbate, rather than solve the serious competitiveness issues faced by American innovative global businesses?

Ms. HANLON. Absolutely, yes.

Mr. YOUNG. Any other thoughts on the issue from members of the panel?

Mr. GRINBERG. Again, one has to think seriously about, in a global economy with a global market for corporate control, thinking about—I think the Congress should consider whether or not we want to use corporate residence as a basis for, you know, a really, truly fundamental tax reform. Because you are exactly right that, you know, if you impose a minimum tax which only applies to U.S.-headquartered companies, then there is an incentive to avoid that regime.

Mr. YOUNG. Mr. Wiacek.

Mr. WIACEK. I am just about done. I mean before you came back there was the comment that we have all been saying the same thing in many different ways, and I think that is right. We need a lower rate, and we need to fix the system, and it is hard to do.

Mr. YOUNG. I would add that this is something we, as Members of Congress, need to continue to be repetitive about, to hammer home the importance of making these sorts of changes so essential sectors, like our life sciences sector, receive the relief they need so they can continue to grow. I yield back.

Chairman BRADY. You know, I am convinced that America is beginning to hear the giant sucking sound of American companies and jobs and investment overseas. Part of that is generated by our global competitors who are shrewdly understanding how our tax code works and are moving aggressively, but the root cause is our tax code.

And I am convinced the first step we can take toward overall pro-growth tax reform is to permanently lower the tax gates to allow our U.S. companies to bring their profits back home to invest in our communities, in our jobs, in research and development, in growth. Because no one has yet convinced me an American dollar stranded overseas is better than an American dollar brought back home to invest in—for any purpose whatsoever. So I am convinced the first step we should take is in that area.

We are determined to create overall pro-growth tax reform. But I am convinced we have to act now. And I am charging our committee and Chairman Boustany and the Tax Policy Subcommittee to bring that solution forward so we can start to put this on the field and move these balls.

Your—witnesses today were tremendously helpful to setting the environment we are competing in. Thank you for being here. And pleased be advised Members may submit written questions to be submitted later in writing, and those questions and your answers will be made part of the formal hearing record.

And with that, the committee stands adjourned.

[Whereupon, at 12:23 p.m., the committee was adjourned.]

[Submissions for the record follow:]

Chairman Brady, Ranking Member Levin, and Members of the Committee on Ways and Means, thank you for the opportunity to submit testimony on these important issues.

My name is Andrew Quinlan, and I am the president of the Center for Freedom & Prosperity (CF&P). The primary mission of the Center for Freedom & Prosperity is to defend tax competition as an important principle that helps ensure a prosperous global economy.

As Congress considers long overdue reforms to the U.S. corporate tax code, it needs to be recognized that corporate flight – such as through inversion – is just a symptom of the disease. The fundamental problem is the uncompetitive tax code.

To that end, I have included a recent editorial explaining why efforts to demonize corporations for responding to current tax incentives are misguided.

Politicians Pointing Fingers Over Corporate Inversions Should Look in the Mirror

Andrew F. Quinlan, Center for Freedom and Prosperity
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With the presidential campaign season in full swing, no one should be surprised to find politicians using hyperbole and demagoguery to energize supporters while vastly oversimplifying complex policy problems.

However, when it comes to a recent example of yet another so-called “corporate inversion,” the knee-jerk political response of attacking and shaming the company reveals a political class that is dangerously out of touch with global economic reality.

An inversion occurs when a U.S.-based company merges with a foreign corporation and relocates its headquarters overseas. This allows the company to compete in foreign markets without being held back by the anchor that is the U.S. corporate tax code.

The last decade has seen around 50 inversions and 20 since just 2012. One of the most recent examples is a proposed merger of major pharmaceutical company Pfizer with the Ireland-based Allergan, news of which prompted swift denunciations from the two current leading Democratic candidates. Bernie Sanders called it a “disaster,” while Hillary Clinton alleged that Pfizer was attempting to “shirk its United States tax obligations.”

Little could be further from the truth.

Many have also slammed those that invert as “unpatriotic” or called them “Benedict Arnold” companies, as if corporations exist solely to fill the coffers of the U.S. Treasury, or that their first duty is to politicians and tax collectors instead of shareholders.

In reality, it is the latter to whom any CEO must answer.

They have a fiduciary duty to shareholders, meaning it is a legal responsibility to put their interests first. And contrary to popular rhetoric, shareholders aren’t primarily found on Wall Street, but among the half of all Americans with pension ties or investment portfolios in the stock market.

It’s worth noting that, contrary to the impression given by opportunist politicians, inverted companies still pay U.S. taxes – just only when they’re actually operating in the U.S. market. It is the unreasonable demand, unique to America’s worldwide tax system, that companies also pay up to the excessive 39 percent U.S. corporate rate even for products entirely made and sold overseas which has forced their hands on inversions.

Under the current system, U.S. companies are put at a huge disadvantage compared to foreign competitors. A French-owned company with an affiliate selling in Ireland, for instance, would only be subject to Ireland’s low 12.5 percent because they use a territorial system that taxes only within their borders, whereas an American-owned company looking to sell the same goods in the same market would not only pay Ireland’s rate, but also the remaining difference up to the much higher U.S. corporate rate. With the U.S. rate so much higher than the OECD average of 25 percent, that creates a serious impediment.

It’s fair to point out that after various deductions are made the total corporate tax bill will come in below the statutory rate. However, business decisions are made on a marginal basis – meaning the tax on the next dollar earned is what determines whether or not an activity occurs. According to the

Tax Foundation, the U.S. has not only the highest statutory rate among developed nations, but also the highest marginal effective rate.

The overseas tax handicap for American companies doesn't only hurt shareholders, but also workers by reducing opportunities for expansion and growth. The system also discourages investment in the U.S. because companies are incentivized to keep profits overseas due to what's known as deferral. Specifically, the U.S. tax is only applied when the money is brought home, which encourages it to be kept abroad where it cannot be put to work growing America's domestic infrastructure and creating jobs.

While the incentives it creates are a problem, simply ending deferral would be even worse than the current system because American companies would then have no release valve for dealing with the economic pressure imposed by an uncompetitive tax code. They would simply invert or find other ways to leave American shores faster than ever before.

Attempting to rig the rules to prevent inversions is also not a viable solution. It's been tried before and has never worked. So long as cross border economic mobility is an option – a given in the globalized economy – companies will flee from uncompetitive and confiscatory tax regimes. Nor should we wish to stop them even if it were possible, as the threat of capital flight is an important mechanism for keeping politicians from trying to extract too much from the productive sector of the economy.

If U.S. companies don't invert or leave on their own accord, they will simply be bought out by foreign corporations. The tax code makes assets currently owned by American companies more valuable to foreign conglomerates who face lower tax burdens, which is why foreign takeovers last year doubled in terms of dollar value. With these takeovers come a greater likelihood of research and development or jobs moving overseas.

Ironically, even the government is harmed by the current burdensome tax code by driving productivity and investment overseas. In contrast, Canada has both a lower corporate tax rate – having reduced it from 43 percent in 2000 to 26 percent today – and collects more corporate revenue as a share of GDP than the U.S.

Rather than publicly shaming companies for making responsible economic decisions, politicians bemoaning inversions need to look in the mirror. It has been 30 years since the last major corporate tax overhaul. In that time the rest of the world has left us behind by reforming their own systems and reducing corporate tax burdens. It's time for the U.S. to be a leader again by shedding the worldwide tax system and lowering corporate rates to help unleash innovation and growth, while keeping American companies at home.



Chairman Brady, Ranking Member Levin, and Members of the Committee on Ways and Means, thank you for looking into these important issues.

My name is Brian Garst, and I am the Director of Policy and Communication for the Center for Freedom & Prosperity (CF&P). The primary mission of the Center for Freedom & Prosperity is to defend tax competition as an important principle that helps ensure a prosperous global economy.

The need for U.S. corporate tax reform is by now well established. Yet as members of Congress turn their attention toward building a more competitive and pro-growth tax code, international organizations are pushing in the other direction.

The OECD's work on Base Erosion and Profit Shifting is merely the organization's latest assault on U.S. interests. The failure of the U.S. to lead on the international stage has resulted in the interests of tax collectors being placed above those of taxpayers and economic growth.

To explain why BEPS poses a greater threat to U.S. interests than even many of its opponents realize, I have included an abridged version of my paper, "Making Sense of BEPS: The Latest OECD Assault on Tax Competition," as well as a related coalition letter from representatives of 22 free-market and taxpayer protection organizations.

BEPS Has Tax Competition in the Crosshairs

Brian Garst, Center for Freedom and Prosperity

Originally published October 2015 by *Offshore Investment*

The OECD's work on Base Erosion and Profit shifting is completing after what can only be described as an extremely rushed process by global policy standards. In an effort to understand the broader implications of the project and what it means for the future of international taxation, I authored a study published June 2015 by the Center for Freedom and Prosperity titled, "Making Sense of BEPS: The Latest OECD Assault on Tax Competition."¹ The following is an abridged version of the paper:

Introduction

Under direction of the G20, the Organization for Economic Cooperation and Development (OECD) began two years ago a major initiative on "base erosion and profit shifting" (BEPS). The project has garnered little interest from U.S. policymakers to date, yet its ever expanding scope and profound implications for the global economy should demand their attention.

In February 2013 the OECD released a report titled, "Addressing Base Erosion and Profit Shifting" (BEPS Report), declaring that, "Base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike." The OECD followed up with a plan in July 2013, "Action Plan on Base Erosion and Profit Shifting" (Action Plan), that identified 15 specific areas to address.

Through the BEPS project, the OECD is continuing its war against tax competition. Its proposals would enable endless global fishing expeditions and provide cover for governments to choke the economy with new taxes.

The Threat to the Economy

The OECD and other supporters of the BEPS initiative argue that there are economic benefits to preventing legal tax avoidance techniques. Namely, they contend that activity undertaken in response to tax policy represents a market distortion. In the narrow sense this is accurate, but as a justification for the OECD's current activities it falls short.

Typically ignored in the BEPS discussion are the broader implications of proposed reforms on the political economy. If all differences in tax policy were successfully minimized, to some extent it would indeed reduce profit-shifting aimed at suppressing tax burdens. So too would reducing taxes to zero, but policymakers have a variety of objectives to weigh and ought not elevate ending profit-shifting above all other national interests.

BEPS would lead to an overall higher tax environment as politicians freed from the pressures of global tax competition inevitably raise rates to levels last seen in the early 1980s, when reforms by Reagan and Thatcher sparked a global reduction in corporate tax rates that has continued to this day. Through tax competition, the average corporate tax rate of OECD nations declined from almost 50% in 1981 to 25% in 2015.

Taxes themselves distort the market by shifting resources away from market driven activities and toward politically driven activities, and higher rates, all else being equal, increase the effect of the distortion. Poorly designed tax systems – the global norm – introduce yet more distortions through the common practice of double taxing capital, which is of particular importance when discussing BEPS given that corporate taxes are often identified as the most destructive form of capital taxation,

as even OECD affiliated economists have acknowledged.

Governments necessarily need taxes to fund essential functions, but ideally should seek to minimize the economic footprint of taxation as much as possible. Political incentives, however, often work in opposition of this goal. Politicians face pressure to demonstrate to constituents that they are performing and to please the interests that support their campaigns, and that in turn encourages taxes to rise above and beyond the level of optimum growth, or where new spending no longer provides net economic benefits.

Tax competition thus provides one of the main sources of push-back against the drive to spend and tax.

Tax collectors and finance ministers have inordinate say in the activities of the OECD, so it's expected that the BEPS initiative would represent their views above all else. The Action Plan thus considers the benefits of tax competition to be the real problem, explaining that "there is a reduction of the overall tax paid by all parties involved as a whole." The prospect of there being less money to be spent by politicians is perceived as a problem to be solved, rather than as a positive for the global economy.

The Threat to Privacy

Several BEPS action items raise serious privacy concerns. Proposed recommendations for transfer-pricing documentation and country-by-country reporting, for instance, feature broad reporting requirements that go far beyond what is required for purposes of immediate tax assessment.

Guidance for Action 13 recommends a three-tiered approach to transfer-pricing documents consisting of a master file, a local file, and a country-by-country (CbC) reports. Information contained in the local and master files are particularly vulnerable, since it would take a breach in only a single jurisdiction for it to be exposed. The OECD makes assurances for the confidentiality of these reports, but they are empty promises. Such government assurances of privacy protection are contradicted by experience and the long history of leaks of taxpayer information. In the United States alone tax data has frequently been exposed thanks to inadequate safeguards, or even released by officials to attack political opponents.

Even without malicious intent, governments are ill equipped to protect sensitive information from outside access. According to the U.S. Treasury Inspector General for Tax Administration, 1.6 million American taxpayers were victimized by identity theft in the first half of 2014, up from just 271,000 in 2010. Chinese hackers were blamed for a breach that exposed the data of four million current and former federal employees, and the massive new collection effort and reporting system being established to enforce the Foreign Account Tax Compliance Act has also been faulted for its insufficient privacy safeguards.

As poor as the United States has proven at protecting privacy, there are likely to be nations even more vulnerable. Through the master file and other reporting mechanisms, BEPS will demand of corporations propriety information and other sensitive data that they have every right to keep private and out of the hands of competitors. When it takes a breach of only a single national government to expose this information, there will no longer be such expectation of privacy.

Is BEPS a Serious Problem?

The OECD's website describes BEPS as "tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic

activity, resulting in little or no overall corporate tax being paid.” The BEPS Report further claims that, “it may be difficult for any single country, acting alone, to fully address the issue.” Or as the website more succinctly describes, BEPS “is a global problem which requires global solutions.”

No significant evidence for these assertions is provided, however. The OECD's BEPS Report itself undercuts the argument that there is a pressing need for a global response when it acknowledges that “revenues from corporate income taxes as a share of GDP have increased over time.”

Academic research on the impact of BEPS is far less certain than the rhetoric of the G20 and the OECD. The strongest analysis yet to date comes from Dhammika Dharmapala, whose survey of the literature reports that recent studies tend to find lower levels of shifting than earlier works. It also challenged arguments that “point to the fraction of the income of MNCs that is reported in tax havens or to various similar measures as self-evidently demonstrating ipso facto the existence and large magnitude of BEPS.” Simply identifying money in other jurisdictions, even those with low tax rates, is not evidence of a BEPS problem. It should be expected to see more money being earned where tax policy is less hostile.

Part of the reason there exists little evidence of a significant global BEPS problem is that domestic policy solutions are already available to address legitimate areas of concern when they arise. More importantly, the best solution available for preventing base erosion is the adoption of a competitive tax code. Pro-growth tax policy that eschews double and worldwide taxation not only won't cause capital flight, but will attract investment instead.

Broader Aims of the OECD

To fully understand the significance of the BEPS effort, it's necessary to place the current agenda within the broader context of the OECD's work in recent decades. In 1998 the OECD declared war on tax competition with a report entitled, “Harmful Tax Competition: An Emerging Global Issue.” Its authors worried that, among other things, tax competition “may hamper the application of progressive tax rates and the achievement of redistributive goals.”

The organization was eventually forced by political opposition to back away from explicit condemnations of all tax competition, but has not abandoned its views. Rather, it has adopted new tactics toward the same end. To make this point clear, the Action Plan favorably references *Harmful Tax Competition* as justification for its recommendations. It also repeats a popular but baseless theory among left-wing academics and politicians about tax competition – that it promotes a ‘race to the bottom.’

The ‘race to the bottom’ theory has claimed for decades that tax competition would force zero rates on mobile capital. It hasn't happened. One review of common such claims finds: “there can be little doubt that history has proven wrong the prediction of a complete erosion of capital tax revenue. Comparative data on corporate and capital tax rates demonstrate that governments in all economies continue to tax mobile sources of capital, effective capital tax rates have not changed much compared with the mid-1980s, when tax competition was triggered by the 1986 US tax act, and tax systems are as varied as countries and political systems themselves, with no visible sign of converging.”

Nevertheless, the BEPS report notes: “In 1998, the OECD issued a report on harmful tax practices in part based on the recognition that a ‘race to the bottom’ would ultimately drive applicable tax rates on certain mobile sources of income to zero for all countries, whether or not this was the tax policy a country wished to pursue.” Reality, essentially, is an unwarranted intrusion on the desire of policymakers to act without consequence. The BEPS report goes on: “It was felt that collectively

agreeing on a set of common rules may in fact help countries to make their sovereign tax policy choices.” Unless, that is, their sovereign choice involves something other than raising taxes.

Nations that opt for little to no taxes on capital are a problem for this quixotic theory of sovereignty – where the rest of the world must be brought to heel in order to ensure that politicians ought not have to consider the economic consequences of their policies – hence why the primary indicator for determining whether a nation is to be identified as “potentially harmful” is that it has “no or low effective tax rates.”

Other factors are said to be considered, but without clear indication of how they are to be weighted any calculation will be arbitrary and open to excessive emphasis on the “gateway criterion” that is a low tax rate. When a low-tax scourge is identified, the OECD benevolently provides that, “the relevant country will be given the opportunity to abolish the regime or remove the features that create the harmful effect.” To make perfectly clear that this is the sort of offer a nation cannot refuse, they warn: “Where this is not done, other countries may then decide to implement defensive measures to counter the effects of the harmful regime, while at the same time continuing to encourage the country applying the regime to modify or remove it.”

The OECD's previous aggressions against low-tax jurisdictions in pursuit of its quest to abolish tax competition make clear just what “defensive measures” it has in mind, and how its members will go about trying to “encourage” compliance. In the years that followed release of *Harmful Tax Competition*, the OECD used threats of blacklists, peer pressure, and intimidation to cajole low-tax jurisdictions into adopting various policies presented under the auspices of increasing tax transparency and combating evasion. In practice the changes were intended to undermine the attractiveness of low-tax jurisdictions and protect high-tax nations from base erosion due to capital flight.

Of particular relevance for understanding the BEPS initiative is the pattern demonstrated by the OECD during the course of this campaign. After each recommendation was widely adopted – typically under duress in the case of low-tax jurisdictions – the OECD immediately pushed a new requirement that was more radical and invasive than the last.

The fact that the OECD is always ready with a new policy after one is implemented suggests either that the organization's goal is not merely what is stated, or that it is horribly ineffective. In either case it should serve as a blow to its credibility and a reason to question its work on BEPS.

Conclusion

Were the OECD merely a research institution, its work could be dismissed simply as a bad idea that no nation need adopt. Unfortunately, Europe's dominant welfare states use the OECD's work as a benchmark when coercing other nations through use of political and economic leverage. For the low-tax jurisdictions, and now multinational businesses, caught in the OECD's crosshairs, the ride truly never ends. The BEPS project is a continuation of the OECD's well-documented effort to eliminate tax competition, and will likely follow the same pattern of consistently moving goalposts.

The BEPS project began at the behest of a tiny few, without open and public debate regarding the assumptions motivating the effort, its goals, or the most appropriate methods to achieve them. There is a lack of accountability, reflected in the activities of the BEPS initiative, that can only be rectified through real public debate and more direct political oversight.

END NOTES:

1. The full version is available at www.freedomandprosperity.org/2015/publications/making-sense-of-beps.



Coalition for Tax Competition

July 14, 2015

Dear Senators and Representatives:

The Organization for Economic Cooperation and Development (OECD) is rapidly working to rewrite global tax rules in the name of combating base erosion and profit shifting (BEPS). We the undersigned organizations are deeply concerned that this process lacks oversight and will result in onerous new reporting requirements and higher taxes on American businesses, and are urging Congress to speak up for U.S. interests by adding its voice to the process.

The OECD has a history of supporting higher tax burdens and larger government, and the BEPS project represents just the latest salvo in a long-running campaign by global bureaucrats to undermine tax competition and its restraining force on political greed.

Because the OECD is populated by tax collectors and finance ministers, new rules being drafted through the BEPS initiative are necessarily going to be skewed in their favor. Businesses are given only a token voice, while other interests are not considered at all. Consumers, employees, and everyone that benefits from global economic growth are not able to make their preferences known.

The inevitable prioritizing of tax collection over every other political or economic interest ensures that the result of the BEPS project will be economic pain. And based on the OECD's own acknowledgement that corporate tax revenues have not declined in recent years, that pain will provide little to no real gain to national treasuries.

BEPS recommendations already released further show a troubling trend toward excessive and unnecessary demands on taxpayers to supply data not typically relevant to the collection of taxes. This includes proprietary information that is not the business of any government, and for which adequate privacy safeguards are not and likely cannot be provided.

The Treasury Department should not be the only voice representing U.S. interests during this critical process. We urge members of Congress to get involved before it is too late, and to protect American interests by ensuring that the voices of tax collectors are not allowed to speak for everyone.

Sincerely,

Andrew F. Quinlan, President
Center for Freedom & Prosperity

Grover Norquist, President
Americans for Tax Reform

Pete Sepp, President
National Taxpayers Union

Michael A. Needham, CEO
Heritage Action for America

Tom Schatz, President

Council for Citizens Against Government Waste

Seton Motley, President
Less Government

Wayne Brough, Chief Economist and Vice President of Research
FreedomWorks

J. Bradley Jansen, Director
Center for Financial Privacy and Human Rights

Phil Kerpen, President
American Commitment

David Williams, President
Taxpayers Protection Alliance

Bob Bauman, Chairman
Sovereign Society Freedom Alliance

Karen Kerrigan, President
Small Business & Entrepreneurship Council

Sabrina Schaeffer, Executive Director
Independent Women's Forum

James L. Martin, Chairman
60 Plus Association

Heather Higgins, President
Independent Women's Voice

George Landrith, President
Frontiers of Freedom

Lew Uhler, President
National Tax Limitation Committee

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**Financial Executives International's Committee on Private Company Policy
Statement for the Record
House Ways & Means Committee
Hearing on International Tax Reform
February 24, 2016**

Financial Executives International (FEI) appreciates the opportunity to submit a statement for the official hearing record on international tax reform. FEI represents more than 10,000 Chief Financial Officers, Vice Presidents of Finance, Corporate Treasurers, Controllers and other senior financial executives from 74 chapters across the United States. Nearly 60% of our members work for private companies, and FEI's Committee on Private Company Policy (CPC-P) focuses on these members' policy concerns.

Pass-Through Entities

In 2011, pass-through entities, including sole proprietorships, partnerships, LLCs, and S-corporations, accounted for 94% of all businesses, 64% of total net business income, 55% of all private sector employment, and paid more than \$1.6 trillion in wages and salariesⁱ. In 2010, private companies generated 53% of fixed non-residential investment, and are, on average, 4 times more responsive to investment opportunities than public companiesⁱⁱ. In 2012, pass-through entities contributed nearly \$840 billion in business AGI to individual returnsⁱⁱⁱ.

Territorial Tax System Access

Increasingly, large and medium-sized pass-throughs are net exporters, i.e. they have real business activity offshore. International tax reform legislation should create a territorial system that puts U.S. companies on an even footing with their foreign competition, removes disincentives for capital mobility and earnings repatriation, and brings U.S. rates in line with other developed countries.

Territorial tax proposals should not be limited to C-Corporations. Congress should grant pass-throughs access to any new territorial tax regime if they are willing to pay tolling charges on retained foreign earnings.

Pass-throughs have very complex international structures because they do not get 902 indirect credits even though they have exposure to Subpart F income. Some have CFCs for offshore deferral, but most use a combination of check the box and hybrid entities to manage tax exposure. A territorial system could reduce the need for this complexity.

Under a territorial system, pass-throughs could establish specified accumulated adjustment accounts (AAA) for offshore earnings and the entity could make distributions comprised of proportionate shares of foreign and domestic earnings as disclosed in the K-1.

Private Companies Need Comprehensive Tax Reform

While FEI supports efforts to address international tax issues for U.S. companies, we urge Congress to enact comprehensive tax reform that provides fair treatment of pass-through entities so that they may compete on a level playing field. If tax reform is to have a meaningful impact on business investment, productivity growth and job creation, privately-held businesses cannot be left out of the equation. FEI recommends that any efforts to reform the U.S. Tax Code should include the following:

Tax rate equivalency: Because corporate-only tax reform would put privately-held and family-owned businesses which operate as pass-throughs at a competitive disadvantage, any reform legislation should include provisions that permit the bifurcation of business and other income on an individual's tax return, and the application of a business rate equivalent to the highest corporate rate.

S-Corp gains recognition period: Make permanent the reduced recognition period for built-in gains for S corporations.

Estate Tax: Repeal is the best solution to protect all family-owned businesses from the serious transition challenges posed by estate taxes

For Additional Information please contact:

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ⁱ Kyle Pomerleau, "An Overview of Pass-through Businesses in the United States", Tax Foundation, January 2015.

ⁱⁱ John Asker et al., "Corporate Investment and Stock Market Listing: A Puzzle?", NBER, October 4, 2014.

ⁱⁱⁱ Joseph Rosenberg, "Flow-Through Business Income as a share of AGI", *Tax Facts*, Urban Institute, Sept. 29, 2014.

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February 23, 2016

Chairman Kevin Brady
Committee on Ways and Means
301 Cannon Building
Washington, DC 20515

Sent by email to: waysandmeans.submissions@mail.house.gov

Dear Chairman Brady:

Re: International Corporate Tax Reform –
Why a Residence-Based System Is
Far Better for our Country Than
a Territorial System that
Provides a Continuing
Preference to Foreign Income

I respectfully submit the attached memorandum.

* * * * *

I would be please to respond to any questions that you might have.

Yours very truly,

⋮



Jeffery M. Kadet

**MEMORANDUM
CONCERNING
INTERNATIONAL TAX REFORM**

Public discussion and what one sees in the press imply that some form of territorial tax system, perhaps with some safeguards to hold back profit shifting, is the only tax reform option to replace our present dysfunctional “deferral” system for taxing U.S. based multinational corporations. Maybe that’s because 99% of the few folks who understand what “deferral” and “territorial” really mean work for the multinationals (MNCs) that would benefit from adopting territoriality or for the law, accounting and lobbying firms that are well paid to service the MNCs.

As for the other 1%, those are mostly law school professors without lobbyists. (Full disclosure: The writer provided international tax advice for more than 30 years to MNCs and is now an adjunct faculty member teaching lawyers how to do likewise within a graduate Tax LLM program within a law school.)

Some of the 1% strongly believe that a residence-based system for active business income is far far superior to the territorial system, even with safeguards built in.

There are various terms that are used for residence-based systems. They include worldwide consolidation and worldwide full-inclusion. In short, the idea is to tax any U.S. headquartered group on all of its income currently at the home country tax rate, no matter in which country or in which subsidiary that income is earned. There are a few different approaches regarding how such a system could be implemented (e.g. through subpart F income inclusions or through a consolidation computation), but that is not the purpose of this letter. Rather, the purpose of this letter is to set out in brief terms why a residence-based system is vastly superior to a territorial system.¹

The chart on the next page summarizes the content of this letter.

¹ This memorandum is intentionally short and concise. For more detailed discussion, please see “U.S. Tax Reform: Full-Inclusion Over Territorial System Compelling”, 139 Tax Notes 295 (April 15, 2013), available at SSRN: <http://ssrn.com/abstract=2275488>.

Chart Contrasting Territorial and Residence-Based Systems

Policy Issue	Territorial System	Residence-Based System	System Best Accomplishing Policy Objective
Competitiveness: U.S. MNCs vs Foreign MNCs	A more level playing field but differences will persist due to varying CFC rules among countries	Competitive disadvantage for a few U.S. MNCs versus Foreign MNCs	Territorial System
Competitiveness: U.S. MNCs vs Pure U.S. Domestic Corporations	Advantages of U.S. MNCs over domestic corps increase further	More level playing field	Residence-Based System
Neutrality (including the export of jobs)	Strong encouragement to move jobs, activities, and ownership of IP from the U.S. to overseas	Neutrality achieved	Residence-Based System
Simplification	CFC rules and subjective areas like transfer pricing critical due to exemption of foreign earnings	Real simplification through elimination of some problematic subjective areas (e.g. no subpart F and TP less important)	Residence-Based System
Broadening the Tax Base (ability to generate tax revenues)	Narrowing the tax base by exempting foreign earnings from any federal tax	True broadening of the tax base by making currently taxable all foreign earnings whether repatriated or not	Residence-Based System This base broadening can pay for corporate rate reduction
Encouragement of “Game Playing” to Shift Profits from U.S. to Low-Tax Countries	Even stronger encouragement than presently exists under our deferral system	Eliminated or significantly curtailed	Residence-Based System
Lock-Out Effect	Not fully solved if 95% Dividend-Received Deduction Mechanism Used	Totally Solved	Residence-Based System

What will a residence-based system accomplish?

It promotes fair competition—“We need a level playing field with our foreign competitors.” This is the rallying cry of the 99% as they argue for not only a lower corporate rate but also a territorial tax system. Yet an even more important competition issue is seldom mentioned. That is the present non-level playing field between U.S. corporations that operate solely domestically within the U.S. and those that operate internationally.

Say two U.S. companies manufacture a widget. One does it in Poughkeepsie while the other does it through a subsidiary in Singapore. The first has its profits taxed at 35% plus NY State tax, while the second is taxed by Singapore at a much lower rate...maybe even zero. This unfairness will be much worse under a territorial system. A residence-based system would eliminate it. And frankly, *this domestic-international fairness issue is the tax policy issue that is more important to make sure we get right.*

But what about the competition issue with foreign-based MNCs? Without meaning to be unkind, the continued whining of MNCs that competition justifies their paying little or no tax is simply a *red herring*. The over \$2 trillion of accumulated overseas profits is powerful proof of this. And after the U.S. corporate tax rate is reduced to something within G20 norms, the competition issue will be completely put to rest.

It broadens the tax base, allowing for a reduced rate—This is a “no brainer”. A territorial tax system eliminates billions from the tax base and puts more pressure on the remaining U.S. taxpayers. Sure, take away more depreciation and other benefits from domestic U.S. taxpayers to give tax-free treatment to MNCs that conduct substantial activities outside the U.S.

A residence-based system broadens the base since foreign income now going untaxed becomes currently taxable. A broadened tax base supports the lower corporate tax rate that both political parties say they want. And, as noted above, this lower rate would make clear that there is no disadvantage faced by our MNCs from their foreign competitors.

It reduces the incentive to export jobs—Remember those widgets manufactured in Poughkeepsie? The tax incentive to move those jobs to Singapore under our current deferral system would become even stronger under a territorial system. Under a residence-based system, this incentive to move operations and jobs overseas virtually disappears.

It is neutral as to physical location and legal ownership—A tax system should not affect business decisions regarding the physical location of assets, personnel, and operations. Business factors such as being close to raw materials and/or customers, labor and transportation costs, etc. should govern such decisions. The same can be said for the legal ownership of business operations and assets, importantly including high value intangibles (intellectual property).

The deferral system we have now strongly encourages companies to transfer actual or economic ownership of valuable intangible property created in the U.S. to tax havens. It also encourages supply chain and other structures that allow MNCs to move the bulk of their operating profits to foreign subsidiaries in zero or low tax locations that assume business risk and hold rights to the MNC's intellectual property. "Transfer pricing" concepts and rules are aggressively used to maximize profits in these tax haven locations and minimize profits in the countries where actual R&D, manufacturing, and sales activities take place.

A territorial system will simply increase the motivation for the game playing that creates these convoluted legal and tax structures. A residence-based system, on the other hand, really approaches true neutrality. Under most circumstances, it should eliminate U.S. tax as a factor and allow business decisions to be made solely on the basis of relevant business factors.

It can promote simplification—Simplification is a mixed bag. Depending on how a residence-based system is implemented, it could eliminate some very troublesome areas of the tax law (e.g. fewer transfer pricing issues and elimination of subpart F). A territorial system, for the most part, will leave in place the current complications and likely make them much worse.

It completely solves the "trapped cash" problem—Under the deferral system, returning foreign earnings to the US via dividends triggers the up to 35% U.S. tax (and sometimes foreign withholding taxes as well). As is well known, many MNCs have stockpiled billions of such low or zero-taxed foreign earnings outside the U.S. and often maintain that those earnings are permanently invested outside the U.S. to provide higher earnings-per-share, higher stock prices, and higher equity-based compensation for CEOs and other executives.

A territorial system "should" eliminate the trapped cash issue. However, a territorial system such as those presented in prior years² unbelievably fails to do this. *The mechanism chosen (a 95% dividend-received deduction) would continue to cause actual dividends to trigger tax to the extent of the 5% taxable portion.* This may seem small. It will, though, impede dividend payments and continue the trapped cash problem. This issue is fixable, but whether it will be changed in future legislation is unknown.³

A residence-based system totally eliminates the trapped cash problem.

² E.g. the October 2011 Discussion Draft from House Ways and Means Committee Chairman Dave Camp (R-MI) and the February 2012 proposal from Senator Mike Enzi (R-Wyo).

³ See suggested approach to fix this issue in "Territorial W&M Discussion Draft: Change Required", 134 Tax Notes 461 (January 23, 2012), available at SSRN: <http://ssrn.com/abstract=1997515>.

Conclusion

Territorial system vs residence-based system...it is not a toss-up. Without doubt, for the benefit of our country and from virtually all tax policy perspectives, a residence-based system is vastly superior.

The 99% downplay the above concerns (export of jobs, etc.) and explain that strong anti-avoidance rules will of course accompany any territorial system. Such rules, it is argued, would prevent many of these terrible results.

Yes, truly strong anti-avoidance rules could prevent some of the worst excesses. But, frankly, it is naïve to think that such strong rules would be put in place. First, the rules under consideration would be understood by few and attacked viciously by corporate lobbyists. So, whatever gets enacted will be very weak. Second, even if something halfway strong were to be enacted, our high-powered tax consulting community has a century-long tradition of working around anti-avoidance rules. So, I have little faith that any strong or effective anti-avoidance rules will accompany a territorial system. And this will mean continued and accelerated erosion of the U.S. tax base and export of jobs.



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February 25, 2016

Chairman Kevin Brady
Committee on Ways and Means
301 Cannon Building
Washington, DC 20515

Sent by email to: waysandmeans.submissions@mail.house.gov

Dear Chairman Brady:

Re: International Corporate Tax Reform –
Taxation of Accumulated Deferred
Foreign Income

I respectfully submit the attached memorandum.

* * * * *

I would be please to respond to any questions that you might have.

Yours very truly,

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Jeffery M. Kadet

**MEMORANDUM
CONCERNING
INTERNATIONAL TAX REFORM**

**Taxation of Accumulated Deferred
Foreign Income as of the Transition Date**

The Committee's planned international tax reform draft (Draft) will undoubtedly suggest some transition from the present deferral system to some other system. As an integral part of that transition, it is expected as well that the Draft will impose taxation on all "accumulated deferred foreign income" existing as of the transition date.

Tax Rate to Apply to Accumulated Deferred Foreign Income upon Transition

At one end of the spectrum, some such as Citizens for Tax Justice say all such earnings should be taxed at the full 35%.¹

At the other end of the spectrum, a number of the prior transition proposals would apply various rates far lower than 35%, some of them being in the single digits with Representative Camp's Tax Reform Act of 2014 bottoming out at 3.5% on earnings reinvested into non-liquid assets.

Under the CTJ approach, we would, so to speak, clobber every multinational (MNC) that has actually conducted real and legitimate activities in foreign countries in accordance with a consistent Congressional intent that goes back almost forever.

Under the prior transition proposals, we would grant an unbelievable windfall to every MNC that has engaged in aggressive profit shifting in which they moved 35% profits out of the U.S. and into tax havens. They are waiting for this windfall with their tongues hanging out.

The Committee's Draft clearly needs an administratively workable mechanism that neither clobbers the former nor rewards the latter.

¹ "...Instead of rewarding corporations for dodging U.S. taxes, lawmakers should end the system of deferral that encourages them to do so, while taxing their offshore profits at the full 35 percent rate (while still allowing for a foreign tax credit)." See "\$2.1 Trillion in Corporate Profits Held Offshore: A Comparison of International Tax Proposals", Citizens for Tax Justice (July 14, 2015), available at: <http://ctj.org/pdf/repatriation0715.pdf>

Two Approaches for an Administratively Workable Mechanism²

1. “Camp” Approach. In his 2014 discussion draft, Camp broke CFC earnings into two portions by imposing a higher 8.75% rate on earnings being held in cash and cash-equivalent forms. The remaining earnings would be subject to the lower 3.5% rate. This approach is administratively easy to apply, objective, and definitely a workable solution. However, it focuses on the form in which CFC earnings are held on the transition date and not on any measure of aggressive profit shifting. But having said this, the existence of earnings that have been subjected to relatively little or no foreign tax and that are held in cash or cash-equivalent form is pretty good evidence of tax avoidance planning. So, it will generally be a very fair and administratively workable approach.

With this in mind, the first suggested approach is to use Camp’s solution with all CFC previously untaxed foreign income — on transition to a new tax system — being subject to 35% but with an FTC offset to the extent of cash and cash equivalents. All remaining previously untaxed foreign income would be taxed on transition at whatever favorable less-than-35% rate Congress chooses.

2. Tax-Structured Vehicle Approach. *This approach defines “tax-structured vehicle.” For any such vehicle, its previously untaxed foreign income — on transition to a new tax system — would be subject to 35% with an FTC offset. The previously untaxed foreign income within all other CFCs would be taxed on transition at whatever favorable less-than-35% rate Congress chooses.*

As a first step to identifying tax-structured vehicles, Treasury would publish a listing of countries that can be used as the place of incorporation of CFCs that earn low- or zero-taxed foreign income through profit-shifting arrangements. Treasury would also provide examples of structures meant to achieve low- or zero-taxes.

A presumption of tax-structured vehicle status would be applied to each CFC established in the listed countries. A U.S. shareholder MNC involved with the vehicle could attempt to rebut this presumption by establishing to the satisfaction of the Treasury secretary or his delegate, based on a facts and circumstances review, that the establishment and operation of the specific CFC involved no tax-motivated structuring. If this presumption is not successfully rebutted, any previously untaxed foreign income within the CFC would be subject to the 35% tax, with an FTC offset.

If the Committee chooses this “tax-structured vehicle” approach over the “Camp” approach, it is strongly suggested that applicable committee reports include a clear statement of the principles behind the definition of tax-structured vehicle and numerous examples.³ Clear legislative instructions would not only provide necessary guidance to

² See more detail in “Fair Approaches for Taxing Previously Untaxed Foreign Income”, 146 Tax Notes 1385 (March 16, 2015), available at: <http://ssrn.com/abstract=2587103>

³ See a partial listing of such structures in “BEPS: A Primer on Where It Came From and Where It’s Going”, 150 Tax Notes 793 (Feb. 15, 2016).

Treasury and the IRS, but also should importantly limit taxpayer presumption-rebuttal efforts to situations that truly deserve consideration. Further, the rules should be clear that the burden of proof is on the taxpayer to support any effort at rebuttal of the presumption.

Application of Interest

The various proposals and discussion drafts released over the past five years have all provided for installment payments but have been inconsistent regarding interest. Several have been silent concerning any interest charge.

This section's discussion assumes that the Committee will include in its Draft the above suggestion for application of a 35% tax rate to all previously untaxed foreign income that results from profit shifting, as determined under the "Camp" approach, the "tax-structured vehicle" approach, or any other approach that the Committee adopts.

For any previously untaxed foreign income that will qualify for a favorable less-than-35% rate, any interest charge is economically only an adjustment of the favorable tax rate. (This, of course, ignores any effect if the interest were tax deductible; in this context, if the Committee requires an interest charge, it should specifically be nondeductible.) It also seems likely that most taxpayers would choose to pay in installments to defer those tax payments. Given that earlier payment would be beneficial to our country's finances, perhaps discounts for early payment could be considered if there is no separate interest charge.

The previously untaxed foreign income that would be subjected to the 35% tax rate has resulted from aggressive profit shifting. Therefore, the applicable taxpayer has already had the real economic benefit of deferral for years. There is no reason for extending the deferral period even more by allowing an interest-free installment payment scheme. Accordingly, the Committee's Draft should include an interest charge to the extent of any installment payments.

**Statement for the record of Matthew Lykken, international tax attorney
Before the House Committee on Ways and Means
hearing on international tax reform**

Thank you for the opportunity to provide input on this subject. Having practiced corporate international tax for some 27 years I am well aware of the dysfunctions in the current tax system that mathematically impel U.S. corporations to locate high-value operations abroad and to resist repatriating cash, and which make our corporations easy targets for foreign takeover. Based on my experience, tweaking the U.S. international tax system, switching to territorial taxation, and implementing a patent box will not solve these problems. However, there is a solution that would be entirely effective, simple, revenue-positive, and would shift the balance of the American economy back in favor of productive effort and away from destabilizing financial speculation. That solution is the Shared Economic Growth Act. The draft text of this act follows, together with an explanation of the provisions. I hope that the Committee will give consideration to this sweeping solution to the games that have plagued tax writers and enforcers for decades.

A Bill

To amend the Internal Revenue Code of 1986 to remove incentives to shift employment abroad, and to remove hidden taxes on retirement savings and provide equitable taxation of earnings.

SECTION 1: SHORT TITLE

This Act may be cited as the “Shared Economic Growth Act of 2016”.

SECTION 2: PROVIDING INCENTIVES TO LOCATE HIGH-VALUE JOBS IN AMERICA AND TO INJECT CASH INTO THE AMERICAN ECONOMY

(a) Part VIII of Subchapter B of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended by adding the following new section:

“251. (a) General Rule. In the case of a corporation, there shall be allowed as a deduction an amount equal to the amount paid as dividends in a taxable year of the corporation beginning on or after January 1, 2017.

(b) Limitation of benefit to tax otherwise payable.

- 1) The deduction under this section may not exceed the corporation’s taxable income (as computed before the deduction allowed under this section) for the taxable year in which the dividend is paid, decreased by an amount equal to 2.85 times any tax credits allowed to the corporation in the taxable year.
- 2) Where the deduction otherwise allowable under this section in a taxable year exceeds the limitation provided in paragraph 1 of this subsection, the excess may be carried back and taken as a deduction in the two prior taxable years or forward to each of the 20 taxable years following the year in which the dividends were paid. However, the total deduction under this section for dividends paid during the taxable year plus carryovers from other taxable years may not exceed the limit provided in paragraph 1 of this subsection. Rules equivalent to those provided in paragraphs 2 and 3 of subsection 172(b) of this subchapter shall govern the application of such carryover deductions.
- 3) No amount carried back under paragraph 2 of this subsection may be claimed as a deduction in any taxable year beginning on or before December 31, 2016.

(c) Consolidated groups. In the case of a group electing to file a consolidated return under section 1501 of this Subtitle, the deduction provided under this section may be claimed only with respect to dividends paid by the parent corporation of such consolidated group.”

(b) Subparagraph (b)(1)(A) of Section 243 of Part VIII of Subchapter B of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended to read as follows:

“(A) if the payor of such dividend is not entitled to receive a dividends paid deduction for any amount of such dividend under section 251 of this Part, and if at the close of the day on which such dividend is received, such corporation is a member of the same affiliated group as the corporation distributing such dividend, and”.

(c) Section 244 of Part VIII of Subchapter B of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is repealed for tax years beginning after December 31, 2016.

(d) Subparagraph (a)(3)(A) of Section 245 of Part VIII of Subchapter B of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended to read as follows:

“(A) the post-1986 undistributed U.S. earnings, excluding any amount for which the distributing corporation or any corporation that paid dividends, directly or indirectly, to the distributing corporation was entitled to receive a deduction under section 251 of this Part, bears to”.

(e) Subsection 1(h) of Part I of Subchapter A of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is repealed for tax years ending after December 31, 2016.

(f) Subsection (a) of Section 901 of Part III of Subchapter N of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended to read as follows:

“(a) Allowance of credit

If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. However, in the case of a corporation, no credit shall be allowed under this section or under section 902 for foreign taxes paid or accrued, or deemed to have been paid or accrued, in tax years beginning after December 31, 2016. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 26(b).”

This amendment shall override any contrary provision in any existing income tax convention.

SECTION 3: PREVENTING WINDFALL BENEFITS FOR FOREIGN INVESTORS

(a) Subchapter A of Chapter 3 of Subtitle A of the Internal Revenue Code of 1986 is amended by adding a new Section 1447 to read:

“1447(a) **General rule.** In the case of dividends paid to any non-resident individual or corporation by a United States corporation that claims a deduction under Section 251 with respect to such dividend, the payor shall deduct and withhold from such dividends the tax shall be equal to 30 percent of the gross amount thereof, in addition to any other tax withheld with respect to such payment under this subchapter. The imposition of this

30 percent withholding tax on dividends shall override any contrary restriction in any income tax convention.

(b) **Alternative additional tax.** In lieu of the withholding tax provided under subsection (a), a payor corporation may instead elect to forego the benefit of the dividends-paid deduction under Section 251 with regard to so much of the dividends as would otherwise be subject to withholding under subsection (a), and instead to withhold from such dividends an amount of tax equal to the top rate of corporate income tax under Section 11 multiplied by the amount of such dividends, and to apply the tax thus withheld as a prepayment of the payor corporation's tax liability. Any tax so withheld under this subsection (b) shall act as an incremental final tax on the relevant shareholder that may not be reduced.

(b) Section 871 of Subchapter N of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended by redesignating subsection (n) as subsection (o) and adding a new subsection (n) to read:

“(n) Additional 30 percent tax on deductible dividends paid to nonresident alien individuals.

- (1) **General rule.** In the case of dividends paid to any non-resident alien individual by a United States corporation that claims a deduction under Section 251 with respect to such dividend, there is hereby imposed for each taxable year a tax equal to 30 percent of the gross amount thereof, in addition to any other tax imposed with respect to such payment under this subchapter. The imposition of this 30 percent tax on dividends shall override any contrary restriction in any income tax convention.
- (2) **Exception.** In the case of any dividend for which the payor corporation elects the alternative final tax under Section 1447(b), the 30 percent tax under paragraph (1) of this subsection shall not apply.
- (3) **Alternative election to pay individual income tax at the highest individual rate.** If the non-resident alien taxpayer elects to treat the dividend income otherwise taxable under paragraph (1) of this subsection as income connected with a United States business, and further agrees to pay tax thereon at the highest rate provided under Section 1, then the 30 percent tax under paragraph (1) of this subsection shall not apply.”

(c) Section 881 of Subchapter N of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended by redesignating subsection (f) as subsection (g) and adding a new subsection (f) to read:

“(f) Additional 30 percent tax on deductible dividends paid to foreign corporations.

- (1) **General rule.** In the case of dividends paid to any foreign corporation by a United States corporation that claims a deduction under Section 251 with respect to such dividend, there is hereby imposed for each taxable year a tax equal to 30 percent of the gross amount thereof, in addition to any other tax imposed with respect to such payment under this subchapter. The imposition of this 30 percent tax on dividends shall override any contrary restriction in any income tax convention.
- (2) **Exception.** In the case of any dividend for which the payor corporation elects the alternative final tax under Section 1447(b), the 30 percent tax under paragraph (1) of this subsection shall not apply.
- (3) **Alternative election to pay income tax at the highest corporate rate.** If the foreign corporate taxpayer elects to treat the dividend income otherwise taxable under paragraph (1) of this subsection as income connected with a

United States business, and further agrees to pay tax thereon at the highest rate provided under Section 11, then the 30 percent tax under paragraph (1) of this subsection shall not apply.”

SECTION 4: FAIR FUNDING FOR RETIREMENT SECURITY

(a) Section 1 of Part I of Subchapter A of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended by adding the following new subsection:

“1(h) (1) (a) Tax imposed. There is hereby imposed a tax of 7.65 percent on so much of the adjusted gross income for the taxable year of that exceeds--

(A) \$500,000, in the case of

- (i) every married individual (as defined in section 7703) who makes a single return jointly with his spouse under section 6013;
- (ii) every surviving spouse (as defined in section 2(a)); and
- (iii) every head of a household (as defined in section 2(b)), ;

(B) \$250,000, in the case of

- (i) every individual (other than a surviving spouse as defined in section 2(a) or the head of a household as defined in section 2(b)) who is not a married individual (as defined in section 7703); and
- (ii) every married individual (as defined in section 7703) who does not make a single return jointly with his spouse under section 6013;

(C) \$7,500, in the case of every estate and every trust taxable under this subsection.

(b) Credit for hospitalization tax paid. There shall be allowed as a credit against the tax imposed by this subsection so much of the amount of hospitalization tax paid by the individual with respect to his wages under subsection 3101(b) and to his self-employment income under subsection 1401(b) of this Title as exceeds the following amounts:

A) In the case of individuals described in subparagraph (1)(A) of this subsection, \$14,500; and

B) In the case of individuals described in subparagraph (1)(B) of this subsection, \$7,250.

SECTION 5: REINVESTING IN AMERICA

Subsection (k) of Section 168 of Part I of Subchapter A of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended by adding the following new paragraph:

“168(k)(8) **Expensing of investments made from post-2016 earnings.** In the case of a corporation subject to tax under Section 11, any qualified U.S. property purchased or constructed from the reinvestment of taxable income accrued in taxable years beginning after December 31, 2016, which income was not offset by a dividends-paid deduction under section 251 or by tax credits, the allowance under subsection (k)(1)(A) of this section shall be 100 percent rather than 50 percent. The Secretary shall prescribe regulations providing for the creation and maintenance of eligible reinvestment accounts, such that taxable income not offset by the Section 251 deduction or credits shall be an addition to the account and investments qualifying for the 100 percent allowance shall be a subtraction from the account, and corporate taxpayers may treat otherwise eligible investments as funded by such earnings to the extent of the positive balance in the reinvestment account.”

Shared Economic Growth – Bill and Computations Summary

The Shared Economic Growth bill allows a corporate dividends paid deduction, restricted to taxable income otherwise reported decreased by 2.85 times any credits claimed, so that the deduction may only reduce tax to zero. Excess reductions could be carried back 2 years and forward 20, so there would be incentive to pay out earnings with 2 years. Subsection 2(a) of the bill makes this change, with Subsections 2(b), (c) and (d) making certain conforming changes to the existing corporate dividends received deduction provisions.

In 2010 corporations paid tax of \$223 billion, so offsets of up to \$223 billion would be required for static revenue neutrality. The first and most natural offset is individual tax payable on the dividends paid. In order for the proposal to work, special rates for dividends and for capital gains on equity would need to be eliminated, so that these dividends would be taxed at full 2017 individual rates. Subsection 2(e) repeals these special rates, but does not otherwise upset the incentives provided for certain special categories of capital gains. This would have provided an offset of \$74 billion without altering the various special capital gains exemption and rollover provisions. As a practical matter, this offset is only feasible in conjunction with the allowance of a dividends paid deduction, since such a deduction eliminates double taxation on the corporate side and thus eliminates any legitimate argument in favor of the capital gains rate benefits. Subsection 2(f) provides an offset mechanism that is only possible in conjunction with enactment of a dividends paid deduction. Because the deduction would effectively eliminate taxation of corporate income, including foreign income, it would no longer be necessary to allow a corporate credit for foreign taxes paid. A deduction could be permitted instead with the same bottom line effect. However, allowance of a deduction would impel corporations to pay out more dividends in order to eliminate the corporate level tax on the foreign income, which in turn increases the offset at the individual level. With this provision, the individual level offset from full 2011 rate taxation of the dividends needed to reduce corporate tax to zero would be some \$54 billion, after factoring out shareholders not subject to tax.

Section 3 provides another offset only feasible in conjunction with a dividends paid deduction. Foreign investors are effectively paying the 35% U.S. corporate level tax on their investment earnings. Congress would not have to let them have the benefit of the dividends paid deduction, since U.S. resident shareholders would have to pay full rate tax on such dividends. So, Section 3 imposes a 30% incremental withholding tax on dividends paid to foreign shareholders. This offset amounts to some \$33 billion. The provision provides certain alternative elections that would be unlikely to be used but which would establish that the incremental tax would be appropriate under the principles of America's tax treaties, essentially leaving the foreign shareholders in the same economic position that they are in now and keeping them on a level with U.S. shareholders.

Section 4 provides the final offset, subjecting individual income over \$500,000 a year to an Adjusted Gross Income tax equivalent to the individual portion of the FICA taxes that ordinary wage earners pay. At a 7.65% level, with an allowance crediting the Obamacare taxes that were implemented since the first version of this proposal was explained to Congress, this levy would offset the revenue attributable to dividends paid to non-taxable retirement plans, so in effect this levy is requiring high income individuals to pay a supplemental tax similar to FICA taxes that supports non-social security private and state pension savings, thereby taking pressure off of the social security system. This is an optional element of the proposal, but it seems like good and fair policy. This provides an offset of \$57 billion. **Moreover, because these retirement savings will ultimately be paid out and taxed, this would increase revenue by at least some \$22 billion per year on a static basis as the pension income is paid out (after accounting for Roth IRAs etc.)** This additional revenue will be important as the baby boomers move through retirement and the government is looking for revenues to pay off the deficit in social security funding.

Section 5 provides an optional add-on. Because Shared Economic Growth would make it attractive for corporations to invest in U.S. operations, it would also be desirable to allow them to retain some of their earnings to make such U.S. investments rather than squeezing out too much in dividends, so that we could encourage the most rapid rebuilding of the U.S. economy. Section 5 therefore allows corporations to take a 100% immediate deduction for their investment in qualified U.S. property made from their post-2016 taxable earnings not paid out as dividends. While prior investment expensing initiatives were not notably successful in increasing investment, they were in the context of an overall U.S. climate that made investments unattractive. Expensing could be expected to be much more successful at encouraging investment under Shared Economic Growth, and given that it is a relatively short-term timing benefit, the cost to the government would be low (essentially interest on 35% of the investment amount over less than 7 years at the U.S. Treasury borrowing rate). Further, because Shared Economic Growth could be expected to encourage accumulated foreign earnings to be brought home, either producing taxable income that neutralizes this expensing benefit at the corporate level or incurring additional shareholder-level tax when paid out as dividends, there should be more than enough incremental revenue to offset the cost of the timing item.



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**Statement for the Record by
Dorothy Coleman**

For the

Hearing of the House Ways and Means Committee

on "The Global Tax Environment in 2016 and Implications for International Tax Reform"

February 24, 2016

Chairman Brady, Ranking Member Levin and members of the committee, thank you for the opportunity to submit a statement about the Global Tax Environment in 2016 and Implications for International Tax Reform. I appreciate the chance to highlight on behalf of the National Association of Manufacturers (NAM) our concerns about some of the recent developments in Europe that will have a negative impact on U.S. manufacturers. In particular, NAM members are deeply concerned about proposals in the European Union (EU) and the Organisation for Economic Cooperation and Development (OECD) on disclosure of tax, financial and other sensitive business information that would both impose substantial and unnecessary compliance costs on companies and, in some cases, force release of sensitive, confidential U.S. taxpayer information. These and other recent developments will create a new set of challenges for manufacturers and stand to harm our competitiveness in an already difficult global economic environment.

The NAM is the nation's largest industrial association and voice for more than 12 million women and men who make things in America. Manufacturing in the United States supports more than 17 million jobs, and in 2014, U.S. manufacturing output reached a record of nearly \$2.1 trillion. It is the engine that drives the U.S. economy by creating jobs, opportunity and prosperity. The NAM is committed to achieving a policy agenda that helps manufacturers grow and create jobs. Manufacturing has the biggest multiplier effect of any industry and manufacturers in the United States perform more than three-quarters of all private-sector R&D in the nation – driving more innovation than any other sector.

Manufacturers know first hand how critically important it is for U.S. companies to invest and compete effectively in the global marketplace. Indeed, 95 percent of the world's customers are outside the United States. Investment by U.S. global companies has paid off for the U.S. economy: U.S. global companies employ 35.2 million workers and are responsible for 20 percent of total U.S. private industry employment¹. Moreover, U.S. companies that invest abroad export more, spend more on U.S. research and development performed by U.S. workers and pay their workers more on average than other companies.

OECD's Base Erosion and Profit Shifting (BEPS) Project

In 2012, representatives from the G-20 asked the OECD to develop a comprehensive approach to address aggressive global tax planning that resulted in inappropriate corporate tax avoidance. The final recommendations, released by the OECD in October 2015, were approved by the G-20 Finance Ministers and by the G-20 Leaders later last year.

¹ Bureau of Economic Analysis, August 2014.

The BEPS Plan includes Action 13, “Re-examine Transfer Pricing Documentation,” to develop rules to require multinational companies (MNEs) “to provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.” Action 13 adopts a three-tiered approach to achieve transfer pricing documentation: a country-by-country report (CbCR) containing aggregated financial and tax data by tax jurisdiction; a master file containing information to provide a complete picture of the MNE’s global operations, including an organizational chart, consolidated financial statements, and analyses of profit drivers, supply chains, intangibles, and financing; and a local file providing more detailed information relating to specific intercompany transactions of the MNE group impacting the specific tax jurisdiction.

According to the OECD, the two documents that provide group-wide information – the CbCR and the master file – are intended to provide governments with information necessary to conduct high-level transfer pricing risk assessment.

Action 13 does require that countries adhere to certain confidentiality, consistency, and appropriate use standards in order to obtain CbCRs. In the case of the United States, the Treasury Department plans to collect CbCRs from U.S. multinationals and transfer them to other countries through treaty information exchange. Treasury officials have indicated that if a foreign tax authority does not comply with these standards, they would suspend transmitting CbCRs to that tax authority².

Unfortunately, the master file, which individual countries will require directly from companies, would not be covered by the confidentiality, consistency, and appropriate use standards that apply to CbCRs. While countries have agreed that confidentiality “should be taken into account”³ when it comes to the master file, there are insufficient safeguards to protect against misuse of the information.

Manufacturers believe that putting this sensitive information into the hands of foreign tax authorities, without any clear safeguards to protect confidentiality, could put critical commercial information at substantial risk of public disclosure. At a time of widely reported corporate espionage and high profile data hacks, there is no guarantee that other countries would not inadvertently compromise companies’ information, a risk that U.S. businesses should not have to face.

In addition, manufacturers do not agree with assertions that companies already include the master file information in filings with the U.S. Securities and Exchange Commission (SEC). Private companies, for example, do not file with the SEC. Thus, requirements to provide foreign tax authorities with a global organizational chart and consolidated financial statements constitute an unprecedented level of disclosure to foreign governments.

The master file also presents problems for publicly traded companies. Since most of the required information is descriptive in nature, it will have to be compiled with substantial input from across the MNE group and some of the information could be considered confidential or proprietary. For example, information about global supply chains could well be considered

² See [proposed regulations](#) to implement the new country by country reporting requirements issued 12/21/15

³ See [Action 13: Final Report](#), OECD 2015, p. 20

sensitive commercial information that, if disclosed, would be of high value to the MNE's market competitors.

Moreover, even if there are individual pieces of information that, taken alone, may not be sensitive, the master file requires companies to pull it all together as a "blueprint of the MNE group," which could reveal competitively important strategic information that would be valuable to competitors. We also believe that, like the information in the CbCR, the global nature of information required in the master file will lead to more aggressive foreign audits and tax assessments that are inconsistent with international tax norms, and U.S. MNEs are likely to be the primary targets.

In the past, companies had the ability to push back on specific information requested by a foreign tax authority during an audit. This is particularly true with respect to global information that has little or no connection with a MNE's operations within a particular country. Action 13 however, would make local filing of master file information part of the international standard, making it much more difficult for U.S. companies to push back on specific information requests.

On numerous occasions, Treasury officials have taken the position that since taxpayers have control over what they include in the master file, confidentiality concerns are manageable. In reality however, the fact that taxpayers have some level of control over what information is included in the master file does little to address confidentiality concerns because, as noted above, it is not clear how much flexibility taxpayers have to exclude sensitive information.

Specifically, the "prudent business judgment" standard in Action 13 to determine the level of information to include in the master file is vague and subjective, and provides little comfort for taxpayers that wish to omit sensitive information and avoid penalties. For example, a taxpayer could reasonably take the position that omitting a global organizational chart or consolidated financial statements would not "affect the reliability of the transfer pricing outcomes" within any particular jurisdiction, yet be concerned that such omissions would constitute non-compliance.

Recent developments in the EU

Manufacturer's concerns about protecting the confidentiality and preventing the misuse of sensitive business information under the BEPS recommendations are exacerbated by recent reports that the European Union is working on legislation to require global companies to publically disclose tax and other financial information.

The latest information disclosure proposal – coming on the heels of the new information requirements in the BEPS plan described above – would both impose additional compliance costs on companies and force disclosure of sensitive taxpayer information. While the EU initially indicated that tax information reported to national tax authorities in Europe would not be made public, it appears that they have changed this position. Indeed, the EU proposal contradicts the assertion by the OECD that CbCRs would not be made publically available, "to protect the confidentiality of potentially sensitive information."⁴

⁴ BEPS: Frequently Asked Questions, 2015 Final Reports, Question #80

From the NAM's perspective, the forced public disclosure of large amounts of company tax and financial information likely will lead to even more aggressive foreign audits and tax assessments. Furthermore, given the rhetoric surrounding these discussions, U.S. global companies likely will be the primary targets. Moreover, public disclosure of this detailed financial information will substantially increase the likelihood that this information will be used for reasons far beyond determining a companies' tax liability, raising additional and significant competitiveness and security concerns for U.S. companies.

The NAM also shares many of Treasury's concerns⁵ about the continuing EU "state aid" cases involving ex post facto and novel application of non-tax European law to effectuate tax policy changes that lead to retroactive taxation. It is a long-standing position of the NAM that the retroactive imposition or increase of taxes is fundamentally unsound, unfair and punitive.

We also believe that, in substance, the state aid cases appear to reach results that are inconsistent with the internationally accepted standards in place at the time the income was earned. In addition, these cases appear to disregard the level of economic activity within the EU member state under investigation, a contradiction of the underlying premise of BEPS to align taxing rights with underlying value-creating activity. Finally, we believe that that the state aid cases potentially undermine U.S. rights under our bilateral tax treaties with EU member states.

Addressing Confidentiality Concerns

Even though the BEPS recommendations were finalized this fall, the NAM strongly believes that taxpayer confidentiality concerns can and should be addressed during the BEPS implementation phase.

While manufacturers recognize that there is a compliance burden associated with the CbCRs, we support efforts by the Internal Revenue Service (IRS) and Treasury to issue CbCR guidance so U.S. global companies can file once with the IRS and have their information confidentially exchanged via tax treaty or tax information exchange agreements with countries that agree with these confidentiality protections. Other countries already have announced that they will require CbCRs, and our members have some level of comfort in exchanging information under a standard process that offers data protection.

Moreover, if the United States does not collect and remit CbCRs, other countries may require local subsidiaries of U.S. MNEs to file a CbCR in a much less controlled and confidential manner under the "secondary mechanism" laid out in the BEPS report. This approach would be more costly for U.S. global companies and provide less protection for confidential taxpayer information than if the IRS requires CbC reporting.

In addition, we believe that Treasury should link master file information to its agreements to provide the CbCR to other countries through information exchange. To that end, the NAM supports legislation (H.R. 4297) introduced by House Ways and Means Committee member Charles Boustany (R-LA) that would require the federal government to withhold CbCRs from countries abusing master file documentation requirements or failing to keep master file information confidential.

⁵ See *testimony* of Assistant Treasury Secretary Robert Stack before the Senate Finance Committee on 12/1/15

The legislation, which clearly describes potential abuses of the master file requirements, provides the federal government with a tool to protect U.S. businesses from being forced to disclose sensitive and confidential taxpayer information to foreign tax authorities – the same tool that that protects CbCRs.

The Need for Comprehensive Tax Reform

Longer term, the NAM strongly supports a comprehensive overhaul of our tax system. It is abundantly clear to NAM members that our current tax system is fundamentally flawed and discourages economic growth and U.S. competitiveness. Indeed, a key objective for the association is to create a national tax climate that promotes manufacturing in America and enhances the global competitiveness of manufacturers in the United States. To achieve these goals, we need a comprehensive tax reform plan that both reduces the corporate tax rate to 25 percent or lower and includes lower rates for the nearly two-thirds of manufacturers organized as flow-through entities. We also believe that comprehensive tax reform must include a shift from the current worldwide system of taxation to a modern and competitive international tax system, a strengthened research and development (R&D) incentive and a strong capital cost-recovery system.

While enactment of a pro-growth tax reform plan will strengthen our economy and ensure vibrant economic growth in the future, our economy is suffering right now because of inaction on tax reform. *A Missed Opportunity: the Economic Cost of Delaying Pro-Business Tax Reform*, a study released by the NAM in January 2015, takes a close look at the economic impact of enacting a five-prong pro-business tax package similar to NAM's priorities and concludes that lack of action on pro-growth tax reform is costing the U.S. economy in terms of slower growth in Gross Domestic Product (GDP), investment and employment. In contrast, the report finds that over a ten-year period, a pro-growth tax plan would increase GDP over \$12 trillion relative to CBO projections, increase investment by over \$3.3 trillion and add over 6.5 million jobs to the U.S. economy.

Conclusion

Manufacturers believe that the OECD's focus on global profit shifting, along with other recent developments in the EU, highlight the critical need for a comprehensive overhaul of the U.S. tax system to reflect the global marketplace of the 21st century. Indeed, policy makers in the United States should focus on the underlying problems of the U.S. business tax system – including the high business tax rates and the double tax burden faced by U.S. global manufacturers and other U.S. multinationals because of our outdated worldwide tax system. Most of our competitor nations – including most of the countries that participated in the BEPS project – have much lower rates and territorial tax systems that only tax income earned within their borders.

At the same time, an appropriate balance needs to be struck between transparency and confidentiality of the proprietary information that enables companies to compete and prosper in a global economy. In contrast, requests for much more information than needed to assess a company's tax liability, coupled with the public disclosure of this tax and financial information will threaten economic growth and competitiveness on a global basis.



ORGANIZATION *for* INTERNATIONAL INVESTMENT
Global Investment Grows America's Economy

February 23, 2015

The Honorable Kevin Brady
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Sander Levin
Ranking Member
Committee on Ways and Means
1106 Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Ranking Member Levin:

The Organization for International Investment (OFII) appreciates the opportunity to submit comments for the Ways and Means Committee hearing, "The Global Tax Environment in 2016 and Implications for International Reform."

OFII is a business association representing U.S. subsidiaries of global companies – a sector of the economy that employs more than 6.1 million Americans and pays compensation 33 percent above the national private sector average.¹ Foreign direct investment (FDI) provides the types of jobs America needs and OFII applauds your goal of keeping the United States economically competitive.

OFII believes the high U.S. corporate tax rate creates an artificial barrier to inward investment and harms overall U.S. competitiveness. In a challenging global environment, it is critical for the Ways and Means Committee to pursue pro-growth tax reform that will ensure the United States remains the top destination for employers to invest and grow. Foreign direct investment is a vital component of the investment and growth story in the United States, and OFII encourages the Committee to attach the same high priority to FDI as to domestic business investment. OFII also urges the Committee to avoid any punitive action against inbound companies or policies that have a discriminatory effect and discourage FDI.

Global companies are highly invested in American manufacturing, accounting for nearly 20 percent of all manufacturing jobs in the United States. These inbound manufacturers increasingly support local domestic suppliers. A recent economic study on the impact of FDI by economist Dan Ikenson demonstrated that these manufacturers increased their purchase of local intermediate inputs by 48 percent over a ten-year period.² During the same period, U.S. manufacturers increased their purchases of local intermediate inputs by just 13 percent.³ The study highlights how FDI helped support the manufacturing sector in a very critical way during the economic recession.

¹ U.S. Department of Commerce, Bureau of Economic Analysis (BEA). (Released January 2016).

² Organization for International Investment. (2013). *Insourcing companies: how they raise our game*. Washington, DC: Ikenson, Daniel J. Web site: http://www.ofii.org/sites/default/files/OFIIRaisingOurGame_FULL.pdf.

³ Ikenson 2013.

The data makes clear that U.S. subsidiaries of global companies are strongly committed to the United States. They innovate in the United States – supporting more than 16 percent of all private sector research and development activity in the United States; they export from the United States – producing 23 percent of U.S. exports; and they reinvest in the United States – annually putting \$100 billion of their earnings back into U.S. operations and spending an additional \$232 billion on expansion, plant construction and new equipment.⁴

Most importantly, these employers support the communities in which they sustainably operate. Over the past decade, insourcing companies increased U.S. charitable contributions by 44 percent, at a time when there was an economy-wide contraction in charitable giving.⁵ In addition, insourcing companies are investing in workforce training and education programs, partnering with schools at various education levels to ensure students and U.S. workers have the knowledge and skills they need to be successful. Insourcing companies bring innovative solutions, based on global expertise, to address challenges like the skills gap in the United States.

Foreign direct investment is a critical component of American economic strength, innovation, and job creation. In light of this, I ask the Committee to remain mindful of the impact that policy changes may have on the 6.1 million U.S. workers whose livelihoods depend on global investment. The Committee has an important opportunity to ensure that reforms embrace an open investment environment that will attract more FDI in the United States, creating more high-paying jobs.

OFII looks forward to our continued work with the Committee in advancing policy that will spur economic growth and opportunities for American workers through increased foreign direct investment.

Sincerely,



Nancy McLernon
President & CEO
Organization for International Investment

⁴ BEA 2016.

⁵ Ikenson 2013.



ORGANIZATION *for* INTERNATIONAL INVESTMENT
Global Investment Grows America's Economy

March 2, 2016

The Honorable Kevin Brady
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Sander Levin
Ranking Member
Committee on Ways and Means
1106 Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Ranking Member Levin:

The Organization for International Investment (OFII) appreciates the opportunity to submit comments for the Ways and Means Committee hearing, "The Global Tax Environment in 2016 and Implications for International Reform."

OFII is a business association representing U.S. subsidiaries of global companies – a sector of the economy that employs more than 6.1 million Americans and pays compensation 33 percent above the national private sector average.¹ Foreign direct investment (FDI) provides the types of jobs America needs and OFII applauds your goal of keeping the United States economically competitive.

OFII believes the high U.S. corporate tax rate creates an artificial barrier to inward investment and harms overall U.S. competitiveness. In a challenging global environment, it is critical for the Ways and Means Committee to pursue pro-growth tax reform that will ensure the United States remains the top destination for employers to invest and grow. Foreign direct investment is a vital component of the investment and growth story in the United States, and OFII encourages the Committee to attach the same high priority to FDI as to domestic business investment. OFII also urges the Committee to avoid any punitive action against inbound companies or policies that have a discriminatory effect and discourage FDI.

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Foreign direct investment is a critical component of American economic strength, innovation, and job creation. In light of this, I ask the Committee to remain mindful of the impact that policy changes may have on the 6.1 million U.S. workers whose livelihoods depend on global investment. The Committee has an important opportunity to ensure that reforms embrace an open investment environment that will attract more FDI in the United States, creating more high-paying jobs.

OFII looks forward to our continued work with the Committee in advancing policy that will spur economic growth and opportunities for American workers through increased foreign direct investment.

Sincerely,



Nancy McLernon
President & CEO
Organization for International Investment

⁴ BEA 2016.

⁵ Ikenson 2013.



OFII is the only business association in Washington D.C. that exclusively represents U.S. subsidiaries of foreign companies and advocates for their non-discriminatory treatment under state and federal law.

Members

ABB Inc.	Experian	Rexam Inc.
Ahold USA, Inc.	Ferguson Enterprises, Inc.	Rio Tinto America
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Air Liquide USA	Food Lion, LLC	Rolls-Royce North America Inc.
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BNP Paribas	L'Oréal USA, Inc.	Sumitomo Corp. of America
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Bridgestone Americas Holding	Maersk Inc.	Teva Pharmaceuticals USA
Brother International Corp.	Magna International	Thales USA, Inc.
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Bunge Ltd.	Maquet	The Tata Group
Bunzl USA, Inc.	Marvell Semiconductor	Thomson Reuters
Cemex USA	McCain Foods USA	ThyssenKrupp North America, Inc.
CGI Group	Medtronic, Inc.	Toa Reinsurance Company of America
Chubb	Michelin North America, Inc.	TOTAL Holdings USA, Inc.
CNH Industrial	Morton Salt, Inc.	Toyota Motor North America
Compass Group USA	National Grid	Transamerica
Continental Corporation	Nestlé USA, Inc.	Tyco
Credit Suisse Securities (USA)	Nissan	UBS
Daiichi Sankyo, Inc.	Nokia	UCB
Daimler	Nomura Holding America, Inc.	Umicore
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DPx Patheon	Pearson Inc.	White Mountains, Inc.
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EMD Serono Inc.	QBE the Americas	WPP Group USA, Inc.
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Ericsson	Restaurant Brands International	
Evonik	Inc.	



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Phone: 919-226-3200
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August 31, 2015

The Honorable Paul Ryan
Chairman
Ways and Means Committee
US House of Representatives
Washington DC 20515

Re: Comments of Gary Shope, Patheon Pharmaceuticals Inc.

Dear Mr. Chairman:

I am very pleased to present my comments on behalf of Patheon Pharmaceuticals Inc. with respect to the discussion draft authored by Congressmen Boustany and Neal. My name is Gary Shope and I serve as Chief of Staff to the President of Patheon Pharmaceuticals Inc., James C. Mullen.

Patheon Pharmaceuticals Inc. is headquartered in Durham, North Carolina and through our integrated global network of 26 facilities is one of the largest providers of contract drug development and manufacturing (CDMO) services in the world.

With over 9,000 employees worldwide, Patheon serves more than 400 clients from large global providers to small emerging players in the pharmaceutical and biopharmaceutical sectors.

Because of the nature of our business Patheon closely follows tax and financial trends worldwide, as is common practice in most companies in our field.

We are well aware of the innovation schemes authored by many of the countries comprising the European Union and similar schemes created by other nations such as China.

As I understand the many patent box/innovation box regimes in other countries, these regions have been successful in enticing capital intensive and knowledge based industries such as ours to their shores.

I can tell you from my personal experience that these countries offer an attractive integrated package of low corporate tax rates, a permanent research and development tax credit, a user-friendly regulatory approval process, and well-designed patent/innovation box incentives.

As patriotic as we are at Patheon being a North Carolina based Company, these "innovation schemes" are very compelling to us and I am not surprised that many U.S. companies have selected foreign jurisdictions, rather than the U.S. to locate plants and other facilities that require highly skilled, knowledge-based jobs that offer attractive compensation.

An average worker at any one of our U.S. facilities, whether in North or South Carolina, Missouri, New Jersey, Ohio, or Oregon earns a salary of \$54,000 not counting normal fringe

 *Performance the World Over*



benefits which taken together provide another third in real benefit. This is our average wage with many in our company earning well above this and a number of our employees earning into the “six figures”.

Although wage scales in Europe are somewhat less, the knowledge base of the workers we hire in Europe and in other locales around the world are comparable to the education levels of workers in our U.S. facilities.

Most of our workforce have earned at least a certificate or two-year degree from a community college and a significant portion have earned college bachelor’s degrees with many having advanced degrees at the master’s and doctoral levels.

Tax and other financial factors as well as the educational and skill of the local work force are key determinative factors in the location of Patheon facilities worldwide.

The draft discussion legislation prepared by Congressmen Boustany and Neal is, in our opinion, timely as global companies like Patheon are constantly seeking opportunities for growth and expansion.

We at Patheon urge the U.S. Congress to rapidly enact a version of a patent box as a down payment on other needed reforms such as a lower corporate tax rate and a permanent research and development tax credit.

My comments regarding the discussion draft really boil down to two levels. First, I believe the most basic issue is to determine the public policy objective underlying the patent box and, second, determine whether in fact the allocation of tax benefits is consistent with achieving that objective.

If the objective is to reward the patent/IP holder for their “invention” I suggest that the draft discussion document amply does that through the provision of a 10% rate on the income derived from that patent or intellectual property.

If the public policy objective is to reward and to further incentivize research, again I believe that the discussion document amply does that as well in the calculation of “innovation box profit” under proposed section 250 (b) (1) (a).

If the public policy objective is to reward and incentivize companies to locate high value jobs in the U.S., then the discussion draft only partially achieves that objective as the definition in the draft limits “5 year research and development” as research and development expenditures ...for which a deduction is allowed under section (a) or (b) of section 174.

That section of the internal revenue code provides for a deduction for expenses incurred for “research and experimentation”. In this context research and experimentation is generally defined as research conducted to resolve a scientific or technical uncertainty in the development or improvement of an invention, patent, formula or similar product.



Experimentation is understood to be research conducted to develop or to discover something new in the laboratory or experimental sense. It does not apply, as I understand this section, to develop an invention that has already been patented or to discover information that is not scientific or technical in nature.

Patheon serves the entire pharmaceutical and biotechnology industry. We claim the top twenty pharmaceutical companies as customers as well as those companies that concentrate on specialty drugs and emerging companies. I understand that over 70% of patents in the pharmaceutical sector are discovered by these emerging companies that employ less than 50 people. For these companies we test their “molecule” to make sure that the results that are claimed are in fact verified. Once we have accomplished this task we prepare the “molecule” for the stringent and multiple reviews conducted by the food and drug administration (FDA).

In many instances the molecule that responds favorably in the laboratory will need further refinement when taken out of the laboratory and subjected to the many tests and verifications required by the FDA. Once this scientific, time intensive and complicated process is complete, the molecule can then move to the clinical materials stage (CTM) then possibly receive FDA approval. A roadmap for a molecule at this stage often receives toxicity, efficacy, and solubility analysis along the way toward FDA approval. This process occurs within our pharmaceutical development services (PDS) and can often lead to scale-up within a larger commercialization effort.

In commercialization or drug product services, our company must “scale” the molecule for production and finally we initiate the commercialization aspect of the process through one of our plants in the US or abroad. In essence then, Patheon has taken, a patented “molecule” that by itself has no or nominal value and through an expensive, complicated, and highly regulated effort Patheon has now created a product that can be manufactured, sold commercially and, ultimately delivered to the patient. The same process and protocols need to be met on legacy products (i.e. Big Pharma) that are tech-transferred into one of our global sites.

Although some of this value added process may be deductible under the provisions of IRC, section 174, a significant part may not be. The Internal Revenue Code does not provide a definition of “commercialization”. In fact, the only reference to commercialization at all in the IRC is in IRC Section 54D (f) (1) (D). The Courts, as in IIR Research v. US 56 AFTR 2d 85-6023, Code Sec(s) 501, (CICT), generally define “commercialization” as the process of “introducing a new product or production method on the market”.

I, therefore, suggest to the Committee and to Congressmen Boustany and Neal that the definition of “5-year research and development expenditures under subparagraph (3) be broadened to include all costs that are “commercially” reasonable; that add value to a product or invention and that may be required, especially in the life sciences industry, by the appropriate regulatory body.



If research and costs, including attorney's fees are deductible under IRC section 174 for purposes of obtaining a patent, by extension it seems appropriate to me for purposes of calculating the "innovation box profit" that costs that add value to the product or invention and that actually produce the "qualified gross receipts" as defined under subsection (b) of the draft discussion bill be included as qualified expenditures under subparagraph (b).

To further incentivize manufacturing in the United States, the Committee may also want to consider coordination with IRC Section 199 whereby businesses with "qualified production activities" are eligible for a deduction equal to 3% of net income.

The draft does not impose any "nexus" requirement for the products resulting from qualified IP to be manufactured in the United States. To the extent that products relating to the IP are manufactured in the United States, businesses should be granted an additional incentive in lieu of the very complicated domestic production activities deduction. For example, the cost relating to domestically produced products under the Innovation Box scheme could be entitled to an additional "deemed" percentage that could be added into the numerator and utilized to further reduce the net income subject to tax.

My second major point has to do with the allocation of benefits under the discussion draft. The definition of "qualified gross receipts" as provided in the draft under subsection (b) (i) is in my opinion unclear as to whether a corporation such as Patheon, which earns income from the creation of value to a patent, may be able to access the tax benefits available under the proposed discussion draft.

Patheon is a "Fee for Service Company". That is, Patheon does have some "process patents" within our Pharmaceutical Product Development business, but generally Patheon is paid a fee to create a marketable and safe pharmaceutical that is then sold to the public with the income from such sales inuring to the benefit of the patent holder.

As a rule, Patheon does not own nor is Patheon the licensee of the intellectual property. If it is the intent of the legislation to "encourage U.S. companies to invest in American workers" and "to keep research and development as well as high paying jobs in the United states" then it seems appropriate to us that the value creators, that is, the companies that sponsor these high paying jobs be incentivized to keep or locate these jobs in the United States by allowing them to share in the associated tax benefits. I therefore recommend that the terms "Development and Commercialization" be added to the definition of "qualified gross receipts" under section (b) (i).

In addition, I suggest that a safe harbor rule be integrated into such innovation box calculation whereby if the IP holder contracts out its development, commercialization and/or manufacture that it may claim no more than 65% of the tax benefit. In such case, the "value creator" may claim the remaining 35% of benefit.

For example the development, commercialization and manufacturing work done by Patheon for its clients is precisely outlined in a contract. It is very easy therefore to track costs, expenses and profit. In a case where Patheon earns a \$10 million dollar profit from a particular



transaction, \$3.5 million of income would be taxed at the innovation box rate and the rest would be subject to the regular corporate income tax. The ratio I have proposed is similar to the ratio currently utilized with the calculation of Qualified Research Expenditures (QRE) for the R&D tax credit whereby an entity that contracts out its research under IRC Section 41(b)(1) may only claim 65% of the cost.

The discussion draft under subsection (4) (b) provides for an exception for certain foreign testing that is conducted outside of the United States because there is an insufficient testing population in the United States or is required by law to be so conducted. This particular subsection is included as part of the definition of "5-year total costs" which is in turn part of the ratio that is provided by the discussion draft in its calculation of the "innovation box profit" under subsection (b) (1) (b). Given the heavily regulated and world-wide nature of the pharmaceutical sector we very much support this exception.

A complementary approach might include a broadening of the proposed exception by allowing testing of drugs in foreign jurisdictions WITHOUT LIMITATION. However, the IP resulting from such testing must be located in the United States and all profits from the IP be mandatorily included in the US tax base on a current and not deferred basis.

Finally, Patheon fully endorses the definition of the "United States" as provided under subsection (6). As "nexus" to a location in the United States is a key element of the draft, we commend the Congressman for ensuring that qualified research and development expenditures include Puerto Rico and all of the U.S. territories. Research and development activities conducted in Puerto Rico and other U.S. territories are key elements of the U.S. supply chain.

In sum, Patheon is very supportive of the efforts of Congressmen Boustany and Neal as well as you Mr. Chairman in creating an innovation box that is intended to incentivize U.S. corporations to further invest in U.S. workers and will also provide affirmative financial reasons for U.S. corporations to retain or relocate high paying jobs as well as intellectual property back to the United State

Thank you again for allowing me the opportunity to submit comments and I look forward to discussions with you and the Members of your Committee in the near future.

Sincerely,

Gary Shope
Chief of Staff to the President
Patheon

 *Performance the World Over*





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WRITTEN STATEMENT OF MR. GARY SHOPE, CHIEF OF STAFF TO THE
PRESIDENT PATHEON, INCORPORATED BEFORE THE HOUSE COMMITTEE ON
WAYS AND MEANS.

HEARING ON INTERNATIONAL TAX REFORM

FEBRUARY 24, 2016

I am very pleased to present my comments on behalf of Patheon Pharmaceuticals Inc. with respect to the hearing today on international tax reform. My name is Gary Shope and I serve as Chief of Staff to the President of Patheon Pharmaceuticals Inc., James C. Mullen.

Patheon Pharmaceuticals Inc. is headquartered in Durham, North Carolina and through our integrated global network of 26 facilities is one of the largest providers of contract drug development and manufacturing (CDMO) services in the world.

With over 9,000 employees worldwide, Patheon serves more than 400 clients from large global providers to small emerging players in the pharmaceutical and biopharmaceutical sectors.

The CDMO industry has substantial operations in the United States, Europe, the Far East, and other parts of the globe. Although headquartered in Durham, Patheon has a substantial presence in Ohio, South Carolina, Missouri, Massachusetts, New Jersey and Oregon. World -wide Patheon plays a key role in delivering a 21st Century health care supply chain.

Let me first identify with the comments of Chairman Brady and other members of the Committee. It is clear to all of us that the current system of US taxation with respect to US international operations is antiquated, non-competitive and is causing key industries like the CDMO sector to expand jobs and operations outside of the US. The CDMO represents a \$40 billion industry.

Yes, we would rather invest in jobs and opportunities here in the US but the return on investment (ROI) in Europe and other locations with their lower corporate tax rate; responsive regulatory structure, permanent research and development tax credit and a well designed patent/innovation box structure compels those of us charged with the

financial success of our Company to seriously entertain commercial locations outside the United States.

The longer this country takes to significantly change this non-competitive tax structure, the more companies and jobs will be lost to foreign locations. I fully agree with the comments of Congressman Boustany (R-LA), Congressman Neal (D-MA) and other members of your Committee who eloquently described the loss of indirect jobs as well as the direct loss of jobs associated with the closure of facilities in the US in favor of more financial hospitable locations outside of the US, the so called inversions.

Congressman Holding (R-NC) spoke of the significant presence of the life sciences sector in his home state (which happens to be my own state) of North Carolina. He spoke of the numerous jobs and economic opportunities sponsored by this one sector. An average Patheon worker in Greenville NC earns a salary of approximately \$54,000 along with an additional third of compensation in fringe benefits. This is almost 2.5 times the income of an average worker in Greenville. When the Congressman visited our facility in Greenville he was told by Patheon's finance manager that for every \$1 invested by our company in Greenville, the multiplier effect of this investment generate \$5-\$7 dollars to the community. This ratio is typical for all of Patheon's locations in the United States. Our site in Greenville, NC is a large part of the economic ecosystem of this region of the state, much like we are in other locations with the U.S.

We in the international corporate community are well aware of the action led by this Committee under your leadership Chairman Brady of the permanent extension of the Research and Development tax credit (IRC Section 41). We take this as an indication of this committee's intention to significantly and drastically replace the current system of US international taxation with one that is pro-growth and that is consistent with America's 21st Century economy.

We at Patheon believe that the Patent/Innovation Box such as that suggested by your colleagues Congressman Boustany and Congressman Neal is a viable starting point for that objective and with some technical but critical revision can be a significant incentive for the life sciences industry to locate plants, jobs and economic opportunities here in the United States rather than elsewhere.

Our thoughts in this regard were well summarized by the recent bipartisan North Carolina Congressional Delegation letter sent to you Mr. Chairman and Cong. Levin which said:

We also understand the significant budgetary pressures posed by any changes to the Innovation Box proposal that would expand benefits to include additional companies. In the instances where the IP development and commercialization has been contracted out to a separate U.S.-based company, we suggest structuring the benefit in a manner similar to the research and development tax credit allocation for parallel scenarios

where certain activities have been contracted out. More specifically, in the context of the current Innovation Box proposal, this would mean a reduced tax deduction for the company that produced the IP, allowing for some level of deduction to be assumed by the company contracted to develop and commercialize the IP.

I have appended a copy of that letter, as well as my correspondence to then Chairman Ryan, on suggested changes to the draft legislation to make it more responsive to the needs of the life sciences sector.

Thank you for the opportunity to submit this testimony.

Gary Shope
Chief Of Staff
Patheon Pharmaceuticals



Carlos Rivera-Vélez
President

Francisco García
Executive Director

**Statement of the Puerto Rico Manufacturers Association
By Mr. Carlos Rivera Vélez, PhD, PE, President**

**For the Hearing Record
of the
Committee on Ways and Means
U.S. House of Representatives**

Hearing on International Tax Reform

February 24, 2016

Mr. Chairman, Ranking Member Levin, and Members of the Ways & Means Committee, it is my pleasure to submit this written statement on behalf of the Puerto Rico Manufacturers Association; Puerto Rico's largest business organization comprised of 1200 members.

We have had the privilege to meet with you, Mr. Chairman, as well as with Ranking Member Levin and a number of your colleagues both on this Committee and throughout the Congress. We have also had the opportunity to express our views regarding a long and short-term solution to the current fiscal crisis faced by the Government of the Commonwealth of Puerto Rico to your colleagues in the Congress and the Administration. It's important to note that no long-term solution to Puerto Rico's fiscal crisis is possible without a healthy, vital private sector paying taxes and creating jobs.

Regardless, of the configuration of the final international tax reform legislation fashioned by your committee and policy makers here in Washington, rewarding investment in economic development, job creation and revitalization must be the cornerstone to that design. To this extent, U.S. tax policy particularly in the international arena will determine whether Puerto Rico's economy can be revitalized with an end result of more taxpayers and more jobs. I am therefore pleased to report that the PRMA in conjunction with the efforts of our leadership in the public and private sector has designed a tax incentive based initiative that we strongly urge this Committee to adopt as part of the overall legislation being fashioned by the House of Representatives under the direction of Speaker Ryan to address the current fiscal crisis in Puerto Rico. We believe that our strategy is pro-growth and is consistent with the principles outlined by your colleagues during the course of today's hearings.

Before getting into the general outlines of our proposal, I think that it is useful to summarize for the Committee the history, background and results of U.S. tax policy as it affects the economy of Puerto Rico.

BACKGROUND AND HISTORY:

The Commonwealth of Puerto Rico has been a U.S. territory since 1898. Puerto Rico today is comprised of approximately 3.5 million U.S. Citizens who pay taxes, actively defend our freedom in the U.S. military and comply with U.S. law and regulation in their daily lives and businesses. We are America's largest Territory and larger than 20 States in population.

We listened with great interest and agreement to the comments made by Congressman Boustany, Congressman Neal and others on your Committee as they vividly described the economic ecosystem that grows up around communities with U.S. based corporate headquarters and manufacturing facilities.

In like manner, manufacturing is the largest single private sector employer in Puerto Rico employing 78,000 people directly and is responsible for an estimated 350,000 jobs locally in total. Our estimates show that for every direct manufacturing job in Puerto Rico, one additional job is created on the mainland making Puerto Rico an integral component of the U.S. values and supply chain.

This is extremely important to note as manufacturing generates 49% of Puerto Rico's GDP and represents one third of local tax revenues in comparison to tourism which comprises only 6% of our GDP. In fact, manufacturing provides the highest paying jobs in Puerto Rico at salary levels 2-3 times our island's per capital household income.

The success of manufacturing in Puerto Rico is not an accident but rather is the direct outcome of carefully structured Federal tax and economic policy enacted by Congress since the 1920's. From "Operation Bootstrap" to the enactment of Internal Revenue Code (IRC) Section 936, the economic incentives put in place by both Democrat and Republican Administrations and Congresses have created a unique economy heavily dependent on manufacturing.

Most U.S. companies currently operate in Puerto Rico through subsidiaries that are Controlled Foreign Corporations (CFCs) under the terms of the IRC. As with U.S. CFCs located in foreign countries, Federal income tax is deferred until corporate profits are repatriated to the United States. It is important to note, however, that it is only in Puerto Rico and the other U.S. territories where CFCs employ U.S. citizens and comply with U.S. law and regulation; an important reminder that international tax reform could have real consequences on U.S. Citizens.

While U.S. manufacturing in recent years has experienced renewed growth, manufacturing and employment in Puerto Rico continues to decline. In 1996, for instance, Puerto Rico's manufacturing sector employed 165,000 Americans in direct jobs on the island while today only half of that number is directly employed.

The real GDP of Puerto Rico—the measure of the economy's total output of goods and services—declined 12.6% between 2005 and 2014—, equivalent to an annual decline of 1.5% per year during nine years. Few countries in the world have experienced such a prolonged and deep contraction in output. In contrast, the US economy as a whole

enjoyed growth of 12.1% in those nine years, even though there was a major recession in 2009. So, Puerto Rico's economy has been shrinking at a rate of 1.5% per year at the same time that the U.S. economy has been expanding at 1.3% annual pace.

The decline in job opportunities for Puerto Rico's highly skilled workforce has resulted in Puerto Rico losing almost 10% of its population as younger better educated workers leave with their families in search of better opportunities. Notably, the public school system has seen a drop by one-third in enrollment with 250,000 fewer children in local schools than five years ago.

As a result of outward migration trends the remaining population is becoming increasingly elderly and, as a result, a higher percentage of the population is outside the labor force. Persons 60 years and older represent more than 20% of the population (the highest in the United States) and children aged five years or less have decreased from 295,406 in 2000 to approximately 187,371 in 2014, a reduction of 37%(6). Clearly, unless economic prospects change significantly; resulting from the addition to the economy of high value jobs in order to reverse outward migration trends of younger people, the future of Puerto Rico will be very bleak.

This continuing trend is caused by a number of factors including the conversion of our manufacturing sector from a labor intensive to a knowledge based economy, the repeal of IRC Section 936 and the increased competition from other countries, not only in the Caribbean Basin but around the world. These are countries that are not faced with the additional energy, labor, maritime transportation, compliance and regulatory costs that Puerto Rico based manufacturing is compelled to assume. It's important to remember that CFCs in Puerto Rico compete directly for expansion and new investment with foreign jurisdictions around the world.

We in the private sector are determined to reverse this trend. In spite of these hurdles, my colleagues and I in the PRMA are actively looking for ways to improve efficiencies, cut costs, enhance our competitive posture and attract and maintain our highly skilled and educated workforce. The resurgence of Puerto Rico from the current fiscal crisis will depend on many factors, including the continued growth of a dynamic and productive private sector.

As the U.S. Congress moves forward with respect to international tax reform we respectfully request that any tax law changes do no harm to our economy. We also urge that Congress provide U.S. companies operating in Puerto Rico a significant competitive differential so that we can continue to grow our economy out of the current fiscal crisis and to allow us to effectively compete against foreign jurisdictions in the Caribbean Basin and globally. The further loss of these highly skilled jobs to these foreign jurisdictions is the loss of U.S. jobs; both to our island and to the United States as a whole.

OUR RECOMMENDED SOLUTION:

The PRMA has requested in our meetings here in Washington, that Federal policy makers give us the tools to help ourselves. This perspective also applies to tax policy. Based upon the advice and expertise of many of you in the Congress, we have developed a tax

proposal in cooperation with our government that we believe will assist in the resurgence of an active and competitive Puerto Rico economy. We recommend a pro-growth strategy that, at its base, establishes a targeted manufacturing tax incentive designed to grow high wage jobs in Puerto Rico and expand the U.S. values and supply chain. Our proposal is consistent with several of the principal policies under discussion by Congress and Federal policy makers as you move forward with international tax reform. We in Puerto Rico agree with the statements of many Members of Congress that the current Federal tax code is not competitive in today's global economy.

The outline of our proposal is as follows:

- Establishes a dividend exemption system for repatriation for CFC's operating in Puerto Rico.
- Requires CFC's to maintain or increase their capital investment and research and development in order to qualify for some of the most significant tax benefits of the proposal.
- Provides rules to limit base erosion while providing recognition of U.S. and Puerto Rico tax bases in a unified manner.
- Recapitalizes local financial institutions thus providing capital for expansion of the small business and entrepreneur sector.
- Provides the option for mandatory repatriation of CFC income from Puerto Rico, which could significantly reduce the cost of the proposal. .

The bottom line is that our proposal is designed to provide a competitive differential for Puerto Rico to compete with foreign jurisdictions while providing the opportunity for growth in private investment, job creation and new tax revenues. Many in Congress have always urged that the private sector play a greater role in solving many challenges. In our case, the local government's fiscal crisis can best be solved when more local taxpayers are working, more taxes are being collected and young people want to return home to Puerto Rico to work and raise their families.

Our proposal has been reviewed by the respected economist, Dr. Juan Lara, who has reviewed this plan with a focus on its job generating impact. He projects that this proposal could boost Puerto Rico's GDP by 6.2% and increase employment through high value manufacturing and related service jobs throughout the entire manufacturing ecosystem.

Some have suggested that Congress should wait until enactment of international tax reform to create a growth incentive to revitalize Puerto Rico's economy, create more jobs and increase the number of taxpayers. Once again, we reinforce the sense of urgency for action and urge inclusion of this key growth initiative as a central component of the package being assembled to address Puerto Rico's fiscal crisis.

We have proposed a pro-growth strategy with this initiative that conforms with the approach to international tax reform under discussion within the tax writing Committees which will revitalize America's largest Territory and provide opportunity for its 3.5 million U.S. Citizens. The solution to Puerto Rico's fiscal and economic crisis is dependent on creating more taxpayers and more job creators.

Mr. Chairman, thank you for the opportunity to share our statement before the Ways & Means Committee. We look forward to your leadership and the opportunity to collaborate on meaningful tax reform that revitalizes our struggling economy and puts Puerto Rico on the path towards fiscal and economic recovery.





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U.S. House of Representatives
 Committee on Ways and Means
 Hearing on the Global Tax Environment in 2016 and
 Implications for Tax Reform

February 24, 2016

Submission of the Tax Innovation Equality (TIE) Coalition

The Tax Innovation Equality (TIE) Coalition is pleased to provide this statement for the record of the hearing in the Ways and Means Committee on The Global Tax Environment in 2016 and Implications for Tax Reform.¹ As the witnesses' testimony made clear, our current tax code is out of step with all the other major industrial countries and as a result is having a detrimental effect on U.S. companies, encouraging inversions and the acquisition of U.S. companies by foreign competitors. We support Chairman Brady's objective to modernize the U.S. tax system and help American businesses compete in a global market. The TIE Coalition believes that the U.S. must: (i) implement a competitive territorial tax system; (ii) lower the U.S. corporate tax rate to a globally competitive level; and (iii) not pick winners and losers in the tax code by discriminating against any particular industry or type of income – including income from intangible property (IP).

Recognizing the importance of IP to the U.S. economy, some of the Members and witnesses at the hearing expressed concern about the adoption of so-called "innovation boxes" by OECD countries, raising questions about whether these measures will result in the movement of IP jobs from the U.S. to other countries and asking whether the U.S. should adopt similar measures. The TIE Coalition does not have a position on adoption of a U.S. "innovation box", but we are very concerned that in prior international tax reform proposals income from intangible property (IP) would be singled out for harsher tax treatment than income from other assets. By discriminating against IP income compared to income from other types of assets, these prior proposals would create an unfair advantage for companies who don't derive their income from IP and significantly disadvantage the most innovative U.S. companies, especially compared to their foreign competition.

For example, the "Tax Reform Act of 2014" (H.R. 1), as introduced by former House Ways and Means Chairman Camp, would seriously disadvantage innovative American companies. Under

¹ The TIE Coalition is comprised of leading American companies and trade associations that drive economic growth here at home and globally through innovative technology and biopharmaceutical products. For more information, please visit <http://www.tiecoalition.com/>.





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that proposal, Chairman Camp chose to use what is now widely known as “Option C.”² The problem with “Option C,” is if it became the law of the land, its adverse tax treatment of IP income would significantly hinder U.S. companies who compete globally, and it would result in more inversions of U.S. companies. The TIE Coalition is opposed to “Option C” because it would have a devastating impact on both innovative technology and biopharmaceutical companies.

In an effort to understand the full scope of “Option C,” the TIE Coalition commissioned a study by Matthew Slaughter, the Dean of the Tuck School of Business at Dartmouth University. The January 2015 study, entitled “Why Tax Reform Should Support Intangible Property in the U.S. Economy” can be found at <http://www.tiecoalition.com/why-tax-reform-should-support-intangible-property-in-the-u-s-economy>. We urge the Ways and Means Committee to consider its findings when examining options for international tax reform.

As Dean Slaughter emphasizes, “Policymakers should understand the long-standing and increasingly important contributions that IP makes to American jobs and American standards of living – and should understand the value of a tax system that encourages the development of IP by American companies.” The study finds that “Option C” in the Camp legislation would fundamentally change the measurement and tax treatment of IP income earned by American companies abroad. The study finds that “Option C” of the proposal would disadvantage IP income earned abroad by U.S. companies in three ways. First, it would tax IP income at a higher rate than under current law. Second, it would tax IP income more than other types of business income. Third, it would impose a higher tax burden on the IP income of U.S. companies compared to their foreign competitors. The likely outcome of using “Option C” as proposed in the Camp legislation would be to increase corporate inversions and incentives for foreign acquisitions of U.S. based IP intensive companies.

The Slaughter study finds that the “United States, not abroad, is where U.S. multinationals perform the large majority of their operations. Indeed, this U.S. concentration is especially pronounced for R&D, which reflects America’s underlying strengths of skilled workers and legal protections such as IP rights that together are the foundation of America’s IP strengths, as discussed earlier.” The Slaughter study concludes that the overseas operations of these companies complement their U.S. activities and support, not reduce, the inventive efforts and related jobs of their U.S. parents. So it is increasingly important to America’s IP success that these companies continue to operate profitably overseas and any tax reform proposals do not impose discriminatory taxes on income from intangible assets located there.

² Please note that the TIE Coalition is opposed to both versions of “Option C” (version one of “Option C” in the Camp Draft and version two of “Option C” in H.R. 1 as introduced).





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IP jobs are essential to the U.S. economy and make up a large portion of the workforce. That is why it is important to have a tax code that supports the IP economy here in the U.S. To that point, the U.S. Chamber's Global Intellectual Property Center commissioned a study on the benefits of IP jobs to economic growth in the U.S. The study found that in 2008-09 that there were 16% or 19.1 million direct IP jobs and 30% or 36.6 million indirect IP jobs in the U.S. IP or IP related jobs account for 46% of the U.S. economy or 55.7 million jobs. With our modernizing economy it is likely that this number has grown.³

To be constructive and help the Committee find solutions that will allow American companies to succeed in a very competitive global market, the TIE Coalition has developed anti-base erosion solutions that do not target IP income. We would like to work with the Committee to develop alternative options that would apply to situations in which companies are simply trying to shift income to low tax jurisdictions with no substance or real business presence, but would not discriminate against income from intangible assets. Such options would apply to income from all goods and services, not just income from intangible assets.

In conclusion, the TIE Coalition supports tax reform that modernizes the U.S. tax system, allowing American businesses to compete in global markets in a manner that does not discriminate against any particular industry or type of income, including income from intangible property. As the witnesses at this hearing indicated, many other countries are lowering their corporate tax rates and adopting tax rules to attract IP companies to their shores. So, it would be especially harmful to the U.S. economy to adopt a tax policy that will hurt, not help, American companies who compete globally. Now is not the time to drive high paying American jobs overseas.⁴

³ See, <http://image.uschamber.com/lib/fee913797d6303/m/1/IP+Creates+Jobs+-+Executive+Summary+Web+-+2013.pdf>

⁴ The U.S. Chamber study found that "IP-intensive companies added more than \$2.8 trillion direct output, accounting for more than 23% of total output in the private sector in 2008-09" and that the "Output per worker in IP-intensive companies averages \$136,556 per worker, nearly 72.5% higher than the \$79,163 national average. Id.

