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INTERNATIONAL TAX REFORM

HEARING

BEFORE THE

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UNITED STATES SENATE

ONE HUNDRED FIFTEENTH CONGRESS

FIRST SESSION

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INTERNATIONAL TAX REFORM

TUESDAY, OCTOBER 3, 2017

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

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Orrin G. Hatch (chairman of the committee) presiding.

Present: Senators Roberts, Thune, Isakson, Portman, Toomey, Cassidy, Wyden, Stabenow, Cantwell, Nelson, Carper, Cardin, Bennet, Casey, Warner, and McCaskill.

Also present: Republican Staff: Jay Khosla, Staff Director; Jennifer Acuna, Senior Tax Counsel and Policy Advisor; Tony Coughlan, Senior Tax Counsel; Jennifer Kuskowski, Health Policy Director; Alex Monie, Professional Staff Member; Eric Oman, Senior Policy Advisor for Tax and Accounting; and Jeff Wrase, Chief Economist. Democratic Staff: Joshua Sheinkman, Staff Director; Ryan Abraham, Senior Tax Counsel; and Tiffany Smith, Chief Tax Counsel.

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. I want to thank everyone for attending this morning. Before we begin, I just want to say something about the awfulness of this past weekend. I think I speak for the entire committee when I say that our thoughts and prayers go out to those who were impacted by the horrific shootings in Las Vegas and to everyone in that community and across the country. It has been shocking to everybody.

Nevada and Utah share a border, and a number of people from both States frequently travel back and forth. I have gotten to know a number of great people from Nevada over the years, not the least of whom is our colleague on this committee, Senator Heller. I am sure he is hurting today, as are so many people in that community.

Our hearts go out to all of them, and I am praying that everyone who has been impacted by this terrible tragedy will be able to find peace, comfort, and, hopefully, a speedy recovery.

With that, I would like to turn to the business at hand. Today's hearing will focus on another piece in the complex tax reform puzzle. But before I get to the details of international tax reform, let me briefly address the elephant in the room.

Last week, I joined with the Secretary of the Treasury, the National Economic Council Director, the Senate Majority Leader, the House Speaker, and the chairman of the Ways and Means Com-

mittee to put forward a broad, unified framework for tax reform. As the document makes clear, this is just one step in the larger tax reform effort. But let us not mince words: it is a big step.

I would be hard-pressed to remember the last time the White House and the House and Senate leadership were in agreement on an issue as complicated as tax reform.

We began discussions earlier this year, and at that time there were a number of high-profile differences among us. I am very pleased that we have been able to bridge so many divides, and I am optimistic about our chances going forward.

I particularly want to thank our ranking member for his open mind and his ability to look at these matters and do so in a constructive way. He has worked very hard on tax reform for years, and, frankly, I hope we can do something together.

I want to express my gratitude to the others who worked on the framework and to the members of the committee who have helped us move the tax reform effort forward. I particularly want to acknowledge the work of Senator Grassley who, as a former chairman and ranking member of this committee, laid much of the groundwork for the ideas we are discussing and for the progress we have made. It was under Senator Grassley's chairmanship that the Finance Committee in 2003–2004 initiated the last package of international tax reforms.

Now, as some have already pointed out, the framework released last week is not, by design, a complete plan. Of course, that has not stopped think tanks and analysts from speculating about its fiscal and distributional impact. We have already seen groups attempting to reverse-engineer a completed tax plan from the framework, generally filling in blanks with their own ideas and assumptions and reaching conclusions about a plan they have essentially written themselves. Generally speaking, it seems that the blank-filling exercise is designed to cast the framework in the worst possible light.

The framework does not include any specific information about things like the break points for the individual tax brackets, the value and indexing of the enhanced Child Tax Credit, or the precise rate for the top bracket. Without those and other key pieces of information, there is simply no way for any outside party to produce a credible analysis of the framework, let alone a detailed estimate of revenue and the distribution of tax burden.

But that did not stop a certain think tank from issuing a "preliminary analysis" of the framework at the end of last week, nor did it stop any of the framework's critics from citing that analysis as authoritative. It is odd, however, that the analysis came with a disclaimer that it was expressing only the views of the authors, not the think tank itself. Even more unusual, no specific authors were listed on the analysis, probably because no respectable academic or researcher was willing to have their name associated with something so haphazardly cobbled together.

But I digress.

As the framework makes clear, this committee will be responsible for writing the Senate tax reform bill, and I am going to work with members of the committee to make sure we are successful.

For now, everyone should take every estimate or analysis about the plan from outside groups with an exceptionally large grain of salt.

Moving on, I also want to say that my preference has always been for this to be a bipartisan effort. And I think there are several elements in the framework where Democrats and Republicans can work together, and I hope we will be able to do so.

The subject of today's hearing is a great example of an area where both parties are largely in agreement. Under our current system, U.S. multinationals that accrue overseas earnings can defer U.S. tax on those earnings until they are brought back to the United States.

In 1962, due to concerns that businesses were moving passive and highly mobile income-producing assets offshore, Congress enacted subpart F of the Internal Revenue Code. Under subpart F, income from these sources is immediately subject to U.S. tax, while taxes on active and less-mobile offshore income remain deferred until the earnings are repatriated.

This is a bit confusing in the abstract, so let me provide a hypothetical. Imagine that an American company headquartered in the United States and subject to our corporate tax rates opens a factory in Germany, incorporating a subsidiary there. The income generated by the subsidiary, legally a German company, will be subject to German taxes paid to German authorities. So long as the American company does not bring that income back to the United States, its income from the German subsidiary will not be subject to U.S. taxes. And in fact, we are finding that many American companies have been keeping this type of income offshore in order to avoid our punitive corporate taxes.

Now, imagine if the American company parked its money in stocks, bonds, or other passive investments and moved the income generated from those assets to an offshore low-tax jurisdiction. Under subpart F, that type of passive and highly mobile income is immediately subject to U.S. tax without any deferral. Now, I know this is a bit arcane. And frankly, I would be nodding off if I did not know how this story ended.

As a result of subpart F, American companies have engaged in a number of sophisticated and complex tax-planning schemes to keep earnings offshore to avoid the U.S. corporate tax. According to the Joint Committee on Taxation, American companies are currently holding more than $2.6 trillion in earnings offshore, thanks in large part to our worldwide tax system, something often referred to as the, quote, "lock-out" effect.

That is $2.6 trillion held by foreign subsidiaries of U.S. corporations that the parent companies are unable to invest here at home. That is income that could be used to create more American jobs and grow wages for American workers. And that income has attracted the interests of foreign tax authorities, particularly in Europe, who wish to tap into what is, by all rights, part of the U.S. tax base.

Now, I know some of my colleagues have proposed to solve this problem of earnings being locked out of the United States by transitioning to a pure worldwide system with no deferral. And while that would rid us of the lock-out problem, it would signifi-

cantly increase pressures for American multinationals to invert or be acquired by foreign-based multinationals.

Many of us have talked at length about inversions in recent years and the problems they pose for our economy and our tax base. Perhaps even worse than an inversion is when a larger foreign corporation simply acquires a smaller American corporation. Either way, the result is the same. A foreign corporation becomes the parent of the restructured multinational group.

Companies takes these routes for a number of reasons. First, they want to escape the high corporate tax rate in the United States, which, as we have heard in our last hearing, is the highest in the industrialized world. Second, they want to minimize the damage caused by our worldwide tax system. If an American multinational can successfully move its tax situs out of the U.S., it will only owe taxes on the earnings accrued here.

There is also the matter of earnings stripping, which is another complicated topic that I look forward to our witness panel discussing today. All of these problems are key for today's hearing because they highlight the shortcomings of our outdated worldwide tax system.

The solution to these and other problems, to put it very simply, is to transition to a territorial-based system like virtually all of our foreign competitors. Under such a system, an American company would owe taxes only on income earned in the United States. Income earned in foreign jurisdictions would only be taxed by those jurisdictions, not here.

This type of reform would have to be accompanied by enforceable anti-base-erosion rules to make sure companies, both domestic and foreign, do not exploit loopholes in order to unduly avoid paying taxes here. That approach is endorsed in the united framework. It was also suggested in the last Congress by our committee's bipartisan working group on international tax, which was co-chaired by Senator Portman and by current Senate Minority Leader Schumer.

Other members of the committee have also made significant contributions in the area of international tax reform, including both my colleague Senator Wyden, whom I have great respect for—I have respect for everybody on this committee—and of course, Senator Enzi, who is always working to try to do good things here.

Finally, as many of you know, I have been interested for some time in the idea of better integrating our individual and corporate tax systems. I continue to believe that corporate integration by means of a dividends paid deduction can significantly help with some of our existing problems. And I look forward to talking more about that today as well.

Once again, international tax reform is an area that is rife for bipartisanship if we are willing to work together on goals that members from both parties share. I hope people will note that the international portion of the framework is particularly short on details. That is because these problems cannot be solved in a nine-page framework document. That will require the work and effort of this committee.

Long story short: today's hearing will surely be informative, important, and timely.

And with that, I turn to my good friend and ranking member, Senator Wyden, for his opening remarks.

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

OPENING STATEMENT OF HON. RON WYDEN, A U.S. SENATOR FROM OREGON

Senator WYDEN. Thank you, Mr. Chairman.

I will turn to taxes in just a moment, but like you, I want to comment briefly on the horrifying shooting in Las Vegas.

Mr. Chairman and colleagues, here is my takeaway from this. It is just unconscionable that this epidemic of violence goes on and on and on and on, and policymakers in Washington, DC sit on their hands and do nothing about it.

Now, we are going to talk about a different subject today, but I think all of us are just heartsick about this. I continue to believe that there is an opportunity for common sense to prevail and reduce gun violence in America.

Mr. Chairman, on taxes, let me first of all thank you for your very kind words. And I continue to believe that there is an opportunity for us in the Finance Committee to find common ground.

Democrats have laid out principles that are important to us. And I would just say, colleagues, the principles Democrats have laid out in the letter very much resemble the bipartisan bill I wrote with Senator Dan Coats, now a member of the Trump Cabinet. And I see Senator Cassidy—that is where Dan Coats sat when we put together the bill.

And Chairman Hatch has ideas that are important that we talked about. So I continue to believe that there is an opportunity for common ground here. And I think the principles that Democrats have talked about in our letter—where our caucus was thoroughly united around where we ought to be headed—and some of the ideas Chairman Hatch has talked about, are an opportunity to find common ground here.

Now, the Trump team says their international tax framework is about creating jobs and firing up the country's economic engine. The details, however, show it is really a con job on America's middle class.

Behind the scenes, the administration recently scrubbed from the Treasury website a 2012 paper showing that workers do not primarily benefit from a corporate rate cut—that trickle-down economics are pretty much a fantasy. Apparently, that mainstream economic analysis had to be purged because it basically did not jibe with the Trump team's patter.

They claimed the study was out of date, but they did not find reason to take down any of the other papers that date back as far as the 1970s. That sure makes it look like the Trump team is simply afraid of the American people getting the facts about taxes.

And the con job is not just about hiding those facts that are inconvenient. The administration is currently working to pick apart the rules that were designed to curb the scourge of inversions, what we call the inversion virus, which is a big factor in decimating our tax base.

Now, folks at home in Oregon at town halls tell me they want tough policies to stop companies from shipping jobs overseas, especially in towns where mills and factories are shuttered and Main Street is vacant. The American people want red, white, and blue jobs with good wages. They believe corporations ought to pay their fair share.

What is on offer, based on what we know today about the Trump plan, is going to disappoint. The Republican tax framework that has been okayed is essentially a corporate wish list, a massive rate cut, a pure territorial system, barely a nod to tough rules to prevent companies from sending jobs abroad or running away to set up a headquarters on some zero-tax island.

Base erosion, a minimum tax—these vital parts of the international tax debate seem to be an afterthought. This is an invitation for corporations to game the system, and the tax lobby has got to be licking its chops this morning.

Bottom line, the President is giving multinationals a green light to pay no taxes. Then, for the benefit of people reading the news, there is a lot of happy talk about jobs, economic growth, and the biggest tax cut ever. It is not hard to predict what will happen if this multi-trillion-dollar tax giveaway to the wealthy and corporations is enacted.

Our tax base will keep eroding, and the deficit will skyrocket. Lawmakers are going to come after Social Security, Medicare, and Medicaid yet again. And by the way, this is not without precedent. Privatizing Social Security was the first priority, the very first priority, of the Bush administration's second term after its big, unpaid-for tax cuts.

Let us remember that every percentage point decrease in the corporate rate results in a loss of $100 billion in revenue. Perhaps that is the kind of issue that caused Senator Corker over the weekend, when I caught him on one of the TV shows, to say that he has some big concerns about the deficit.

Democrats have reached out to the majority with our principles for tax reform. There are a lot of members on this side with big ideas of how to help the middle class, create jobs, bring some fairness to the tax code through bipartisan reform. As I said, that is the kind of thing Dan Coats and I put our names on; that is the kind of reform that Ronald Reagan signed into law back in 1986.

But the framework that was released last week does not resemble what Ronald Reagan accomplished, and it is nowhere near, as I say, the reforms built on fairness and fiscal responsibility that Senate Republicans over the years have worked with Democrats to write into bipartisan plans.

And wrapping up, I believe international taxation is going to be a key part of the debate and involves a lot of very complicated questions.

The committee has a terrific panel of witnesses here. I am particularly pleased that Kim Clausing, professor at Reed College from my neighborhood in southeast Portland—which Senator Stabenow has visited, by the way—is going to give us a very thoughtful presentation, as Oregonians invariably do.

And I also respect the views of our other witnesses as well, and we have heard from a number of them over the years.

Mr. Chairman, thank you, and I look forward to working with you.

The CHAIRMAN. Thank you, Senator.

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

The CHAIRMAN. International taxation is a very complex issue area, and we are grateful to each of our witnesses for being with us today to discuss it with us. We will hear from each of the witnesses in the order they are introduced.

First, we will hear from Professor Bret Wells, a professor of law and George Butler research professor at the University of Houston Law Center. Professor Wells teaches in the fields of tax law and oil and gas law. Prior to joining the University of Houston Law Center, Professor Wells served as the vice president, treasurer, and chief tax officer for BJ Services company. He received his bachelor's degree from Southwestern University and then went on to earn his law degree from the University of Texas School of Law.

Next up will be Dr. Kimberly Clausing, the Thormund A. Miller and Walter Mintz professor of economics at Reed College. Dr. Clausing's research is focused on the taxation of multinational firms and how their decisions are impacted by government decisions. She is the recipient of two Fulbright Research Awards and has worked on related policy research with many different think tanks. She has worked previously as a staff economist for the Council of Economic Advisers and also served as an associate professor of economics at Wellesley College. Professor Clausing received her B.A. from Carleton College and her Ph.D. from Harvard University.

Third will be Professor Stephen Shay, a senior lecturer on law at Harvard Law School. Before joining the Harvard Law School faculty, Professor Shay served as the Deputy Assistant Secretary for International Tax Affairs at the U.S. Treasury. Before that, Professor Shay was a tax partner for 22 years with Ropes and Gray LLP. Prior to that work, Professor Shay served in the Office of International Tax Counsel at the Department of Treasury, including as International Tax Counsel from 1982 to 1987. Professor Shay graduated from Wesleyan University with his undergraduate degree and earned both his J.D. and M.B.A. degrees from Columbia University.

And finally, we will hear from Professor Itai Grinberg, a professor of law at Georgetown University Law Center. Professor Grinberg's research interests center on cross-border taxation and development and U.S. tax policy. Prior to his work at Georgetown, Professor Grinberg worked at the Office of International Tax Counsel at the Department of Treasury. Before that, Professor Grinberg practiced tax law at Skadden, Arps, Slate, Meagher, and Flom LLP. In 2005, Professor Grinberg served as counsel to the President's Advisory Panel on Federal Tax Reform. Professor Grinberg earned his B.A. from Amherst College and his J.D. from Yale Law School.

I want to thank you all again for being here, and you are a particularly great panel. We all look forward to hearing your testi-

mony here today and your expert views on these important matters.

So, Mr. Wells, will you please get us started then?

STATEMENT OF BRET WELLS, PROFESSOR OF LAW AND GEORGE R. BUTLER RESEARCH PROFESSOR OF LAW, LAW CENTER, UNIVERSITY OF HOUSTON, HOUSTON, TX

Mr. WELLS. All right. Thank you. My name is Bret Wells, and I want to thank Chairman Hatch, Ranking Member Wyden, and the other members of the committee for inviting me to testify.

Before addressing international taxation, I want to make a preliminary statement about the related topic of business tax reform.

As to business tax reform, Chairman Hatch is to be commended for his work on corporate integration. Under his partial dividends paid deduction proposal, the dividend deduction can be limited to preserve corporate-level taxation for earnings in an amount broadly equal to the equity ownership of nontaxable shareholders. A partial dividends paid deduction regime narrows the tax distinction between debt and equity.

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

Now I want to make a few statements about outbound international taxation, but I want to start this thought process from the perspective of the foreign-based multinational enterprise.

From the perspective of the foreign-based multinational enterprise, outside of its country of residency, only the business profits attributable to a particular territory are subject to taxation in the various inbound host countries. So the inbound, foreign-based enterprise is afforded a territorial result regardless of the formal international tax choices that might be made by a particular inbound host country. Faced with this reality, each country must decide whether or not to have a system of international taxation that would disadvantage their own resident corporations or would instead afford comparable territorial tax results for resident multinational enterprises as are afforded by the country to inbound, foreign-based enterprises.

This committee is well aware that every other G7 country, after facing this Hobson's choice, has opted for some form or variant of a territorial tax regime. For the same competitiveness reasons that motivated those decisions, this Congress should now adopt a territorial tax regime to level the playing field. But at the same time, this Congress must take steps to protect the U.S. tax base from inappropriate profit-shifting strategies. Under current law, the U.S. subpart F regime provides a fairly narrow set of exceptions to the deferral privilege, and these anti-deferral provisions serve as an important backstop to prevent tax avoidance of U.S.-origin profits.

Another means to attack profit shifting with respect to U.S.-origin profits would be to adopt greater source-taxation measures. Attacking the profit-shifting problem with a source-taxation solu-

tion has the favorable benefit of implementing base protection measures that apply equally to both U.S.-based multinational enterprises and foreign-based multinational enterprises.

In contrast, solutions that rely on residency taxation principles, such as a minimum tax under the U.S. subpart F regime, only protect against the profit-shifting strategies of U.S.-based multinationals. Thus, I favor source-taxation measures over an expanded subpart F regime, exactly because subpart F measures create divergent tax results for U.S.-based multinational enterprises and leave in place the inbound earnings-stripping advantages for foreign-based multinational enterprises.

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

First, leveling the playing field requires that Congress address each type of inbound earnings-stripping technique that unfairly advantages the U.S. activities of foreign-based multinational enterprises and companies that have engaged in corporate inversions. We should not treat those companies more harshly than U.S. companies, but they should not have an unfair earnings-stripping advantage.

Second, corporate inversions are a telltale symptom of the larger inbound earnings-stripping cancer. Thus, instead of attacking the corporate inversion messenger in isolation, Congress should focus attention on the inversion message, namely that the earnings-stripping techniques available to foreign-based multinational enterprises, if left unchecked, create an unlevel playing field that motivates U.S. companies to engage in corporate inversions. Corporate inversions are simply the alter ego of the inbound earnings-stripping problem and should not be viewed as a separate policy problem.

Third, Congress needs a new approach to the earnings-stripping problem. And again, Congress must address this problem in a comprehensive way. I believe that a base-protecting surtax does comprehensively address the inbound earnings-stripping problem, so I urge this committee to seriously include this proposal in the final legislation.

This concludes my opening statement. Thank you for allowing me to speak at today's hearing. I would be happy to answer any of your questions.

The CHAIRMAN. Thank you so much.

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

The CHAIRMAN. We will now go to you, Dr. Clausing. And we are looking forward to hearing your testimony as well.

STATEMENT OF KIMBERLY A. CLAUSING, Ph.D., THORMUND A. MILLER AND WALTER MINTZ PROFESSOR OF ECONOMICS, REED COLLEGE, PORTLAND, OR

Dr. CLAUSING. Chairman Hatch, Ranking Member Wyden, members of the committee, thank you for inviting me to share my views on international tax reform.

The most essential trade-off we face in international tax reform is between tax competitiveness and corporate base protection.

First, let us think about this idea of competitiveness. When folks talk about competitiveness, they are usually referring to multi-

national companies. These companies are mobile and they are very profitable, but they also tend to face low effective tax rates.

Of course, we also have many smaller companies that face higher tax rates. But our most mobile multinational companies simply do not have a competitiveness problem. These companies are some of the most successful companies on the planet.

If you look at after-tax corporate profits over the last 10 years, they have averaged 9 percent of national income, 50 percent higher than they averaged over the previous 40 years. Our companies dominate lists of the world's most successful companies, and their dominance has not dimmed in recent years.

And our corporate tax revenues are about one-third lower than those in peer countries relative to our economy's size. It is therefore difficult to claim that our companies need even more after-tax profits to be successful or to unleash investment.

That said, there is far more to competitiveness than tax. We do need more investments in infrastructure, education, and research to equip workers for the modern global economy.

Now, let us also consider our serious corporate tax base-erosion problem. My past research shows that international profit shifting to tax havens now costs the U.S. Government more than $100 billion every year. This is big money, money that could be used to lower tax rates or pay for key investments. Our corporate tax base is also quite narrow.

Beyond that, the proposed new preferential rates on pass-through income are likely to create a huge new base-erosion problem. This step will drain revenue from our tax system on a large scale. So I suggest four guiding principles for future international tax reform.

First, let us not make a bad base-erosion problem worse. Moving to a territorial system further tilts the playing field toward earning income abroad, and it will make our base-erosion problem larger.

If a territorial system is adopted, lawmakers should be very serious about tough base-erosion protection mechanisms. Slashing the tax rate is not going to be enough here. There will always be jurisdictions with lower and even zero rates. Over 80 percent of our profit-shifting problem is with havens that have rock-bottom tax rates.

To reduce profit shifting, a per-country minimum tax could be helpful. And this would be far more effective than a global minimum tax. But a simpler and more intellectually coherent plan would be to simply combine a rate reduction with the elimination of deferral. This evens the tax treatment of foreign and domestic income, no longer tilting the playing field toward tax havens. And this is the approach behind several bipartisan proposals put together by Senator Wyden and his Republican cosponsors. This approach should be combined with steps to limit inversions, such as toughening earnings-stripping laws and other measures.

A second principle is regarding repatriation. It simply does not make good economic sense from either an efficiency or an equity perspective to give a big tax break for income that has already been earned and moved to tax havens. Special tax breaks on haven earnings are not warranted, and evidence suggests they will not

help investment, they will not help employment, and they will not help the middle class.

Third, let us pay serious attention to the middle class. Business tax cuts primarily benefit those at the top of the income distribution. All major respected models distribute business tax cuts primarily to capital or shareholders, and there is a good reason for that.

Recent analysis of the Big Six framework by the highly respected and nonpartisan Tax Policy Center showed that, when fully phased in, it would give the top 1 percent 80 percent of the tax cuts with an average tax cut of over $200,000, whereas the bottom 80 percent of the distribution get a tax cut that averages less than $300. After decades of increasing inequality and middle-class economic stagnation, tax policy should be working to counter, not reinforce these inequalities.

Finally, let us not increase the deficit. We already have a debt-to-GDP ratio over 75 percent, and our Social Security and Medicare commitments are due to increase deficits by 2 percentage points over the coming decade. We need to keep budget flexibility so we are ready if another recession arrives.

Deficits are basically taxes on our children and grandchildren. And on this topic, we also owe future generations a serious response to climate change. Recent hurricanes in Houston and forest fires in Oregon serve as a reminder of this urgent priority. A carbon tax is both a very effective response but also a key step towards more efficient taxation. Economists throughout the political spectrum back this idea, for good reasons.

Thank you so much for your invitation to testify today. I look forward to your questions.

The CHAIRMAN. Thank you.

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

The CHAIRMAN. Mr. Shay, we will turn to you now.

STATEMENT OF STEPHEN E. SHAY, SENIOR LECTURER ON LAW, HARVARD LAW SCHOOL, HARVARD UNIVERSITY, CAMBRIDGE, MA

Mr. SHAY. Thank you, Mr. Chairman. Good morning, Ranking Member Wyden, members of the committee.

I want to start with two general observations before getting into international tax reform in particular. I agree with Professor Clausing. Tax reform should be revenue-neutral or increase net revenues. We need to raise the revenue to fund needed public expenditure, not add trillions to the national debt. In the face of pressing needs for public investment in human capital and infrastructure, and demographic trends that cannot be reversed, we will be forced to spend more in the future, even as we need to spend today to help our neighbors in Texas, Florida, Puerto Rico, and elsewhere where there are crises.

It would be foolhardy to adopt a revenue-losing tax reform, particularly one that would benefit those with high incomes, in the unsupported hope based on "tooth fairy" economics that short-term growth will outweigh longer-term effects on interest rates and inflation.

The second general observation I would make is that tax reform should maintain or enhance our tax system's current level of progressivity in distributing the benefits and burdens of government. The taxation of cross-border income of U.S. multinationals should be analyzed under the same fairness standards that apply to other income. In particular, a reduced holiday tax rate on U.S. multinationals' pre-effective-date offshore earnings will overwhelmingly benefit high-income Americans and foreigners who are shareholders of these companies. And it is not justified on policy grounds.

Turning to international taxation, my first choice also would be to proceed along the lines of the Wyden-Coats Bipartisan Tax Fairness and Simplification Act of 2011. Why do I say this?

The evidence does not support claims that U.S. multinationals are overtaxed or noncompetitive as a consequence of U.S. tax rules. In April 2016, the U.S. Treasury Department found that the average tax paid by U.S. companies from 2007 to 2011 on their book earnings plus foreign dividends—actual dividends, not deemed dividends—was 22 percent. I have charts in my testimony at pages 4 and 5 that illustrate that study.

The most recently available statistics of income data for 2012, which is the most recent year, show that foreign subsidiaries of U.S. multinationals—so this is the income that was not paid out in actual dividends—paid in the aggregate an average foreign tax rate of 12 percent. This is not just a few outliers, this is the average rate of foreign tax on foreign subsidiaries' earnings and profits before tax—12 percent. If you are thinking in terms of a minimum tax on foreign income, you have to deal with that.

And I also have a chart in my testimony at page 6 that shows that 52 percent of those low-taxed earnings are earned at even lower tax rates in some of those countries, in five countries that I consider tax havens.

So a territorial system has been suggested, at least in the GOP tax reform plan that was issued on September 27th. If not designed properly, it can leave us worse off than we are today. I have suggested several principles that will help maintain a strengthened minimum tax that has some prospect to actually improve from where we are today.

First, the minimum tax should be a relatively high percentage of the regular U.S. tax rate adopted in tax reform, no less than 60 percent and preferably 80 percent of the regular rate that you end up at. And I personally think 20 percent is fantasy in a revenue-neutral deal, so we are talking higher rates.

Second, it absolutely needs to be applied on a country-by-country basis and not a global basis. If you do it on a global basis, people like myself in my prior career can blend high and low foreign tax rates, and in some cases this will incentivize foreign investments. You need to do it country by country.

You should allow a foreign tax credit, but the foreign tax credit should be prorated so that the amount of foreign taxes you credit will not be greater than the portion of those taxes that the minimum tax rate you choose bears to your regular tax rate.

That is complicated. I will be happy to take it up with your staffs. But it is absolutely critical to prevent foreign taxes from eroding any minimum tax you actually adopt.

So, Mr. Chairman, I have other ideas in my testimony.

I agree with the sentiment that we need to strengthen our source taxation rules. I disagree perhaps with Professor Wells's specific proposal, but directionally we are very much on the same page there, so I think there is a lot to work with.

And I thank you for your time, and I will be happy to answer any questions.

The CHAIRMAN. Well, thank you.

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

The CHAIRMAN. Professor Grinberg, we will turn to you.

STATEMENT OF ITAI GRINBERG, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER, WASHINGTON, DC

Mr. GRINBERG. Chairman Hatch, Ranking Member Wyden, and distinguished members of the committee, good morning. My name is Itai Grinberg. I am a professor of law at Georgetown. It is a pleasure to appear before you today.

There is now a widespread consensus the United States needs to abandon its abhorrent worldwide corporate tax system, lower the rate, and go territorial. Although some of today's other panelists disagree, this general consensus was even reflected, to some extent, in the final proposals of the Obama administration.

Our corporate tax rate and international tax rules are just totally out of line with international norms. Continuing to lag behind would cost us an opportunity and employment for our kids.

The United States statutory corporate income tax rate is the highest in the OECD, and our effective corporate tax rate is also very high. We are the only major developed economy that has not adopted a territorial tax system.

But what I want to emphasize today is that dropping the rate and going territorial are not enough. One of the most senseless aspects of our current law is that, more than any other major economy, we create relative tax disadvantages for being a U.S. multinational as opposed to a foreign multinational, most upsettingly with respect to income earned in the United States.

We make foreign ownership of almost any business more attractive than U.S. ownership from a tax perspective. That creates incentives for foreign takeovers, for inversions, for U.S. companies to produce abroad, and for income shifting.

The consequence is obvious: we are creating incentives for companies to become foreign with negative consequences to U.S. employment. Our reliance on subpart F, a regime that affects only U.S. multinationals, as our main anti-base-erosion device, is the source of the problem.

Some may argue that rectifying the situation and leveling the playing field would discourage foreign investment. But last year, 97 percent of inbound foreign direct investment was an acquisition of an existing U.S. business rather than a new investment. Acquisitions of existing U.S. businesses do not necessarily create jobs, and they can cost U.S. jobs.

Foreign acquisitions of U.S. businesses can also be beneficial. We should welcome them when it makes a business more economically productive on a pre-tax basis and, therefore, liable to create employment. But if a business is acquired primarily because of the tax benefit of being foreign-owned, that is not economically efficient, and it can hurt U.S. employment. Unless we lower the corporate tax and level the playing field, the benefits in terms of jobs that prior generations obtained from the United States being the world's most important headquarters country for multinationals, will simply bleed away. Meanwhile, the relative tax advantage given to foreign multinationals results in a revenue loss to the United States.

Separately, the foreign tax credit that comes with our worldwide system encourages revenue grabs from U.S. companies. As the committee knows, this has become a massive problem in recent years.

Globally, we used to have multilateral principles that organized the international tax architecture around residence-country taxation. That is all simply falling apart. Countries around the world are shifting towards greater source-based taxation, and that is irreversible. Moreover, that process, which has already harmed us, is liable to be long, messy, and arbitrary.

At this point, if we sit still, both our fisc and our companies are disadvantaged. If we continue to insist on the idea of worldwide residence-country taxation with a foreign tax credit for U.S. multinationals and current law advantages for inbound multinationals—neither of which other countries do anymore—we will simply make our companies uncompetitive outliers subject to further foreign revenue grabs and continue to lose businesses and revenue at home.

Meanwhile, with respect to source taxation, there is simply no international status quo. As a result, this time, inbound reform will not be a one-step process. We are going to have to respond over time to the policies of other countries.

So, when addressing inbound corporate tax reform now, policymakers should give the United States leverage. It is important to put the United States in a good position to bargain internationally about future rules that will most likely be agreed to multilaterally at a later date. For now, we should choose a pragmatic administrable policy that levels the playing field for our national interests and our companies alike.

Unlike Europe, our policies should be based on a defensible principle, for instance, an inbound corporate minimum tax that applies to U.S. and foreign multinationals alike. An inbound minimum tax can provide base protection without all the negative consequences of a subpart F-type minimum tax.

Moreover, the inbound policy we come up with now need not be perfect. That can come later, either through global negotiation, domestic legislation, or both.

The key for now is to choose inbound measures that maximize our national interests, do not give implicit approval to things we would not want to see done abroad, and provide the U.S. leverage to help end this period of instability in the international tax regime and shape a principled global settlement.

Thank you, and I would be happy to answer any questions you may have.

The CHAIRMAN. Well, thank you.

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

The CHAIRMAN. This has been an excellent panel. I really appreciate you.

This is a question for all of you to briefly respond to. I want to be clear that our view is that foreign direct investment fuels new jobs across the country. In fact, if the corporate rate drops from 35 percent to 20 percent, foreign and domestic investments should grow markedly.

It is important to distinguish legitimate business transactions from tax-driven earnings-stripping deals. So I am very concerned about that.

So the question for the witnesses is, do you believe that foreign multinational companies have significant tax-planning opportunities such as earnings stripping that U.S. multinational companies do not have?

I think some of you have talked on that a little bit, and I would just have you repeat.

Professor Wells, we will start with you.

Mr. WELLS. There is just no question that that is the case. There is just no question. And the reason there is no question is that our main base-protection measure since 1962 is subpart F that only applies to resident companies.

So if you are not a resident company, you are not subject to that regime; you get a pass. You can be excused from the room.

Senator Hatch, when I was vice president of tax, half of my peer group engaged in a corporate inversion transaction. Our executive officers were compensated based upon relative performance versus a peer group. So I spent quite a lot of time trying to understand, what were the tax advantages that reduced their taxes on their U.S. operations in our sandbox, in the United States?

And it is clear to me—and it should be clear to everyone here—that a corporate inversion is the U.S. company saying, I just want to be treated like a foreign-based multinational with respect to owning U.S. assets.

And what techniques are they using to strip the U.S. tax base? The same ones that inbound investors use every day.

When I put together my tax footnote disclosures for SEC filings, in the footnotes to that you can see a rate table of what taxes you pay in the U.S. versus what taxes you pay internationally. Professor Shay is exactly right: internationally, the U.S. is competitive in the international markets and able to achieve a tax rate that is comparable outside of the United States. But in the United States, the tax rate that is applied on U.S. companies—because they do not have the same earnings-stripping benefits—is significantly higher than exists for a foreign-owned company that runs those exact same U.S. activities. I think that that is a huge issue that ought to be addressed.

We do not want to treat foreign companies in a discriminatory way, but we should not give them an advantage that we do not give our own domestic businesses.

The CHAIRMAN. Professor Clausing?

Dr. CLAUSING. I agree that we should even the treatment of foreign and U.S. firms in the U.S. And it is easier for foreign firms

to strip income out. My understanding is that there are off-the-shelf remedies that would help with that, including tougher earnings-stripping regulations.

There was an article in *Tax Notes* that went over 10 different proposals to tighten earnings-stripping regulations. I believe that is 163(j), but I will leave that to the lawyers. So I would suggest something like that to create a more even treatment.

The CHAIRMAN. Professor Shay?

Mr. SHAY. I have said previously that I agree that we need to take steps to improve our source taxation.

But I think it is very important for all the members to understand that there are structural advantages in every income tax system of the world for a company that is not a local resident to invest locally. So this is not a United States-only problem, and our companies are vigorous in taking advantage of their external status in relation to other countries.

So we should take steps to strengthen our source taxation, but we should do so mindful that what we do is likely to be copied by other countries and that we have to be balanced and nondiscriminatory.

Notwithstanding that, it seems to me that the concept of nondiscrimination has been taken too far in formal terms and not been applied in substantive terms.

And when we look at the kinds of issues that Professor Wells is talking about, I think our substantive differences give us plenty of room, and not just room, but encourage us to adopt strengthened source taxation to make sure that we do have a level playing field for carrying on business in the United States.

The CHAIRMAN. Thank you.

Professor Grinberg, you will be the last one.

Mr. GRINBERG. Thank you, Chairman Hatch. Look, I love foreign investment and want it to create jobs when it is actually creating jobs. But basically the reality is, multinationals can structure their internal affairs between their relateds as they choose, subject to legal constraints. And U.S. law keeps a U.S. multinational from having its foreign affiliates loan the U.S. money or charge the U.S. royalties to lower U.S. tax and increase the tax base in a low- or no-tax jurisdiction. U.S. multinationals cannot do that because of subpart F, as Professor Wells explained.

In contrast, foreign multinationals can. They get their U.S. affiliates to agree to pay their foreign affiliates for expensive intercompany obligations, subject to much less binding constraints under our law. All they need are basically good transfer pricing studies, and they have to live with the, by international standards, weak limitations of section 163(j). That gives them a significant financial advantage, because it allows them to reduce their U.S. tax liability effectively through self-dealing.

So why does this link back to jobs? Well, this advantage makes foreign acquisitions of U.S. firms more common than U.S. acquisitions of foreign firms. And firms continue to have a home-country bias for headquarters and R&D jobs as well as the support jobs that go around those.

And you know, if you want to see the data about this, look, there is this great German ZEW—Centre for European Economic Re-

search—study by Feld and Voget that basically finds that, if we went territorial, we would make the U.S. the acquirer instead of the acquired 17 percent more of the time.

Meanwhile, you know, since the productivity of assets depends in part on their owners, if tax reasons are producing less productive ownership, the underlying business is going to grow less well and produce fewer jobs.

So not only is the U.S. losing jobs, actually, globally we are decreasing well-being, because the most productive owner is not necessarily owning the asset.

The CHAIRMAN. Senator Wyden?

Senator WYDEN. Thank you very much, Mr. Chairman.

And I am very glad that we have the four of you distinguished academics, professors, spanning the philosophical spectrum. And I think that is exactly why this is an important hearing.

And I want to start by mentioning, tomorrow the Senate Republicans are going to start, apparently, discussion of a budget that eliminates the requirement that the reported tax bill be scored at all. Now, I am not sure there is a precedent for it. But what I know is, we are going to hear an awful lot of talk about this magical growth fairy. And I want to get into with all of you specifically what we are talking about.

Now, Secretary Mnuchin on Sunday said, again, that the tax cuts pay for themselves. He said the President's framework is going to cost $1.5 trillion on a static basis. Through a budget gimmick arguing for a policy baseline, you can take $500 billion off the score.

Then he said the tax cuts are going to create $2 trillion of economic growth so that the bill would actually raise a trillion dollars. It was almost like this administration was comatose for Reagan trickle-down economics.

Now, here we are with this terrific panel. And I would just like to put to rest this growth fairy theory with respect to tax cuts. So I would like to just kind of go down the list, go down the four of you, and have a "yes" or "no" answer to the question.

Do you believe tax cuts pay for themselves?

Professor Wells?

Mr. WELLS. From my perspective, other things need to be in the system to offset the revenue. So by themselves, I do not think tax cuts are going to pay for themselves.

Senator WYDEN. We will count that as a "no." Okay.

Dr. Clausing?

Dr. CLAUSING. No, I do not think so.

Senator WYDEN. Professor Shay?

Mr. SHAY. No.

Senator WYDEN. Professor Grinberg?

Mr. GRINBERG. Appropriate tax reform can increase economic growth, but only by a certain amount.

Senator WYDEN. So tax cuts do not pay for themselves?

Mr. GRINBERG. Yes.

Senator WYDEN. Look, the reason I am asking is, it is very important we define what this debate is all about. I am one who believes, when we talk about our bipartisan bill and the Democratic principles, behavior does matter. That is not the debate. The de-

bate is whether we are going to have this magical growth fairy, and then we are not even going to score the proposal.

I do not even know of a precedent like that. And it certainly defies the public interest to do a major outline for tax reform and budget judgments for years to come and then just say, well, gee, we are not going to score this thing at all. So I appreciate your being clear about that.

Now, let me go to you, Dr. Clausing, with respect to the Trump tax framework claims. One of the arguments for the corporate rate reduction is—and again, we understand you need competitive rates—they say that the corporate cut is going to primarily benefit the U.S. worker.

My question to you—and I am certainly willing to have anyone else be part of this discussion—my understanding is, the mainstream consensus of economists is that overwhelmingly the benefit of corporate tax cuts goes not to the U.S. worker, but it goes to the shareholders. Is that true?

And my understanding is it might be, in terms of the ballpark, at most 20 or 25 percent as it relates to the benefits that get to workers.

Dr. CLAUSING. That is correct. And all the mainstream models, and this includes the CBO, the JCT, the Treasury——

Senator WYDEN. Go slowly on that.

The mainstream models, colleagues.

Dr. CLAUSING. All the mainstream models, yes.

Senator WYDEN. The Joint Committee on Taxation——

Dr. CLAUSING. The Congressional Budget Office, the Treasury—in the study that you can still find on the *National Tax Journal* website and from the nonpartisan Tax Policy Center—all of them give the benefits of corporate tax cuts, about 80 percent, to capital or shareholders.

And if you want to think intuitively about why this is, we have to recognize that businesses really do understand their own interests. If they are coming in to talk about lower tax rates and how it is important to them, but it is actually the case that the workers would pay the tax and not them, then you are presuming that businesses do not understand their own economic interests.

And I am inclined to think that businesses do understand their economic interests, which is why they push for these corporate rate cuts which primarily benefit managers and shareholders.

Senator WYDEN. Thank you, Mr. Chairman.

The CHAIRMAN. We next go to Senator Thune.

Senator THUNE. Thank you, Mr. Chairman.

Professor Grinberg, you note in your testimony that the number of U.S. multinationals in the Fortune 500 has declined by over 25 percent from 202 in 2000 to 147 in 2016.

I would argue, clearly, that the United States' antiquated international tax rules contribute to that and bear much of the blame. And we have an opportunity in tax reform to modernize these rules, which have not kept pace with our economy or the global marketplace over the past half century. So we have a chance to seize this opportunity to make our code competitive again.

So let me ask you this: if we fail to capture or pick up on these recent trends in international tax reform that a lot of other coun-

tries have implemented, what do you see as the cost of failing to do so?

Mr. GRINBERG. I mean, I think there are many costs. The cost I am most concerned about is opportunity for our kids. I think that multinationals, both U.S. and foreign, produce jobs that the data shows pay about a third higher than anything else in the private sector, on average. And you know, having more U.S. multinationals produces more of those jobs at home, because companies are not totally de-centered yet. There is still a home-country bias to R&D, headquarters, and support jobs. And that probably will not change for the duration of this tax reform.

So fewer U.S. companies means fewer high-quality opportunities for our kids, and that is my biggest fear.

The other thing is, and you know, the CBO estimates show this too, slowly the corporate tax base is going to whittle away. So it is maybe pennywise but pound foolish to try to get more revenue there.

That is why the CBO long-term scores show erosion of the U.S. corporate tax base, because they are concerned about this trend too.

Senator THUNE. Thank you. I would direct my next question to you and to Dr. Wells as well. Do you see reforming our international tax system and, generally, overall tax reform, as is being contemplated here, leading to greater economic growth? Does it contribute to growth?

Mr. WELLS. Yes, I do believe it will contribute to greater economic growth, absolutely. But more importantly than that, I think that when we think about base-protection measures that will level the playing field, that will provide revenue for this Congress to meet the other needs.

And I think what you and others need to consider is, foreign-based companies and corporate inverted companies, they have self-helped themselves to a territorial regime. No matter what you do, this country is territorial as to them.

You really have just one question: are you going to have the same playing field for U.S. companies? That is the question.

And if we are concerned about earnings stripping and base erosion, let us set up a set of rules that applies to U.S. and foreign companies equally to raise the revenue that you need, then the tax system is not creating winners and losers. You are collecting revenue in a thoughtful way.

Proposals like subpart F only apply to U.S. companies and excuse the foreign-based companies. That is the issue that I would address.

So yes, I believe it raises economic growth, but I also believe that the way to raise revenue is by leveling the playing field.

Senator THUNE. But growth would generate revenue as well.

Mr. WELLS. Growth would also generate more revenue.

Senator THUNE. I think this was in your response or maybe part of a statement that you made, Mr. Grinberg, too, but you talked about, when addressing inbound corporate tax reform in this Congress, policymakers should seek to give the United States leverage. "It is important to put the United States in a good position to bargain internationally about a future set of broadly accepted rules

that will most likely be agreed to multilaterally at a later date;" and that is your quote.

Would you elaborate on that point? And specifically, what form do you see that leverage taking? And how do we balance that with the important role that foreign direct investment plays in this country, which you also noted?

Mr. GRINBERG. So again, I do believe that foreign direct investment that creates new investment or otherwise supports increases in jobs is important. And therefore, I believe that we should try to level the playing field. I do not want to be understood as protectionist, we should simply level the playing field.

But the bottom line is that, abroad we see countries taking a series of measures that are intended to go after U.S. multinationals. So two obvious examples are the state aid investigations out of the EU and the recent suggestion by the EU that it would do a turnover tax on just digital businesses, which means just U.S. tech. This is not principled.

Instead, what I am suggesting is a principled approach in which we create an inbound minimum tax that treats U.S. multinationals and foreign multinationals alike and that defends the base that we can protect, which is the base of income earned in the United States from U.S. citizens and customers.

Senator THUNE. Okay, thank you.

Mr. Chairman, thank you. My time is expired.

The CHAIRMAN. Okay, thank you.

Senator Stabenow?

Senator STABENOW. Thank you very much, Mr. Chairman, for this hearing.

And I want to talk about one specific industry as we are talking about moving production facilities and profits overseas.

One of the concerns I hear the most from Michigan families is about the rapidly rising cost of prescription drugs. Drug prices in the United States are increasing at an astronomical rate, outpacing the increase in Social Security benefits, wages, and inflation by a factor of 10.

Despite record profits from the sale of prescription drugs, many pharmaceutical companies have moved their production facilities and profits overseas to get out of paying their fair share in taxes. These companies have aggressively taken every possible approach to lower their tax liabilities, from inversions to abusing tax havens.

Dr. Clausing and Mr. Shay, do you think the proposal put forward last week will help solve any of these problems?

Dr. CLAUSING. I did not see anything that really addresses in a serious way tax base erosion in that proposal last week.

There was mention of a global minimum tax. And as Steve Shay already mentioned, with a global minimum tax you have this opportunity to use taxes paid in one country to offset the minimum tax that would be due in another country. So in a way, it encourages foreign income in both high- and low-tax countries. So I did not think that was a serious response, so far at least, to the corporate tax base erosion problem.

Senator STABENOW. So nothing at this point yet to solve that.

Dr. CLAUSING. Nothing yet.

Senator STABENOW. Mr. Shay?

Mr. SHAY. Well, in fairness, nothing other than the word "global" has been specified, so we have no idea what is being contemplated. And the idea of moving forward without knowing what is being contemplated and without a score for what is ultimately done is indefensible as a policy matter.

But if it is under any normal conception of a global minimum tax—and of course we do not know what that is, so I hope I am not impugned for inferring from what we do not know. But if it is any normal conception of a global minimum tax—I have already testified that the average rate of taxes paid on all foreign CFCs as reflected in the 2012 data is 12 percent, 12.10 to be precise, so if the minimum tax is anywhere below that, then you almost certainly have not accomplished a lot. You have accomplished maybe a little for Ireland, which has about a 2-percent effective rate.

But without a per-country approach, it will be relatively toothless. That and the height of the rate are the two key points, and we just do not know what those are yet.

Senator STABENOW. So we are at a point where we have companies raising prices through the roof, getting tax benefits to do research and to create new kinds of medicines that they are charging astronomical prices for, many of them lifesaving medicines, and at the same time being subsidized by taxpayers through Medicare and Medicaid expenditures. And yet, there is nothing in here to address what is one of the most important issues I hear about from my constituents.

What specific steps should we be taking to address the problem of drug companies not paying their fair share?

Dr. Clausing?

Dr. CLAUSING. Yes, I think this is a big problem. And if you look at the Fortune 500 companies, the ones that have achieved effective tax rates in the single digits are often those such as pharma that have a lot of intangible value, which makes it easier for them to shift profits abroad.

So there is a lot that we can do here, from very simple, small, incremental steps to big steps. I think the approach that both Mr. Shay and I have recommended is to simply lower the rate and combine that with eliminating deferral. You have no disincentive to repatriate, and you are treating income abroad the same as you are treating income at home.

But if you do go to a territorial approach, a per-country minimum tax, I think, is a more promising step than many. And the higher that rate is and the closer it is to the U.S. rate, the less distortion there is and the less incentive to move income to tax havens.

Senator STABENOW. Thank you.

I would like to ask each of you just really quickly in my time, one of the most important things for me is closing tax loopholes that send our jobs overseas, and basically supporting American businesses. And there is a simple bill called the Bring Jobs Home Act I have introduced for multiple years that would just take away the deduction for moving expenses. At least we should not be paying for the moving expenses when a company is moving overseas.

Do you think—I would like to ask each of you, would you support stopping the deduction for ordinary and necessary business expenses for a business moving their jobs overseas?

Mr. Wells?

Mr. WELLS. I think that the problem is larger than that. For example, on your pharma question——

Senator STABENOW. Well, no question it is larger, but——

Mr. WELLS [continuing]. A minimum tax under subpart F would not apply to any of the pharma companies, because they are not U.S. companies anymore. And so if you are looking for a minimum tax or a subpart F regime or worldwide, all that discussion you heard does not apply to that sector. We need another discussion about base protection.

Senator STABENOW. Well, let me ask though, simply, for any company picking up and moving overseas, should their workers, the community, through their taxes, pay for the move?

Mr. WELLS. I think that what we should have is a base protection that is broad and comprehensive to protect the U.S. tax base. I think cherry-picking one observation and allowing all the other earnings stripping to occur is the bigger problem. So I think targeted reforms are not a solution.

Senator STABENOW. I realize that is not enough, but it certainly would help, though, if they did not have the insult of having to pay for the move.

Dr. Clausing? Just "yes" or "no," I know my time is up.

Dr. CLAUSING. Yes, I think that is justified, but there are bigger things I would worry about too.

Senator STABENOW. Of course, of course.

Mr. Shay?

Mr. SHAY. I am reluctant to pick out pieces. I think as a symbolic matter, it could be helpful.

Senator STABENOW. Yes.

Mr. Grinberg?

Mr. GRINBERG. It is peanuts. We should do something much more comprehensive. I do not see any reason for just making that change.

Senator STABENOW. I agree with you: we should have a big bowl of peanuts, a lot more than just that, but that would be a nice place to start.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Portman?

Senator PORTMAN. Mr. Chairman, thank you. Thanks for holding this hearing. And I appreciate our witnesses today. And what a great opportunity we have before us.

There is a big bowl of peanuts, as my colleague from Michigan just said, and that is a tax code that is outdated, antiquated, and broken. And it is no wonder; I mean, it goes back to the 1960s. Our tax code could qualify for AARP benefits on the international side.

Many of the members on this panel, at least to my left, were not even born when this thing was thought up, and it does not make any sense. And you look at the G7 countries, you know, all of them are territorial except us.

And with all due respect, Dr. Shay and Dr. Clausing, I appreciate your testimony, and I know you actually agree with a lot of what I think, at least in terms of base-erosion rules, but we have to catch up.

I mean, at one point we were the leader in terms of global tax policy. Now, you know, we are struggling to catch up, and it is hurting us. And it is hurting the workers I represent. And, darn it, we have to figure this out as a committee.

So you know, E&Y recently came up with a study, Ernst and Young, saying there would be 4,700 companies that would be American companies today, just in the last 13 years, if we had a 20-percent rate and a territorial system—4,700 companies.

Laura Tyson, former chair of the Council of Economic Advisers for President Clinton, just came out with her study showing that if you went to this kind of a policy we are talking about, 20-percent rate and territorial, it would result in $144 billion a year ongoing in repatriations coming back and about 154,000 jobs a year. And by the way, she said more in the short term because, during the transition, it would be even more positive. She is a Democrat, and she looks at this and just says, this makes no sense.

And companies are voting with their feet. Between 2003 and 2011, there were seven inversions. Between 2012 and 2016, just in those 4 years, 33 inversions.

And by the way, inversions are the tip of the iceberg. It really is not the bigger problem. The bigger problem is acquisitions. Foreign companies, as was said here today by Mr. Wells—I think all four of you agree with this—have a huge advantage. They can pay a premium for U.S. companies.

And you know, it makes all the sense in the world that we would be losing companies. So here are the numbers. In 2016, foreign acquisitions of U.S. companies were over three times greater than U.S. acquisitions of foreign companies. That is by volume.

You could either look at that or look at the study Mr. Grinberg cited, which is some German study he referenced: 17 percent more U.S. acquisitions of companies. So it would flip, and the U.S. companies would have an advantage.

Why does this matter? We did a study in the Permanent Subcommittee on Investigations. It was bipartisan. We all really drilled down into these inversions and acquisitions, what is really happening.

I am not from Missouri, but if I was, on this committee, I would care a lot about this, because when Anheuser-Busch decided to move overseas, they took 5,400 jobs with them. I mean, they did—and it is all documented; we have all the information. It is a study you can look at.

We went behind the curtain in these corporate boardrooms to listen to what Mr. Wells talked about today, and I appreciate your candor. What goes on in these boardrooms is, they want to be foreign companies for one simple reason: our tax code.

And when they change their headquarters, they do not just move their situs, they move people and investment and commitment to the community. That does not include all the nonprofits and charitable institutions in St. Louis that lost out.

So we have to do this; we have to fix it. And I know there are different ways to look at it, I get that, but I do not sense an urgency here today. And I hope that we can get to it.

Now, in terms of this issue of balancing inbound and outbound so you do not end up continuing to benefit foreign investment in foreign companies here, we do need to do something. It has to be balanced, because we want FDI. It is important in my home State of Ohio; it is important in all of our States, but it has to be a level playing field.

And I think Mr. Grinberg has laid out some interesting ideas of how we can come up with a way to have that right balance while we are encouraging investment here.

I want to ask you about outbound for a second, because that is something we have not talked about as much today.

Professor Grinberg, countries that have a minimum tax system that was talked about by Dr. Clausing and Mr. Shay—France, Germany, Japan, the entire EU, by the way, starting in 2019 after they implemented their new policies—they have a carve-out for active business exceptions. Can you comment on these European-style carve-outs and how we should think about them when designing our own outbound base-erosion rules?

Mr. GRINBERG. Thank you for that question, Senator Portman. So territorial systems often have some rules for base protection that then allow an active business exception. The active business exception under EU law is incredibly narrow. In other words, all you need are five guys and a dog. Okay?

And the reason you only need five guys and a dog is because of this case called *Cadbury Schweppes* out of the European Court of Justice that said that anything but wholly artificial arrangements have to be respected. And so the active business exception rule that is used in European jurisdictions is quite narrow, and we should understand that, if we are thinking about having a similar rule in the United States.

We would not want to create a rule that required a higher level of substance, because the problem with rules that say you only get deferral if you put substance in a foreign jurisdiction is that the higher the substance bar is, the more jobs you are asking to move offshore.

So those active business exception rules require a very limited amount of people and activity, especially the EU ones. And one should be concerned, if one writes a similar rule, that the IRS would up the bar and effectively ask U.S. companies to put more people offshore in order to avoid a minimum tax.

Senator PORTMAN. My time has expired. I appreciate that fact. Hopefully, we will have a second round and we can talk more about the outbound issues. But thank you very much.

The CHAIRMAN. Well, thank you.

Our next one is Senator Cassidy. You are up.

Senator CASSIDY. Mr. Shay, in your testimony you speak about not, I think, bifurcating cash, cash equivalence from non-cash. Very briefly, could you just comment on that, please, because I do not think you spoke to that in your spoken testimony.

Mr. SHAY. Yes. I was pretty clear in my testimony, I think, that I am not in favor of a reduced rate on pre-effective-date earnings.

But if, as has been proposed, there is a different rate on earnings that are reinvested in illiquid assets—that is the term that is used in the framework—versus cash, so there is a higher rate on cash, it is not good. It is not a good idea to announce to sophisticated business people that if you shift your offshore earnings from cash into illiquid assets, which has already, in essence, been announced, you are going to get a lower rate by something like 4 percent. And then what is really an illiquid asset will become the subject of a definition.

My strong recommendation——

Senator CASSIDY. So, can I interrupt you?

Mr. SHAY. Yes.

Senator CASSIDY. You are implying that it is perhaps ambiguous as to what is cash or cash equivalence as opposed to illiquid?

Mr. SHAY. It is unspecified at this point. But whatever you do as a rule, I will be testing the line of that rule as a tax planner.

Senator CASSIDY. Okay.

Mr. SHAY. And the issue for cash is—the reason there is a higher rate for cash, presumably, is liquidity. For the companies, as I demonstrate in my testimony, that have the most offshore earnings—and the vast preponderance are credit-worthy companies—you are better off picking a single rate, whatever it may be, forget what my preference may be, than a bifurcated rate, or else you are going to have——

Senator CASSIDY. Okay, let me interrupt, just because we have limited time.

Mr. Wells, you have been in the boardroom and you have helped with those strategies, not that Mr. Shay has not been. Would you agree with that assessment?

Mr. WELLS. Again, I think that I agree with his assessment that people are going to do tax planning to try to minimize that outbound tax. So whatever system you put in place, there is going to be a reactionary planning.

But the discussion we are having is only for U.S. companies. We are giving a complete pass——

Senator CASSIDY. I accept that; I totally accept your premise of that.

Mr. WELLS. Then the question is, well, why are we doing that? I mean, what we should do is have rules that are going to apply across the board.

Senator CASSIDY. I get that, but I want to narrow the thing right there.

Mr. Grinberg, any comments on this?

Mr. GRINBERG. You know, on this point, I agree with the concern Steve describes. One needs to be careful about announcing in advance that if you take certain planning steps, you will receive a lower rate on previously unrepatriated earnings.

Senator CASSIDY. And, Dr. Clausing, I presume you feel the same way?

Dr. CLAUSING. That is correct.

Senator CASSIDY. Okay.

Mr. Grinberg, Mr. Shay is making the point that we should have a country-by-country variation.

I think I follow what you said, Mr. Shay, that if you have a lower effective tax rate in one country and that is the country of domicile of the company of which we are—I am saying it in as complicated a way as you, but you know far more than I.

Mr. Grinberg, would you agree with that?

Mr. GRINBERG. So my view is that we should have an inbound minimum tax, not an outbound minimum tax. And therefore, this question would drop away, so that would be my strong preference.

But if one were to have an outbound minimum tax, then I would simply point out that a country-by-country approach is not consistent with the way multinationals do business around the world.

In Europe, you know, you have a completely integrated economy. In Asia, it is that way too. Global supply chains cross borders.

If you go with a country-by-country approach, it is pretty inadministrable because now you have to police the transfer pricing decisions on transactions between France and Luxembourg. Do not kid yourself that people will not manipulate that stuff in order to make sure that they get around the country-by-country approach.

There are a series of reasons why we got rid of——

Senator CASSIDY. So, tax law arbitrage.

Mr. GRINBERG. Yes. A country approach is unworkable.

Senator CASSIDY. Mr. Wells, any comments?

Mr. WELLS. Yes, I think it would be extremely complicated, for the reasons Itai just said.

Senator CASSIDY. Okay, I am almost out of time. I yield back. Thank you.

The CHAIRMAN. Senator Carper and then Senator Cardin.

Senator CARPER. All right. We are happy you are here. Thanks very much for taking a really complex subject and making it even more so. [Laughter.]

I expect someday a light is going to go on in my head and I will say, oh, I get it now. It probably will not happen today, but it is not your fault.

Thank you for joining us.

I have four questions I always ask—my colleagues have heard me say this a few times—four questions I always ask whenever somebody comes to us and says, this is my proposal for tax reform. I ask these questions. One, is it fair? Two, does it stimulate economic growth? Three, does it simplify the tax code or make it more complex? And four, what is the fiscal impact, the budget impact, of what is being proposed?

And I do not ask "yes" or "no" questions very often. But I am just going to ask a question of you, just starting with you, Mr. Grinberg. Are those four reasonable questions to ask? You can just say "yes" or "no" or you could say "maybe."

Mr. GRINBERG. They are reasonable questions to ask. I happen to believe that in the corporate tax space, revenue-losing corporate tax reform is better than revenue-neutral tax reform.

Senator CARPER. Okay, thanks. All right. Thank you.

Are those, Mr. Shay, reasonable questions to ask?

Mr. SHAY. In the context of international tax reform, simplification is less important than it is for individuals, low- and middle-income individuals who have to struggle to do their returns.

Senator CARPER. Okay.

Mr. SHAY. And multinationals have more capacity to deal with complexity. And frankly, you need it more to deal with their economic issues.

Senator CARPER. Fair enough, thank you.

Yes, please?

Dr. CLAUSING. Yes, those are the questions I would ask too.

Senator CARPER. Thank you.

Mr. WELLS. In the multinational context, assuming "fair" means a level playing field among multinational companies so that everyone is treated fairly, equally, then, yes, I think those are four great questions.

Senator CARPER. Thanks so much.

One of the things we like to do here is, when we have a difficult subject to consider, and where there is a wide range of opinions on how to go about addressing it, one of the questions I like to ask is, where do you find consensus among the four of you?

If we could just assume, maybe not a good assumption, that we are going to move closer to a territorial tax system as we go through these debates and legislation, where do you think there is some agreement amongst the four of you?

And just very briefly, where do you think there is some consensus?

Mr. WELLS. I think we have broad agreement that on earnings stripping, inbound base erosion, source taxation, if not the preferred solution by everyone, is at least a respected point of view, that we need to broaden the base and protect against the inbound earnings-stripping problem that would exist for both in a territorial world.

Senator CARPER. Good; thank you.

Where do you think there is some agreement here?

Dr. CLAUSING. I think there is an agreement to have a combination of a lower rate and closing loopholes and better base protection.

I think at least three of us are worried about the base protection aspect of this on both an outbound and an inbound basis. And I think that it is important to keep both of those margins in mind.

Senator CARPER. Thank you.

Mr. Shay?

Mr. SHAY. I agree. There is a consensus that there needs to be some strengthening of the source taxation and, I think for all of us, anti-abuse constraints on territorial, but the difference within that is very substantial.

Senator CARPER. Good; thank you.

Mr. Grinberg?

Mr. GRINBERG. Yes. I think we all agree that one needs to look at inbound reform and that one needs to lower the rate. That is where I have heard consensus.

Senator CARPER. All right; thanks.

Mr. Shay, looking at your resume, my recollection is that you were serving in Treasury from 1982 to 1987, which is when we were trying to debate and adopt comprehensive tax reform during the Reagan administration. And it is interesting that now you are a panelist here. But drawing back on the process that we went through, the reason why we were successful in finding a com-

promise—it was difficult then, God knows it is difficult now. What advice can you share with us from your experience, 1980 to 1987 when this was running front and center, that would be helpful to us now?

Mr. SHAY. At the time, the Senate and the administration were under control of one party, and the House was under control of another party. There had to be a bipartisan starting point. That was one.

Senator CARPER. We need to flip. So you are saying we need to flip either the House or the Senate to get real, true tax reform? [Laughter.]

Mr. SHAY. I think bipartisanship is very important for a reform that will be sustainable. And there were arguments as to how much the 1986 act would sustain. In fact, it has. We are still dealing with huge portions of it today.

Secondly, tax reform is in the details. You cannot get it done—it started at the beginning of 1984. We took a year to draft the proposals in Treasury. They went through the Baker-Darman political review in the first part of 1985. They got through the House at the end of 1985. They went to the Senate side at the beginning of 1986. There was a conference committee at the end of 1986.

Every single step of the way we made corrections, improvements, changes. This cannot be done on the fly. It is just beyond my comprehension that we would try to make a major tax change as quickly as is being contemplated for political objectives.

Senator CARPER. All right; thank you all. Very good.

The CHAIRMAN. Okay.

Senator Cardin?

Senator CARDIN. Thank you, Mr. Chairman.

I have been listening very carefully to this hearing, and I think the last point, Mr. Shay, is pretty telling because, as I understand it, the budget instructions would have us complete our work in the next 5 or 6 weeks, at least the Senate, so that is not realistic.

But I was listening—and on the business tax issues, you all talk about harmonizing, that the United States business tax is an outlier, that we would like to have a level playing field for American businesses globally. All those I hear are objectives.

And then I look at the Big Six proposal, Mr. Chairman, and I see that their way of getting there is to reduce the business tax rates so that we can be more competitive on business tax rates, but no real way to pay for it. The traditional ways of using the Joint Tax Committee and traditional scoring are not going to be done. They have identified very few of the offsets, even with knowing that they are going to blow a hole in the deficit.

So we do not have time to analyze the consequences, Mr. Shay, of some of the issues you are talking about. We do know that State and local deductions will have an impact on real estate, will have an impact on federalism, will have an impact on the ability of our States to do their business. We do know that restrictions on business interest deductions will have a direct impact on businesses. They will be losers in that regard.

And I mention all that because I think the point of harmonizing, the point of a level playing field, is legitimate. And I think the tax rate issues are certainly legitimate concerns. So if we want to sig-

nificantly reduce our business tax rates, then the major difference that we have with harmonizing in the global community is the fact that we get virtually all of our income from income taxes, whereas every other country we are talking about has consumption taxes.

And it is very interesting that, as we developed the international trade rules that Senator Portman is very familiar with, we had no difficulty in doing border adjustment on consumption taxes, but we do not have border adjustment on income taxes. So it is a double insult to the United States on international competitiveness.

So it seems to me that if we really are looking at harmonizing, we have to tackle that problem. And I think the Big Six proposal underscores how difficult, if not impossible, it will be—impossible—to have competitive business tax rates, which is the driving force behind all of the base-erosion things you are talking about, unless we look at harmonizing with other revenues coming in other than income tax revenues.

It seems like that is the only way that we are going to be able to get to deal with the fundamental problems that you are talking about. Where is my logic wrong?

Mr. WELLS. I would not say you are wrong. But what I would say is that an unlevel playing field needs to be fixed.

Senator CARDIN. And is it not the rates that we are mainly concerned about?

Mr. WELLS. What I am concerned about——

Senator CARDIN. Is it mainly the rates or not?

Mr. WELLS. To me, it is not mainly the rates.

Senator CARDIN. So we can continue with a 35-percent corporate rate and still be competitive?

Mr. WELLS. I think it would be great to drop the rates. But I think if a foreign——

Senator CARDIN. No, I want to drill down on that, because I was under that impression. So you believe we can be competitive globally with a 35-percent corporate rate?

Mr. WELLS. No, I think we need to have a lower rate.

Senator CARDIN. Okay, so you are agreeing with me that we have to lower the rate.

Mr. WELLS. Yes.

Senator CARDIN. Now, let me take it to the next step. The United States, as far as its percentage of its economy invested in governmental services, is near the bottom of the global community. And yet, we have the highest marginal tax rates. Have we not given away our competitive advantage because we have been stubborn, as we are—Americans are very stubborn—saying that income taxes are the way to finance the Federal Government?

Mr. Grinberg?

Mr. GRINBERG. Senator Cardin, as I say in my testimony, I agree we should find a way to lower the corporate tax rate even further and not just meet, but beat our foreign competitors. But I would urge you not to make the perfect the enemy of the good. And I specifically reference your proposal in my testimony. And I am an advocate of having a value-added tax to let us sharply reduce corporate and individual income tax rates. But we need to move on corporate tax reform.

Senator CARDIN. I could not agree with you more. And I agree with that. I am prepared to move on corporate tax reform, but not by increasing the deficit, not by dealing with additional problems that are going to be created because of the unintended consequences, not by jeopardizing entitlement programs that are critically important to the American people. I am not going to do it under those terms.

But I am prepared to deal with it, but we have not seen any real effort here to isolate international tax reform. We have offered proposals coupled with infrastructure reform, different ways to do it. But if you look at the Big Six plan, I think we are heading down a proposed path that will be devastating and will not accomplish what you are trying to accomplish.

Thank you, Mr. Chairman.

The CHAIRMAN. Okay.

Senator Bennet?

Senator BENNET. Thank you, Mr. Chairman.

And just to piggyback on what my colleague was saying, I think in the 9-page proposal, there are roughly 200 words, I think, devoted to international taxation. That is what this committee is looking at right now.

And I gather—I apologize for being in the Education Committee this morning, which is where I was—but I gather from the conversation today, what we have learned is how complex this undertaking is and the possibility that real, unintended consequences can flow if we do not get it right.

And we face now, because of our own fecklessness, an artificial deadline of November 13th here as a procedural matter, which is 23 legislative days away. That is when that deadline is. And it does not have anything to do with creating a better tax code, it just has to do with the legislative antics of the United States Congress.

And I want to ask each of you for your honest view of whether you think we can reform the tax code in a way that is going to be productive to the American people without a bunch of unpredicted mistakes if we rush it through in a period of 23 legislative days; in fact, you do not even need to use my language, if we use 23 legislative days to do it.

Mr. Wells?

Mr. WELLS. Without seeing legislation, it is difficult to know how far apart you are.

Senator BENNET. And that is another important point. We have no legislative language; we have not seen legislation.

Dr. Clausing?

Dr. CLAUSING. I think this will be very difficult. And if you try to rush it in that way, I think you run the risk of losing a lot of revenue by doing the tax-cutting part but not taking seriously the base-protection part. And that would be very costly in the future.

Senator BENNET. Mr. Shay?

Mr. SHAY. I agree with that. And it is mind-boggling that you could think about having a major change with that little consideration.

Senator BENNET. Mr. Grinberg?

Mr. GRINBERG. Thank you, Senator Bennet. I mean, we have had, like, a 6-year process on tax reform, so I think it just depends

what the legislative text says. I mean, that is the thing. I assume we are not starting from zero, so I think it depends.

Senator BENNET. Well, I think that is a fair comment, and we will see whether there is legislative language coming later.

What is the risk that we could leave loopholes or make other mistakes that multinational corporations could take advantage of if we do not do the work thoroughly and well?

Mr. WELLS. It is hard to imagine that we could make more than we already have. I mean, we have earnings-stripping problems that are unaddressed. And the resulting legislation needs to fix inbound taxation, and we should be more competitive internationally.

From my perspective, there is very little in the way of inbound base-protection measures today. And so for me, I think you have an open field with no tacklers in the area. I mean, I think moving forward is going to make progress, given how bad the current system is right now.

But I think we should have a thoughtful move forward, but I do not think we need to, as Itai said, let the perfect get in the way of the good enough. We need to get a system that better balances the multinational and the business environment in the United States, because we are lagging behind and we need a sense of urgency to fix that.

Senator BENNET. We also do not want the highly imperfect to be the enemy of the imperfect either.

Dr. Clausing?

Dr. CLAUSING. We have a very large problem at present, but that does not mean it cannot be an even larger problem.

And we have been talking a lot about the inbound side, but let us look at the outbound side. My estimates suggest that multinational profit shifting to tax havens is costing $100 billion a year. We have $2.6 trillion sitting offshore in tax havens. If we move to a toothless territorial system where we exempt all foreign income and we do not try to protect the base, those revenue losses will definitely increase, not shrink. And I think that that is a big risk here.

Senator BENNET. Anybody else?

Mr. SHAY. I would agree with that. If you do not have strong anti-base-erosion, the clients who used to come into my office and say, "Can I do what the big people do?" and my question is, "Do you really run your business back in the U.S., do you really need your money back in the U.S.?" and they say, "Yes," I say, "Well, then you cannot do it very effectively."

If you move from deferral and its current restrictions on using that money in the U.S. to exemption, then any mom-and-pop business that is of even modest size, at that point can create a foreign office, use the five people and a dog that Itai was talking about, allocate income there, and then it is exempted.

This system can be so much worse. Do not go there without knowing what you are buying into.

Mr. GRINBERG. An inbound corporate minimum tax is not a toothless territorial system, it is just a fundamentally different approach. Moreover, it takes advantage of the immobility of the U.S. customer base, something that Dr. Clausing praised in her testi-

mony to the House Ways and Means Committee only a few months ago.

Senator BENNET. Mr. Chairman, I am out of time, so I just want to thank you.

I also want to thank the excellent witnesses here today whom I think give us a sense of how broad the array of choices are that we have to make, and I hope we will take the time to make them well, because this is something we only get to do once every 30 years.

The CHAIRMAN. Okay. Let us go to Senator Isakson.

Senator ISAKSON. Thank you, Mr. Chairman.

Dr. Clausing, continue on this subject for a minute about the toothless territorial tax system. If it were yours to do and you were told to change the U.S. to a territorial tax system, what teeth would you install in that system to make it palatable for you?

Dr. CLAUSING. I would have a tough per-country minimum tax. And I think that having it on a per-country basis is absolutely essential here. If you earn income in Bermuda, say, where the tax rate is zero, that per-country minimum tax would tax the Bermuda income right away.

If you have a global minimum tax, you can just use taxes paid in Germany to offset the Bermuda income. And then you have an incentive to move income to both Germany and Bermuda.

I would also protect the earnings stripping, have tougher earnings-stripping regulations. And there are other anti-inversion things that are off-the-shelf that Congress could have done a long time ago, things like an exit tax and raising the threshold that is required to invert. And I think those would be important off-the-shelf, easy things to do to help protect the tax base.

Senator ISAKSON. In Georgia we benefit from a lot of foreign direct investment into our State and have been a big growth State in the last decade. If you had selected countries that you had different tax levels for, for those coming to invest in the country, could that possibly turn some of that around and send it somewhere else?

Dr. CLAUSING. I am not suggesting different tax rates for inbound investment, so I do not think that that would apply in this context.

Senator ISAKSON. Okay.

Mr. Wells, what about you? If you were going to design a territorial system, what teeth would you install?

Mr. WELLS. The teeth I would have would be that we want the business profits that are in the United States subject to one level of tax in the United States, so that whether you are a U.S.-owned company or a foreign-owned company, you will pay one level of tax, that there is not one group of companies that can strip their profits to Bermuda or somewhere else.

We do not want to tax the inbound investor in a punitive way that causes them to have a double tax or a triple tax. But they ought to be on the same playing field with respect to the profits in their U.S. business, whether you are a U.S. company or a foreign company.

I think there are a lot of revenue offsets that are there if you leveled the playing field. And I think what you would say to the in-

bound investor is, if you can be on the same playing field as everyone else, do not have a tax disadvantage but do not have a tax advantage, you are not being competitively disadvantaged.

And what I would say to the U.S. companies is, you do not need to do corporate inversions anymore because you are now on the same level playing field with respect to operating a business in the United States.

So from my perspective, if you have a territorial regime, you need to make sure that the round-tripping problem that Professor Shay mentioned is not going to be possible. But please understand, that round-tripping problem is what multinational foreign-based companies are able to do today because we have not instituted any rules yet as to them.

Senator ISAKSON. Effectively, going to a territorial system ends the repatriation issue for the Congress, because it goes away. Is that not correct?

Mr. WELLS. Depending on what you do with the one-time tax on the foreign earnings, but yes.

Senator ISAKSON. Right, which is behind the question I am asking about the teeth. It is also important to all of us; we want to do the right ones.

Mr. WELLS. Correct.

Senator ISAKSON. Dr. Clausing, one other question. I read your testimony, and one thing really struck me about it that I had not thought about. I knew it was happening, but I had not thought about it. Ninety percent of the people born in the 1940s have out-earned their parents in their lifetime, but only about 50 percent of those born in the 1980s are going to out-earn their parents.

And you talked about a number of solutions—or I do not know whether they are solutions, but ways to get to adjust that in our policy. One was increasing the EITC, if I remember correctly, and the other, I think, had to do with wage stabilization, which I took as probably a minimum wage or a wage table that people would have to meet. Am I right in that?

Dr. CLAUSING. I talked about the EITC as an excellent tool. And I think economists and policymakers from throughout the political spectrum really like the Earned Income Tax Credit, because it encourages work and it brings more income to those lower in the income distribution.

I also mentioned a wage insurance, which is different from what you just characterized. But basically, the wage insurance would mean if you lost your job due to technological change, domestic competition, or international competition, effectively you would be insured for some fraction of the difference between your current wage and the old wage.

And that is part of our Trade Adjustment Assistance now for a small number of workers, but that could be expanded and would be an important ingredient to sort of help the middle-class workers adjust to a modern and technologically sophisticated economy.

Senator ISAKSON. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Toomey?

Senator TOOMEY. Thank you, Mr. Chairman.

A couple of my colleagues on the other side have raised issues about the budget resolution that the Senate Budget Committee will be taking up tomorrow, and I just wanted to clarify.

First of all, under the terms of the budget resolution that we will be considering tomorrow, the subsequent tax reform, should this committee report out a bill, will be scored. Let us just be clear about that: it will be scored.

And in fact, the way the budget is drafted, it is my understanding that the score will have to be on a static basis against a current-law baseline, a legislation that would not expand the deficit by more than $1.5 trillion over the budget window, and if it were to do so, it would lose the reconciliation protection that it is meant to have. So I would like to be clear about that.

Second point: several people have suggested that there is this 5- or 6-week deadline for getting the tax reform done. I happen to believe that there has been a tremendous amount of work done for years which can be compiled, much of which has been intensified over the last year, and we in fact can produce a very constructive tax reform in that period of time.

But I would point out that the goal in the budget resolution is not binding. The reconciliation instructions do not expire until September 30th of 2018.

A second point I want to push back on: Senator Wyden asked the question of whether tax cuts pay for themselves. To characterize this effort as simply a tax cut, I think is a gross oversimplification of what we hope to achieve here. And specifically, what I am referring to is, what we are contemplating is a multi-trillion-dollar series of pro-growth reforms, most of which would be offset by a multi-trillion-dollar series of base broadenings.

So we are hoping to have significant rate reductions, a significant move towards expensing CapEx, a significant simplification which helps compliance, and, of course, a move to a territorial system to be mostly offset by diminishing the extent to which the tax code currently favors certain activities over others.

Now, if the pro-growth elements are on the order of $4 trillion and the base broadeners are on the order of $3 trillion, there is what appears on a static basis to be a net tax cut of a trillion dollars, but until we have defined those things, I do not know how anyone can suggest that we can know in advance that we would not have enough growth to pay for the small fraction of this reform that will score statically as a negative. So I just wanted to make that point.

Professor Grinberg, we have had a considerable discussion this morning about how uncompetitive the U.S. international tax system is. The combination of a very, very high statutory rate, together with being one of the very few countries in the world that has a global system, contributes to that.

You have also made the point repeatedly that foreign direct investment in the United States, investment in American businesses, can be a constructive thing. And if it is done for economic reasons, then America wins, the foreign investor wins, the global economy is better off. But I wonder if you could just elaborate a little bit on how it is that the current uncompetitive international system is harmful to American workers.

Mr. GRINBERG. The system is harmful in a plethora of ways. First of all, there is just the fact that in lots of foreign markets U.S. companies are disadvantaged relative to foreign corporations because they face a worldwide system with deferral, whereas other companies face a territorial system. So you know, the other companies will only pay tax in the country where they are operating, not at home.

But then beyond that, and what I tried to emphasize in my remarks, is that we have created a disadvantage for U.S. companies in the United States. And to the extent that we believe that U.S. companies, everything else being equal, right—I mean, I love foreign direct investment when it makes the asset most productive and when it adds jobs in the United States. And I do not want to be understood as discouraging that. I am for that; I welcome that kind of investment.

But at the end of the day, there remains a headquarters bias for U.S. companies. And you know, you see it when you see an inversion happen, right? In an inversion, what we see happen is that, at first, you have just the tax re-domiciliation. But then there are a whole bunch of tax-based pressures, both in terms of our law and in terms of foreign law and in terms of the way the IRS audits, that create pressures to move the actual headquarters abroad, right, to move senior management abroad, to move R&D abroad, to move the support jobs associated with that abroad.

And initially, amazingly, the company actually, when it does that, moves Americans, right? So Americans leave the United States.

But here is the thing. Five years later, they want their kids to go to high school or college here, and so they come back. And who replaces them? Who replaces them is a European. And now you have taken a tax-driven re-domiciliation and you have turned it into a substantive change in the corporation, a substantive change in its leadership and its leadership's bias at the margins for where they are going to put jobs.

Senator TOOMEY. So I will just finish, Mr. Chairman.

So the bottom line is, we have a tax code that creates an incentive, apparently a powerful incentive, to headquarter multinationals somewhere other than the United States of America. And headquarters are very often a source of really good jobs.

Mr. GRINBERG. Yes.

Senator TOOMEY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Before I go to Senator Cantwell, I have been hearing some complaints about the committee's process for considering tax reform. Now, let me remind my colleagues, in the 6 years that I have been the lead Republican on this committee we have held roughly 70 hearings on tax reform. We have had the options papers that we have come forth with. There was the Baucus plan. There was the 200-page committee staff report on tax reform. We had the bipartisan working groups and all of their reports.

Now, this is the third hearing we have had in the last month on tax reform. And I might add that we are going to have a robust and fair markup.

Long story short, we have been at this a long time, and there are very few ideas and proposals that have not been exhaustively examined by this committee. So anybody arguing that we are rushing or ramming anything through has a pretty selective memory. So I just wanted to make that one point before I call on——

Senator WYDEN. Mr. Chairman?

The CHAIRMAN. Yes, Senator Wyden?

Senator WYDEN. Just briefly to respond.

The CHAIRMAN. Okay.

Senator WYDEN. Mr. Chairman, as you know, I and my colleagues on this side have enormous respect for you and your desire to have this committee work in a bipartisan way——

The CHAIRMAN. Vice versa.

Senator WYDEN [continuing]. And of course your history, which we are going to talk about tomorrow with the CHIP bill, where you started with Senator Kennedy. So I want to be really specific what is so troubling.

Gary Cohn, the President's top economic adviser, said last Thursday that he was presenting his first and last offer. His words, not mine. And when I heard that, I was just stunned by how dramatic the difference his words were with your words, which I know are very sincere, about wanting to do a bipartisan proposal, and I would say how different it was from the process that Ronald Reagan followed in 1986.

I talk to Bill Bradley a fair amount, another tall Democrat who was on the committee, with a lot better jump shot than me. But the point is, Mr. Chairman, he has described many times the process where the administration spent time with leaders on the committee who worked with the administration trying to find common ground. There has been none of that—none of that.

So I want it understood, this is not commentary about your intentions; quite the opposite. And I have appreciated your comments with respect to my work with Senator Coats and Senator Gregg, because I think that shows some bona fides for trying to get a bipartisan bill. And I continue to believe that the Democratic principles, particularly given some of your ideas, are very consistent.

But let us make no mistake about it. When Gary Cohn says he has put his first and final offer on the table and we are completely in the dark about details, that is stepping all over the history of successful tax reform, which is to do it in a bipartisan way.

And I just wanted to have that on the record. I did not want to take the time of my colleague.

The CHAIRMAN. Well, thank you. Thank you.

Senator McCaskill, you are next, and then we will go to Senator Cantwell.

Senator MCCASKILL. Thank you, Mr. Chairman.

Can any of you point to anything specific in the plan that has been laid out that would prevent the problem we have now, which is a wide disparity among U.S. companies in terms of how much they pay?

We know the effective rate is 22 percent—not the percentage. We know that service providers, construction, retail, and agriculture are paying 28 or more. And lots of industries have effective rates in the teens. And this is for a variety of reasons; it is not just terri-

torial. There are a variety of reasons why there is a wide disparity in what corporations pay.

I have scoured this plan, and I see nothing that levels the playing field here. Is there anything specific that you see in this plan—or maybe this is a detail to be determined later? Do you see anything specific in the plan, Dr. Clausing, that would level the playing field among the various corporations?

Dr. CLAUSING. No. As it is specified now, there is not much to hang your hat on in terms of leveling the playing field between different corporations. I mean, they are lowering the top rate, which means that the most you could pay would be less.

Senator MCCASKILL. Right.

Dr. CLAUSING. So I guess by definition that lowers the discrepancy.

Senator MCCASKILL. No, I am talking about between corporations.

Dr. CLAUSING. Yes, but on a relative basis, you are right, yes.

Senator MCCASKILL. Right. On a relative basis, I see nothing here that gets away from some paying zero and others paying at the top of the rate.

Dr. CLAUSING. That is right.

Mr. GRINBERG. So just one thing, Senator McCaskill. I just want to correct you on this 22-percent number. So that is a very particular way of calculating an average actual tax rate. Let me quote what the Obama Treasury in its final document said about that version of calculation. This is on page 42 and 43: "Because it is backwards-looking, determined by tax rules, decisions, and economic events that occurred in the past, it is not necessarily helpful as an indication of the effect of taxes on a new investment, one whose returns will accrue in the future."

It is also very different in scope than other measures. Other people tend to look at effective marginal tax rates or effective average tax rates where the studies clearly show that U.S. companies are uncompetitive internationally. And I would urge you to look at those numbers, not the 22-percent number.

Senator MCCASKILL. The point of my question—and I understand the point you are making, and it is a valid one—but the point of my question is this disparity between corporations based on other loopholes that are in the code. There is nothing being done that we can see to eliminate those problems, that you are going to have one type of industry that may have a certain business model pay very, very little and others pay at the top of the bracket. That is the point I was trying to make. And we have to address that.

Mr. GRINBERG. And I agree that we should try to clean that stuff out of the code.

Mr. SHAY. Senator McCaskill, in some respects, the proposal would worsen it to the extent it applies expensing to all assets.

Senator MCCASKILL. Right.

Mr. SHAY. Some assets have longer lives, some shorter lives. It can have a disparate effect depending on the footprint of the business in particular. It also is quite costly from a revenue point of view; at least in the early periods. It turns eventually. But if you really want to get more equality in terms of treatment, I think you would move towards economic depreciation for all assets.

That gets pretty much into the weeds and requires, frankly, a lot of work and a lot more effort. But that would go in the direction that you are asking about.

Senator MCCASKILL. That makes sense.

I want to make sure I spend just a moment at the end of my time here to talk about pass-throughs. The reason they are called pass-throughs is because the income passes through at the taxable rate of the person who receives it.

So let us assume for purposes of this discussion that you have somebody who is in the top tax bracket. Right now that is almost 37 percent. Let us assume they have hundreds and hundreds of pass-throughs, like they were a real estate developer. And now all of a sudden, they are going to go from a tax rate of 30, almost 40 percent to a tax rate of 25. And this would be true for upwards of 90 percent of the businesses formed in America. And the vast majority of the income we are getting from these pass-throughs is in fact coming from people in the top tax bracket. This is real estate developers, law firms, doctors—you name it.

So in essence, this is why, when you say "pass-through," most Americans' eyes glaze over. We are only talking about C corps when we talk about a lower corporate rate. We are dramatically lowering by 14 points the tax burden on anybody who is wealthy who has pass-throughs. Is that correct? Am I explaining that correctly?

Dr. CLAUSING. That is correct. And if you look at the estimates, about 88 percent of the benefit of a tax cut on pass-throughs goes to the top 1 percent of the income distribution. It creates a massive new base-erosion problem as people will seek to characterize their labor income as business income, and you will also lose a lot of income out of the personal income tax base. So this is a huge problem.

Senator MCCASKILL. A huge problem. Eighty-eight percent of the income coming from pass-throughs is for the 1 percent. And I guarantee you, anybody who looks somebody straight in the eye and says, "This is not going to benefit me," who has hundreds and hundreds of LLCs, is just lying to the American people—flat out lying.

Thank you, Mr. Chairman.

Senator WYDEN. Mr. Chairman?

Senator PORTMAN [presiding]. Senator Wyden?

Senator WYDEN. Per an agreement with Chairman Hatch, I just want to make a unanimous consent request to add section 4111 of Chairman Enzi's budget mark, which would repeal existing points of order requiring a budget score on a reported bill.* Thank you.

Senator PORTMAN. Without objection.

Senator Cantwell?

Senator CANTWELL. Thank you, Mr. Chairman.

I want to note the impressive list of witnesses we have from prestigious universities here today. I am specifically speaking of the University of Houston and Reed College. Thank you.

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*SEC. 4111. REPEAL OF CERTAIN LIMITATIONS.

Sections 3205 and 3206 of S. Con. Res. 11 (114th Congress), the concurrent resolution on the budget for fiscal year 2016, are repealed.

The other two institutions get a lot of credit, but we like the out-of-the-box thinking that comes from other parts of the country as well. So thank you both for being here.

Dr. Clausing, on your statement about broader notions of competitiveness, you outline this issue of making investments in other things that help our economy grow and require earning higher wages, such as a well-educated workforce. I see later in your testimony you also talk about this from the perspective of the fact that there have been sharply declining shares of GDP that go to labor versus increasing shares of GDP that go to profits.

So one of the things that I see, at least in my State, which I guarantee you has lots of economic activity, is the importance of skilling up the workforce. How important do you think this is to our competitiveness, and how much should our tax incentives reflect something that would help us get the skill level to maintain U.S. competitiveness?

Dr. CLAUSING. Yes, I think that is an excellent question. There are a lot of aspects to competitiveness that are underappreciated in this debate. And if you think about what makes a business really succeed, there are a lot of components. Do they have skilled, innovative workers? Is the middle class healthy enough that they can purchase their products? Is our infrastructure sound? Do we have healthy spending on R&D? All of these can make our businesses more successful.

And many of those things also require government revenue. So that makes attention to deficits particularly important because, if you are giving away the government revenue that you would use to repair bridges and roads and to fund education, that is a big hit to the potential for economic growth.

Back when they were looking at repatriation tax breaks in previous years, they often paired that with the idea of the infrastructure investment. These days it seems to be paired with the idea of deficits. So I think that that is more problematic for competitiveness.

Senator CANTWELL. Well, I was thinking more specifically about incentivizing apprenticeships. You know, given the fact that there are so many people who are not skilled in the jobs that we have open—something like 67 percent of companies are saying they cannot find the skilled workers that they need—what about investing in that as a way to keep our competitiveness?

Dr. CLAUSING. Yes, I think that is going to be a really important issue in the future, not just because of global competition, but also because of technological change. We have had a huge transformation in the economy with the role of technology. And computers and robots can do a lot of the things that unskilled workers used to do, which means that if you want good job opportunities, you need to have skills. So paying for programs and education to make our workers more skilled, I think, is essential.

Senator CANTWELL. What would you say, Mr. Wells? A more robust workforce—I think we define that in the Northwest as people who are flexible to change, that is in the context of being able to do a variety of things as models and businesses change. You know, going from aluminum in aerospace to composites is a big move and needs new skills.

Mr. WELLS. Yes, I agree with what Professor Clausing is saying. I think all of those are important factors. And to achieve those goals, we are going to need to have revenue to the government to be able to fund those objectives.

And from my perspective, the question then is, what is the fair way to raise the revenue? And base protection, preventing earnings stripping in a way that levels the playing field, is a nice way to get the revenue to meet the goals that you said and that I agree with are important goals for the country.

Senator CANTWELL. Yes.

Mr. WELLS. So I see those as being—when you think about tax reform legislation, we need to have a competitive, neutral system, but we need to have a system that really does collect tax in a way that will fund the things that the government desires to promote.

Senator CANTWELL. Well, I feel like if I cannot convince a guy who had a TV show called *The Apprentice* to be for apprenticeships, then I do not know what I can convince him of. I am pretty sure that what we need to do to maintain the shares of that GDP going in the right direction for higher wages and better jobs is to make sure we make the investment in those people whom the companies are saying they need. So it is not like they are not saying they need them.

So thank you, Mr. Chairman.

Senator PORTMAN. Senator Cassidy, do you have a question you would like to ask?

Senator CASSIDY. Yes.

One of our challenges seems to be the treatment of highly mobile intangibles. I have read each of your testimonies, but I cannot recall which of you specifically addressed that. But I suspect you all have thoughts.

And with the rise of the so-called modified nexus in the EU patent box regimes, we are seeing jobs and business activity move offshore—and I think you referenced this earlier, Mr. Grinberg—not just the intangible assets themselves.

So I guess the question is—now, by the way, I mentioned this to Mnuchin, and Mnuchin said, "Well, we have modeled it, and having an IP box actually costs the U.S. economy money." So in their modeling, they did not think it worked.

Now, that is a conversation over coffee, and I cannot say that that is their final position. I am just saying that at the time, that is what he raised.

So I guess my question for any of you or all of you is, what is the proper balance of carrots and sticks for IP income? Because, by the way, I look at these companies with a lot of cash overseas, and a lot of them have a lot of IP. I gather that a lot of them park that license in Dublin and the income thereof goes to Dublin and not to us.

Mr. Wells, do you want to take a crack?

Mr. WELLS. Okay. So I very much appreciate this question, because it will get me back to a dialogue I had earlier. Let us think about countries that have very strict rules on charging related party royalty arrangements, like China and Brazil. I cannot charge for those, so I will do interest stripping; I will do related party leas-

ing into those countries; I will do supply chain transactions; I will charge my costs in in other ways.

So a multinational comes to a jurisdiction with a toolbox of earnings-stripping strategies that are in a variety of categories. And then they just ask the question, "Well, which ones work here?"

So if you enact a targeted rule that deals with royalty stripping, that is great. But if you leave the other opportunities available, all that is going to do is allow for the multinational to say, "Well, I cannot use a hammer, so I will use a different tool in my toolbox to do the same earnings-stripping technique."

And so what I would caution the Congress to consider is, instead of targeting IP or instead of targeting moving expenses, we need to deal with this as a holistic question. What are the things that are related party payments that are reducing the U.S. tax base and shifting profits overseas?

Senator CASSIDY. Now, I accept that point, but there are some industries that seem very IP-heavy, if you will. Now, this is more than moving expenses. This is the fact that you are generating such a percent of your income from a license.

Mr. WELLS. Yes. So there are two different aspects to that: inbound royalty stripping for the use of IP in the United States—and I think we need better earnings-stripping protections on that. On IP migration, this is something Professor Shay and I have written and spoken about in other contexts. I think, from my perspective, the Treasury Department should do more under section 367(d) to prevent the shifting of intangibles from the United States to a foreign jurisdiction. I think they have the authority to do that and have not done that. But that is a separate issue that would need to be dealt with.

Senator CASSIDY. Let me just work down the line.

Dr. Clausing?

Dr. CLAUSING. Yes, I think intangibles are an important part of this tax base-erosion problem. And one thing I would encourage you to think about, as you think about other countries' tax systems, is also to look at some of the things that other countries are doing to protect their tax base.

It seems that we are in an important period where we can either, you know, all race to the bottom effectively, cutting rates and making tax evasion easier, or we can work together to try to combat that problem.

The EU recently adopted an anti-tax-avoidance directive that works with CFC rules, exit taxes, earnings stripping, general anti-abuse rules. Member states are going to apply those——

Senator CASSIDY. A little bit more slowly. My ears turned 60 years old this past week, so I apologize. [Laughter.]

Dr. CLAUSING. Sure. Yes, so the EU is working on this anti-tax-avoidance directive with many components, including controlled foreign corporation rules, exit taxes to address inversions, earnings-stripping rules, and general anti-abuse rules. And the member states of the EU are going to be applying these rules as of 2019.

And you know, I think it is clear that if we do not tax this intangible income, other countries will, but there are ways that we can support each other in these anti-tax-avoidance efforts.

To the extent that we prevent our companies, for instance, from moving income to Bermuda, that also helps Germany and France and other countries where foreign-to-foreign stripping will occur too. So I think that there are a lot of ways that countries can work together to protect their tax bases in a way that will help the countries that are trying to tax, as opposed to the havens.

Senator CASSIDY. Mr. Shay?

Mr. SHAY. Can I take it back one step? I agree with everything that Dr. Clausing just said. But by the time we are talking about income shifting, we are talking about successful intangibles that have been moved—really paper shuffling by good tax lawyers to get profits to move.

What we care about as a country is, where is the R&D conducted? R&D is a deduction. And so really, our ultimate focus is, we want the thinking, the knowledge economy to be in the United States. And for that, it is not just taxes or it is really not even taxes, it is education, starting from the primary, moving into secondary, going into higher education.

My town and city of Boston and Cambridge lost a headquarters to Senator Portman's State a number of years ago, Gillette, when P&G took them. We just got back General Electric, a large amount. We got General Electric. Some of it, of course, was incentives, but most of it was a knowledge economy that they valued, because they know they need to bring their businesses into the digital age.

Moreover, we have a very significant R&D center for Novartis, the Swiss-based company. We have to keep our eye on the ball here. It is not just about taxes. We need to preserve our revenue so we can fund the education and infrastructure and other things that really allow our people to——

Senator CASSIDY. But then the paper shuffling can still occur. And once that R&D has developed the marketable license, it could then be moved overseas.

Mr. SHAY. Under current law, and that can be substantially affected by the steps that Dr. Clausing was referring to.

Senator CASSIDY. Mr. Grinberg?

Mr. GRINBERG. You know, my view is that we need appropriate R&D incentives. We should have very, very strong R&D incentives.

I have previously expressed concerns about a patent box, but I have made the point before—and it goes specifically to why Dr. Clausing is wrong—that both the BEPS project and the EU have blessed patent boxes. And that has made patent boxes less of a bad idea than they were before. And that was a decision of the Obama administration, so let us understand that.

Nevertheless, what I think is, we should have appropriate R&D incentives that try to incentivize R&D. And if you have inbound rules that are appropriate, then there is less of an incentive to move to a jurisdiction with a patent box in the first place.

Senator CASSIDY. Okay. I yield back. Thank you.

Senator PORTMAN. I thank the witnesses for providing us some great input today.

I am just going to end with a couple of questions that dig a little deeper into the outbound side.

We have talked a lot about inbound. It is very important, and I appreciate the focus that all four of you have had on that issue. I

do think we have to have a level playing field. And as difficult as it is to find sometimes, I think we have gotten some good ideas here today.

We all want this FDI to be here in the United States, because foreign direct investment creates jobs. But at the same time, we do not want to be disadvantaging U.S. companies, particularly by putting in place round-tripping rules and other things on the outbound side.

The one thing I will say about intangible income leaving our country—which is more mobile, and that, to me, is the primary problem—is that Mr. Grinberg just mentioned patent boxes. Increasingly, our competitive countries in the OECD are saying, it is fine if you want to take advantage of our patent box, but you also have to move your R&D.

So to Mr. Shay's point, absolutely I agree we need a more competitive economy and a knowledge economy and trained employees who can handle it. But ultimately, if a company wants to take advantage of the lower rates from a patent box and they are told you can take advantage of it only if you include R&D work in that country, Ireland is an example, there is an incentive to move out of Boston or, in your Gillette case, Cincinnati. So I do think that has to be part of our focus here.

I guess I would just ask you, on the outbound side, the balancing act is to prevent that base erosion, particularly intangible income going to a low-tax jurisdiction, but not making U.S. multinationals uncompetitive. So how do we strike that balance?

Mr. Wells talked about 367(d) and how Treasury could do more with existing law. What do you all think about his idea? And what else can we do on the outbound side, particularly with regard to intangible income?

I will start right in the middle with Mr. Shay, and then we will move out right and left.

Mr. SHAY. The patent boxes that I have examined, and I have examined quite a few, they are very difficult to design; they are very difficult to limit. They end up being essentially rate reductions. So let us be clear that generally they are very poor so far, and I am not sure we have seen much effect of anything other than changing titles to patents.

With respect to how we achieve the balance of competitive versus uncompetitive, I think today we have had a suggestion of an array of ideas, but I think it does come down to—we cannot just look at source taxation, we cannot just look at outbound taxation; we need to have both be robust and protect U.S. interests. And U.S. interests are a level playing field in the United States and discouraging the kind of massive income shifting that Dr. Clausing's research has described.

And I think if you go in the direction of territorial, if you do not have a robust minimum tax, then you are going to have an issue. The European Union minimum tax is only five people and a dog within the EU. They have a different standard with respect to non-EU countries. So we should really be—again, this comes down to details, and we need to be very careful in how we do it.

Senator PORTMAN. Mr. Grinberg?

Mr. GRINBERG. So the most important thing we can do is lower the rate, lower the rate as sharply as possible. That is the bottom line.

Senator PORTMAN. Lowering the rate helps, because if you have a 20-percent rate, you handle a lot of the potential tax avoidance problems. But still, there are jurisdictions well below that, some with as low as zero, others in the, you know, 10 to 15 range.

Mr. GRINBERG. The other thing that I would hope we do is make it relatively easy in a transition to repatriate IP back into the United States so that, if you want to locate here, you can pretty easily.

And then you want appropriate, strong R&D incentives to do work in the United States. And then, frankly, if the U.S. moves to a system that looks more like the rest of the world, then instead of the BEPS process harming us, it can begin to provide us some support, because it is getting harder to move IP, as you pointed out, to zero-rate jurisdictions where you do not do anything.

And if there is an inbound tax, well, suddenly, you know, even if you go to the zero-rate jurisdiction, you are not going to pay nothing coming into the United States, so that is less of an attraction. You are not round-tripping, and you are not round-tripping successfully.

And the same thing applies equally for foreign-based multinationals, so you are not concerned that you cannot do it, but your foreign competitors can, which is a big problem under current law that round-trippers rightly complain about.

And so I think that you end up in a better place if you just lower the rate as much as you can, create strong R&D incentives, let people bring intellectual property back. That is my instinct. Do not create substance rules to force people to take jobs out.

Senator PORTMAN. Mr. Wells?

Mr. WELLS. Okay. I think I agree, and maybe all of us agree, lowering the rate is a wonderful idea that will help.

I think that if you move to a territorial regime, which I think you should and you must, then what we are saying is that subpart F should not serve as an important backstop or it should not be expanded as a base-protection measure.

As today's hearing has said, many times we say we worry about earnings stripping. Well, the answer to that is not simply to apply a tax on only U.S. companies under subpart F. And what I hope has come out of this hearing is that, no, subpart F is not the answer to base erosion.

And if we do go toward a territorial regime and we do not make a robust subpart F regime with it, then we really do need source taxation. We have to get busy about, how do we protect the U.S. tax base from interest stripping, royalty stripping, and related party payments generally?

And I think if we do that, then I think that you can come up with a system that will be a level playing field.

And again, I would just caution with this comment. Every time we seem to talk about protecting what is the rate of tax in the U.S., to the extent an inbound company can get a tax advantage, that puts them at a competitive advantage versus U.S. companies.

And we need a system that levels that playing field for competitiveness reasons.

Senator PORTMAN. Dr. Clausing, I am going to ask you to at least base part of your answer on the possibility of a territorial system, because I think that is what we are talking about in general here. And not that I am not interested in your other comments, but if you could think about, if there were a territorial system, how would it work?

Dr. CLAUSING. Absolutely. The first thing I would note is that lowering the tax rate is definitely not enough, and it is not going to get you there. If you look at the actual data on the profit-shifting problem, over 80 percent of the profit shifting for U.S. multinational firms is destined to seven havens. And those havens have effective tax rates that are typically 2 or 3 percent or sometimes less. So simply slashing the rate is not going to handle that base-erosion protection.

So, assuming you go with a territorial system, I think the key is to do tough base-erosion protection measures, including a per-country minimum tax, which I think would be one of the more effective measures you could take. This should be coupled with off-the-shelf remedies to deal with the inversion problem, like a 50-percent ownership threshold, exit tax, earnings-stripping limits, and the like.

You can also address the check-the-box regulations and work with some of our trading partners on the BEPS steps. Some of these steps are Band-Aids, but they are better than nothing at all.

And focusing on the fundamentals of the economy, I think, is also a really important thing that I would come back to—paying for your tax cuts, funding education, funding infrastructure.

Senator PORTMAN. Great.

Well, listen, thank you all. I could stay here all morning and afternoon, but I am afraid you probably have better things to do. We have not even gotten into the repatriation and, you know, whether it should be bifurcated or not. Any thoughts on that are helpful—not today—but presenting those to the committee and the staff. Whether there should be differences, as the Camp draft had, with regard to subpart F is important.

So, thank you for what you have done.

I would just end by saying two things. One, there is an urgency here. And I know that people are saying we need more time, more time. We have spent, I think Mr. Grinberg said, 6 years—it seems more like 20 years—talking about this. And there have been, you know, dozens of hearings, broadly speaking, on tax reform. This is not something that has not had a lot of debate, not to say we should not have more—I am all for it. And I am really happy we are in the committee process here, because we need to have public debate.

Infrastructure—our health care was not subject to that, and that was a mistake, in my view. I hope that infrastructure will have that kind of debate as an example.

And then finally, I just want to say I think we need to be very careful when we talk about this notion that somehow this is tax cuts that will pay for themselves. That is not what Secretary Mnuchin said over the weekend. I saw his comments. What he said

was, there will be economic growth that will accompany good tax reform, the right kind of tax reform, which includes the business side, because our code is so out of date right now.

There is an enormous opportunity to repatriate profits, but also to just allow American companies to be competitive and add more jobs here, and that will raise economic growth. And if you increase growth—I think it is about .4 percent over what the projections would otherwise be—I think that accounts for about the trillion and a half that is talked about.

So it is not that tax cuts pay for themselves, it is that the right kinds of tax relief and, more importantly for me, reform will lead to better economic growth. And we should take that into account. And that is my view, anyway.

For any of my colleagues who have written questions for the record, I ask that you submit them by close of business on October 13th.

And with that, again, thank you so much for your time today. And please continue to give us input.

This hearing is adjourned.

[Whereupon, at 12:27 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF KIMBERLY A. CLAUSING, PH.D., THORMUND A. MILLER AND WALTER MINTZ PROFESSOR OF ECONOMICS, REED COLLEGE

Chairman Hatch, Ranking Member Wyden, members of the committee, thank you for inviting me to share my views on the international aspects of business tax reform. Business tax reform is an important priority, and it should reflect the needs of our country. We need to raise revenue in a way that is simple, fair, and efficient. We can do this without resorting to increasing the budget deficit. And we can do this in a way that focuses on the needs of the American middle class.

In my testimony today, I will discuss several crucial issues related to good business tax reform. First, I will discuss the concept of competitiveness, the contribution of our business tax system to the Nation's competitiveness, and other important features of national competitiveness. Second, I will address the issue of corporate tax base erosion, an issue that has plagued our business tax system. Third, I will suggest important priorities in business tax reform, discussing how the corporate tax can be modernized to make our tax system better suited to a globally integrated economy. Toward this end, our tax system must serve the interests of American middle-class workers, workers too often left behind in tax reform proposals.

ARE U.S. COMPANIES COMPETITIVE?

By any broad measure, our Nation's businesses are incredibly successful. Corporate profits are a higher share of GDP than they have been at any time in history, whether one considers corporate profits in before-tax or after-tax terms. Over the past 10 years, after-tax profits have averaged 9.3% of GDP, whereas over the 40 years before, they averaged 6.2% of GDP. In light of these clear facts, it is difficult to argue that our economy is being held back by a scarcity of after-tax profits. Indeed, our companies are awash in cash, but they are missing investment opportunities, due in part to the economic weakness of middle-class consumers. (*See* Figure 1.) Also, our companies dominate the Forbes Global 2000 lists of the world's most important companies. (*See* Figure 2.) While our economy is about one-fifth the size of the world economy (16% in purchasing power parity terms (PPP)[1] and 22% in U.S. dollar terms), we have larger fractions of the world's top 2,000 firms: 28% by count, 33% by sales, 37% by profits (consolidated), 24% by assets, and 44% by market capitalization.

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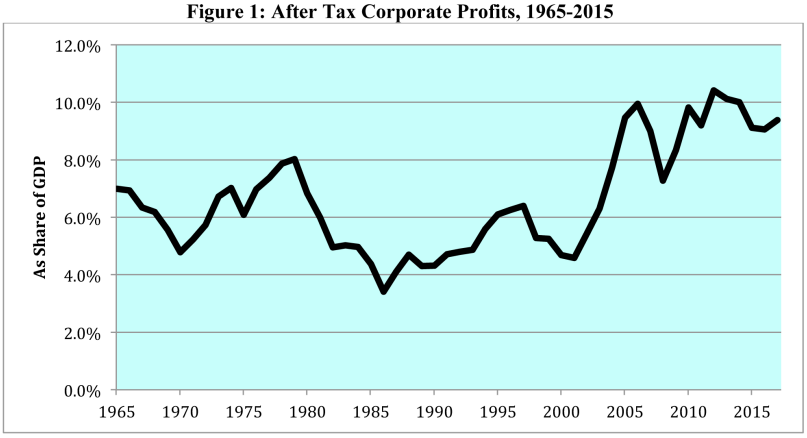
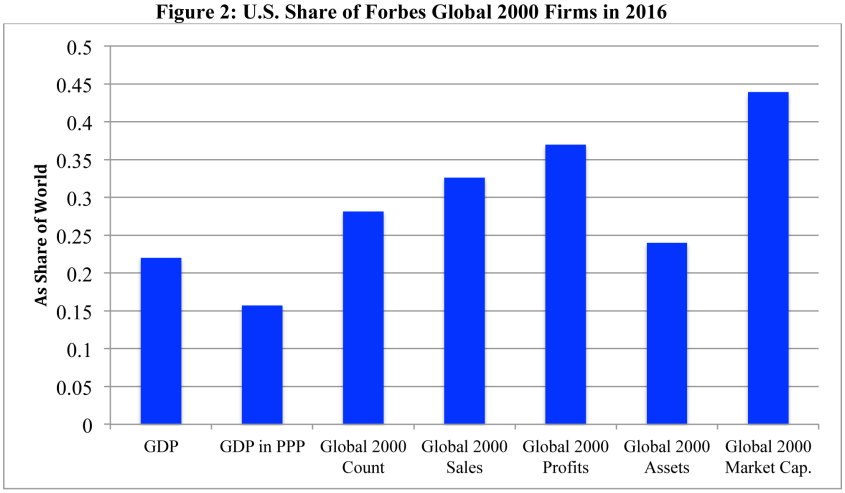
[1] PPP numbers adjust for price differences across countries. This makes the United States a smaller share of the world economy since price levels are lower in most developing countries.

Figure 1: After Tax Corporate Profits, 1965-2015



Source: U.S. Bureau of Economic Analysis

Figure 2: U.S. Share of Forbes Global 2000 Firms in 2016



Source: Forbes Global 2000 Lists and World Development Indictors Data on GDP and GDP PPP.

Is the U.S. Tax System Competitive?

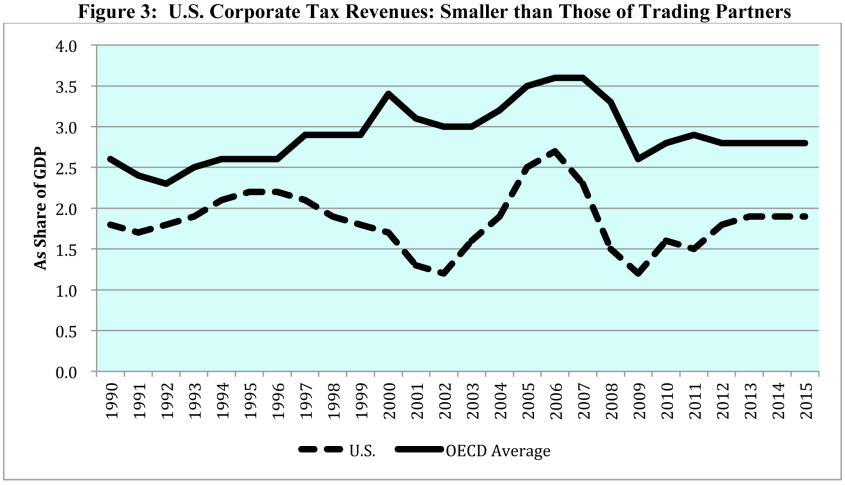
While our corporate tax system certainly has problems, high tax burdens for multinational corporations are not one of them. Due to the aggressive use of corporate loopholes, many U.S. multinationals have effective tax rates in the single digits, far lower than the U.S. statutory rate.[2] And, our purportedly "worldwide" system of taxation generates no revenue from taxing foreign income, while our trading partners that use purportedly "territorial" systems of taxation frequently tax more foreign income than we do.[3] Further, U.S. corporate tax revenues are lower than the cor-

[2] The U.S. statutory rate is high relative to peer nations, but this is not the relevant measure of corporate tax burdens since most companies pay effective tax rates that are far lower than the statutory rate. *See* footnote 5 for evidence.

[3] Under the U.S. system, some types of foreign income are more lightly taxed. For example, foreign tax credits can be used to shield royalty income from taxation. Also, other countries often have tougher base-erosion laws, and their adoption of the OECD/G20 BEPS guidelines will continue this trend. *See* Joint Committee on Taxation JCX–42–11. In addition to tough CFC laws, many territorial countries have other provisions aimed at countering corporate tax base erosion, including thin capitalization (earnings stripping) rules, which are widely used. Beyond these

porate tax revenues of our peer trading partners by about 1 percent of GDP. Part of the revenue shortfall is explained by profit shifting to tax havens, and there are also other reasons for weak U.S. corporate tax revenues.[4] These considerations do not mean that U.S. business taxation cannot be substantially improved; I make suggestions below.

Figure 3: U.S. Corporate Tax Revenues: Smaller than Those of Trading Partners



Source: OECD Revenue Statistics. Data are for collections by all levels of government.

Broader Notions of Competitiveness

In discussions about the "competitiveness" of U.S. multinational firms, corporate interests often emphasize tax burdens as a determinative influence. Yet, for many companies, the U.S. statutory rate and our purportedly "worldwide" system have more bark than bite, and multinational firms are often able to achieve very low *effective* tax rates.[5] In terms of the ability to generate after-tax profits and market dominance, U.S. multinational companies are already quite competitive.

But broader notions of competitiveness emphasize the fundamentals that determine the health and well-being of our broader economy. Are workers well-educated, and do they have the skills required to earn high wages in the global economy? Are customers economically secure and sufficiently prosperous that they are not overleveraged? Are standards of living for the middle class rising at a pace that is consistent with societal expectations and a healthy middle class? Is our infrastructure sound? Are our political and economic institutions stable? Are we avoiding fragility in our financial system and other weak spots that could lead to recessions or crises?

While we often take such things for granted, they are essential to the success of U.S. businesses and the workers within them. In short, the attractiveness of a particular country as a location for production depends on much more than the corporate tax environment. And many crucial ingredients for a competitive economy require government revenue to finance investments in education, infrastructure, and

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measures, there are also new anti-base erosion measures such as the European Union Anti-Tax Avoidance Directive and Australia's anti-avoidance law.

[4] Much business income is earned by pass-through organizations; this is discussed below. Beyond that, the U.S. tax base is notoriously narrow and there are important distortions within the corporate tax code. For example, debt-financed investments are tax-favored relative to equity-financed investments. This increased leverage creates financial vulnerability for the U.S. economy.

[5] *See* Matthew Gardner, Robert S. McIntyre, and Richard Phillips, "The 35 Percent Corporate Tax Myth," ITEP Report, March 2017. *See also* these studies on effective tax rates: Congressional Research Service: *https://fas.org/sgp/crs/misc/R41743.pdf;* General Accounting Office: *https://www.gao.gov/products/GAO-16-363;* Treasury: *https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Responsible-Business-Tax-Reform-2017.pdf;* and the appendix of this academics letter: *https://americansfortaxfairness.org/files/24-International-Tax-Experts-Letter-to-Congress-9-25-15-FINAL-for-printing.pdf.*

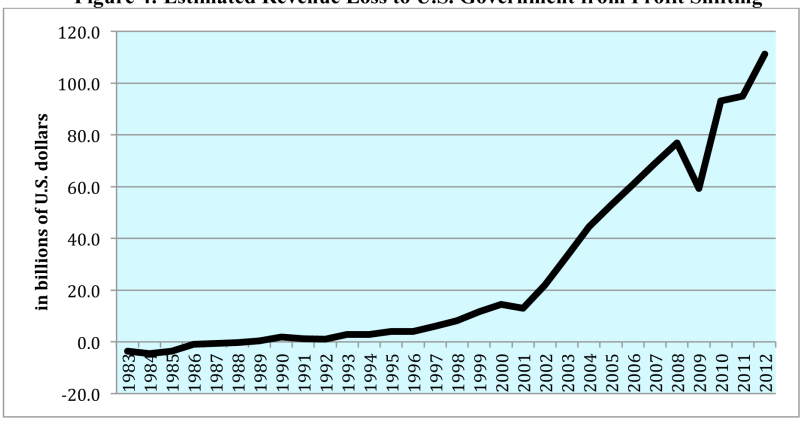
essential services. The investments in our economy that make the middle class prosperous will also make our businesses successful.

CORPORATE TAX BASE PROTECTION

Offshore profit shifting has become a huge problem. My research suggests that this problem has increased dramatically over the past 20 years, and profit shifting to tax havens now costs the U.S. Government more than $100 billion each year.[6]

Figure 4 shows the dramatic increase in the revenue lost to profit shifting in recent years, and Figure 5 shows that most profit shifting is artificially directed toward tax havens. Indeed, the income booked in low-tax havens is implausibly high by any reasonable metric. In 2010, U.S. affiliate firm profits were many multiples of island havens' entire GDP: over 16 times GDP in Bermuda and over 20 times GDP in the Caymans.[7] Further, estimates indicate that U.S. multinational firms have accumulated over $2.6 trillion in permanently reinvested earnings in tax havens, over $1 trillion of which is held in cash.

Figure 4: Estimated Revenue Loss to U.S. Government from Profit Shifting[8]



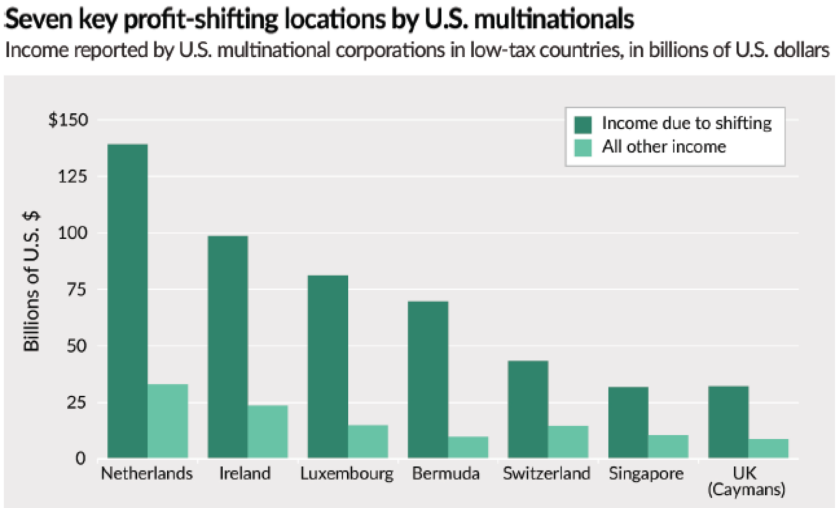
The tax havens that are destinations for profit shifting abroad have extremely low effective tax rates, often less than 5%. My research suggests that 82% of our profit shifting problem is with just 7 tax havens, the ones shown in Figure 5. And 98% of the profit shifting occurs with countries that have effective tax rates that are less than 15%. These facts clearly show that lowering the corporate tax rate is not enough to stem this type of tax avoidance. Absent tough measures to combat tax base erosion, haven tax rates under 5% will remain big magnets for internationally mobile income, even if the U.S. corporate tax rate declines substantially.

[6] *See* Kimberly A. Clausing, "The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond," 2016, *National Tax Journal,* December, 69(4), 905–934. Similar facts regarding the scale of the problem are reported by many sources, including Keightly (2013), Dowd, Landefeld, and Moore (2017), and Guvenen, Mataloni, Rassier, and Ruhl (2017). These practices also hurt our trading partners, as discussed in Clausing (2016).

[7] *See* Jane Gravelle, "Policy Options to Address Profit Shifting: Carrots or Sticks?", *Tax Notes,* July 4, 2016.

[8] For the full analysis behind Figures 4 and 5, *see* Kimberly Clausing, "The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond," 69 *National Tax Journal* 905, 905–934 (2016).

Figure 5: Main Destinations for Profit Shifting



More Base Erosion: The Problem of Favorable Pass-Through Taxation

While multinational companies almost always operate in corporate form, in part due to the benefits of deferral of U.S. taxation on foreign income until income is repatriated, much domestic business activity has moved from corporate to pass-through form. Pass-through income is now over half of business income. For domestic companies, tax burdens are often far lower in pass-through form, and tax avoidance is a big problem. Pass-through businesses often feature opaque organizational forms that facilitate tax avoidance. The average Federal rate on pass-through income is 19%, a rate lower than the rate on corporate income, and the movement of business income into pass-through form has reduced corporate tax revenues by about $100 billion each year.[9]

Providing a tax preference for pass-through income risks more tax base erosion. Rates below the top personal rate will open up massive new opportunities for tax avoidance, as (typically high-income) individuals with discretion will be tempted to reorganize their income as business rather than personal income. This type of tax avoidance was endemic in Kansas after their experiment with lower pass-through rates, and in general, it is very difficult to combat without adding immense complexity to the tax system. While some small businesses are the sorts of endeavors that are easily romanticized in these types of committee hearings, pass-through organizational form is also popular among very wealthy individuals, including President Trump, who owns many pass-through businesses. According to estimates from the nonpartisan Tax Policy Center, an astonishing 85% of a pass-through tax cut would accrue to those in the top 1% of the income distribution.[10]

WHY IS IT IMPORTANT TO PROTECT THE CORPORATE TAX?

1. Revenue. As demonstrated in Figure 3, U.S. corporate tax revenues are lower than those of peer nations, due to both profit shifting and the importance of the pass-through sector. In the wake of record high corporate profits in recent years, the low, flat trend of our corporate tax revenues is particularly noticeable. Protecting the corporate tax base would help ensure adequate government revenues in

[9] *See* Michael Cooper, et al., 2016, "Business in the United States: Who Owns It and How Much Tax Do They Pay?", *Tax Policy and the Economy,* 30(1), 91–128.

[10] *See http://www.taxpolicycenter.org/sites/default/files/publication/141541/2001271-options-to-reduce-the-taxation-of-pass-through-income.pdf.*

a time when the labor share of income is steadily shrinking.[11] Revenues are particularly important to finance urgent priorities that are important for the competitiveness of our economy and the economic health of the middle class: priorities like infrastructure, education, and research and development.

Business tax reform that is not (at least) revenue neutral increases the government budget deficit. The deficit is already scheduled to increase by about 2% of GDP over the next decade due to our aging population and our important commitments to Social Security and Medicare. Debt held by the public is now about 75% of GDP. Further increasing our indebtedness at this moment in time is unwise. When another recession occurs, and unfortunately recessions *do* always come, we will need room for the natural increases in budget deficits that occur as the economy collects less tax revenue and spends more on unemployment. Our current levels of indebtedness already provide little wiggle room. Also, monetary policy will have limited ability to respond to the next recession since interest rates are already quite low. This is a bad time for tax cuts.

Deficit-financed tax cuts increase tax burdens on our children and grandchildren. Also, government budget deficits reduce any growth-enhancing effects of tax cuts, since they either raise interest costs (due to greater government borrowing) *or* they pull in foreign sources of financial capital, which have the advantage of keeping interest rates lower, but result in future repayments of debts abroad, lowering standards of living at home during that period.

The nonpartisan Tax Policy Center has calculated that base broadening can only finance a limited revenue-neutral corporate rate reduction. Ignoring deferral, if you eliminate every single business tax expenditure (some of which are very popular), it only pays for a rate reduction to 26%, a far higher rate than those in the news lately.[12]

2. A Fair Tax System. Any proposed business tax plan follows several decades of dramatically increasing income inequality, sharply declining shares of GDP that go to labor, sharply increasing shares of GDP that go to corporate profits, and middle class wage stagnation. Tax policy should work to counter, not reinforce, such trends.

Business taxation has an important role to play in the progressivity of the tax system. As already noted, 85% of pass-through tax rate cuts accrue to the top 1% of the income distribution. And, aside from the estate tax, the corporate tax is our most progressive tax. All conventional models of corporate tax incidence assign the vast majority of the burden of the corporate tax to capital or shareholders, including models used by the Joint Committee on Taxation, the Congressional Budget Office, the U.S. Treasury, and the nonpartisan Tax Policy Center.[13] Given the strong advocacy by shareholders and the business community for corporate tax cuts, it should not be surprising that these groups are the ones who would benefit from the tax cuts. They understand their own economic interests.

Those concerned about the well-being of workers might usefully advocate for tax cuts on taxes that workers pay: economists agree that workers bear the burden of the payroll tax and the labor income tax. For *corporate* tax cuts to benefit workers, the resulting increase in corporate after-tax profits needs to fuel new investments, those new investments need to increase the productivity of labor, and the higher productivity needs to boost wages. Why rely on such indirect mechanisms to help workers when we have far more direct tools? If the aim is to help workers, then policymakers should go straight to the taxes that fall on them.

Further, much of the U.S. corporate tax base at present is excess profits, which are profits above the normal level accruing due to intangible sources of economic

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[11] *See* Kimberly Clausing, "Labor and Capital in the Global Economy," *Democracy: A Journal of Ideas,* 43, 2017, *http://democracyjournal.org/magazine/43/labor-and-capital-in-the-global-economy/*.

[12] TPC Staff, "The Tax Reform Tradeoff: Eliminating Tax Expenditures, Reducing Rates," September 13, 2017. Of course, ending deferral would enable further rate reduction; however, a move toward a territorial system is likely to worsen erosion.

[13] For JCT, *see https://www.jct.gov/publications.html?func=startdown&id=4528.* For CBO, *see https://www.jct.gov/publications.html?func=startdown&id=4528.* For Treasury, *see https://www.ntanet.org/NTJ/66/1/ntj-v66n01p239-62-distributing-corporate-income-tax.html.* (This was previously available at *https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/TP-5.pdf,* but it was mysteriously pulled from the Treasury website in recent weeks.) For the TPC, *see http://www.taxpolicycenter.org/publications/how-tpc-distributes-corporate-income-tax.*

value and market power. U.S. Treasury economists now calculate that three quarters of the corporate tax base is excess profits, often in the hands of very few superstar companies.[14] Giving a tax cut to this part of the tax base just makes excess profits even larger, without stimulating capital investment or wages.

Finally, if burgeoning corporate after-tax profits were the key to investment and wage growth, then the previous 15 years should have already been a paradise of wage growth, as after-tax profits in recent years have been about 50 percent higher than in decades prior (as a share of GDP), and higher than at any point in the past half-century.

I would urge the committee to focus on the distribution tables when designing tax law changes, relying on the well-regarded, nonpartisan economists at the Joint Committee on Taxation and the Congressional Budget Office to estimate the effects of tax and budget changes. The ultimate test of whether tax legislation will help American workers is the distribution analyses. In these analyses, it is important to consider the tax system as a whole: business taxes, individual income taxes, and estate taxes should all be considered together.

3. An Efficient Tax System. Taxing corporate income helps make the tax system function better. Without the corporate tax, individuals could use the corporate form itself as a tax shelter. The corporate tax is also our only effective tool for taxing capital income. In my recent research with Leonard Burman and Lydia Austin of the Tax Policy Center, we show that only about 30% of U.S. equity income is taxed at the individual level by the U.S. Government; the rest is earned in tax free accounts, in non-taxable endowments, or by foreign investors.[15]

Taxing all types of income at the same rate of taxation is a good ideal for tax policy. After the last great tax reform (that emerged from this very body) in 1986, both capital and labor income were taxed at the same rate. This sort of uniformity is consistent with the latest research on the ideal efficient tax policy design.[16] Taxing different types of income at the same rate also cuts down on the many gimmicks and shenanigans that litter our tax system when tax rates differ.

Finally, since the vast majority of the corporate tax base is excess profits, this also has efficiency implications. Taxing excess profits does not distort capital investment or hiring decisions, and excess profit taxes are far more efficient than taxes that target capital or labor.

IMPLICATIONS FOR BUSINESS TAX REFORM

1. First, Do No Harm: A Toothless Territorial System Heads in the Wrong Direction

Many in the multinational community use the notion of "competitiveness" to suggest that that the United States should adopt a territorial system of taxation. Yet, as noted above, multinational firms already face low effective tax rates that are comparable to those of firms headquartered in other countries, and very little tax is presently collected on foreign income. Indeed, a well-designed territorial system could easily *raise* the tax burden on foreign income, as noted by many observers.[17]

So, presumably, those that push for adoption of a territorial system under the guise of competitiveness concerns truly have in mind a "toothless territorial" system that would lower the tax burden on foreign income. A toothless territorial system, without serious and effective base erosion protection measures, risks worsening an already large corporate tax base erosion problem. Exempting foreign income from taxation would relax the remaining constraint on shifting income abroad, the potential tax due upon repatriation. This turbocharges the already large incentive to book profits in low-tax havens, likely generating large revenue losses.

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[14] *See http://www.ntanet.org/NTJ/69/4/ntj-v69n04p831-846-excess-corporate-returns-increasing.pdf* for evidence on excess profits.

[15] Leonard Burman, Kimberly Clausing, and Lydia Austin, "Is U.S. Corporate Income Double-Taxed?", *National Tax Journal,* September 2017.

[16] As examples, *see* Peter Diamond and Emmanuel Saez, 2011, "The Case for a Progressive Tax: From Basic Research to Policy Recommendations," *Journal of Economic Perspectives* 25: 165–90; Emmanuel Farhi, Christopher Sleet, Ivan Werning, and Sevin Yeltekin, 2012, "Non-Linear Capital Taxation Without Commitment," *Review of Economic Studies* forthcoming: 1–25; Thomas Piketty and Emmanuel Saez, 2012, "A Theory of Optimal Capital Taxation," National Bureau of Economic Research Working Paper No. 17989, April; Thomas Piketty and Emmanuel Saez, 2013, "A Theory of Optimal Inheritance Taxation," *Econometrica* 81 (5): 1851–86.

[17] Leslie Robinson, 2014, testimony of Leslie Robinson before the United States Senate Committee on Finance, presented at the hearing on international corporate taxation, Washington, DC, July 22; Jane G. Gravelle, 2012, "Moving to a Territorial Income Tax: Options and Challenges," Washington DC: Congressional Research Service.

2. Cutting Business Rates Below Personal Tax Rates Risks More Tax Base Erosion

Discrepancies between the top personal rate and the business rate will create new avoidance opportunities as wealthy individuals seek to earn their income in tax-preferred ways, reducing their labor compensation in favor of business income. Companies would be inclined to tilt executive compensation toward stock-options and away from salary income, and high-income earners would be inclined to earn income through their businesses in pass-through form. Thus, serious tax revenue leakage in the personal income tax system is also likely.

3. Much Ado About Repatriation . . . Why Give Windfalls for Income Already Earned?

U.S. multinational companies have accumulated over $2.6 trillion in offshore profits, sitting in countries with very low effective tax rates, typically less than 5%. Companies are able to borrow against these funds, and even invest these funds in U.S. financial markets, but they are not able to distribute the funds to shareholders in the form of dividends and share repurchases without triggering U.S. tax on the repatriated funds. As a consequence, companies have left funds piling up offshore, in the hope that Congress will give them a special holiday rate again (as in the 2004 American Jobs Creation Act), or even enact permanently favorable treatment of foreign income.

Company decisions about when to pay dividends and repurchase shares are distorted by these tax incentives. However, it is unlikely that repatriation tax is reducing U.S. investment. The companies that have accumulated these earnings abroad are the most credit-worthy companies on the planet, and they can easily borrow to finance worthy new investments in the United States. In fact, borrowing achieves the equivalent of a tax-free repatriation, since the funds abroad accumulate interest income that offsets the interest deduction on funds borrowed at home, giving companies the same access to financial capital at no tax cost.

Despite the hopeful title of the legislation, the 2004 American Jobs Creation Act's repatriation tax holiday did not create jobs or spur investment.[18] Instead, it was effectively a tax windfall to shareholders based on companies' past tax avoidance. The only effect was a substantial increase in share repurchases and dividend issues.

Further, preferential rates on income that has *already been earned* and that is stashed in tax havens makes no economic sense from either an efficiency or equity perspective. Giving shareholders a tax windfall on income they have already earned does not encourage job creation or investment. Instead, it merely enriches those at the very top of the income distribution. We have *far* more effective tools to encourage new investment, job creation, and the prosperity of the middle class.

4. Tackling Base Erosion

Congress should focus on a revenue-neutral (or revenue-increasing) business tax reform that reduces the statutory corporate tax rate and eliminates the major corporate tax expenditures *including deferral,* taxing accumulated offshore earnings in full. Eliminating deferral would eliminate the incentive to earn income in low-tax countries, by treating foreign and domestic income alike for tax purposes. Pairing that reform with a lower corporate tax rate need not raise tax burdens on average, although it would create winners and losers among corporate taxpayers. A more fundamental reform would require worldwide corporate tax consolidation; this would align the tax system with the reality of globally-integrated corporations.[19] These reforms should be combined with anti-inversion measures such as better earnings stripping rules and an exit tax.

Taxing foreign income currently also eliminates the incentive to build up large stocks of unrepatriated foreign income, now estimated at $2.6 trillion. Settling the future tax treatment of foreign income should be a key goal of reform efforts.

In terms of more incremental reforms, even a per-country minimum tax would be a big step toward reducing profit shifting toward tax havens and protecting the cor-

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[18] *See* Jane G. Gravelle and Donald J. Marples, 2011, "Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis," R40178, Congressional Research Service. This paper provides an extensive review of several papers, all of which show no jobs or investment stimulus resulting from the repatriation tax holiday.

[19] One proposal for worldwide consolidation is within Kleinbard's proposal for a Dual BEIT: Edward D. Kleinbard, "Business Taxes Reinvented: A Term Sheet" (September 25, 2017), *Tax Notes,* Vol. 156, 2017. Another fundamental reform worthy of long-run consideration is formulary apportionment. *See* Reuven S. Avi-Yonah and Kimberly A. Clausing, 2008, "Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment."

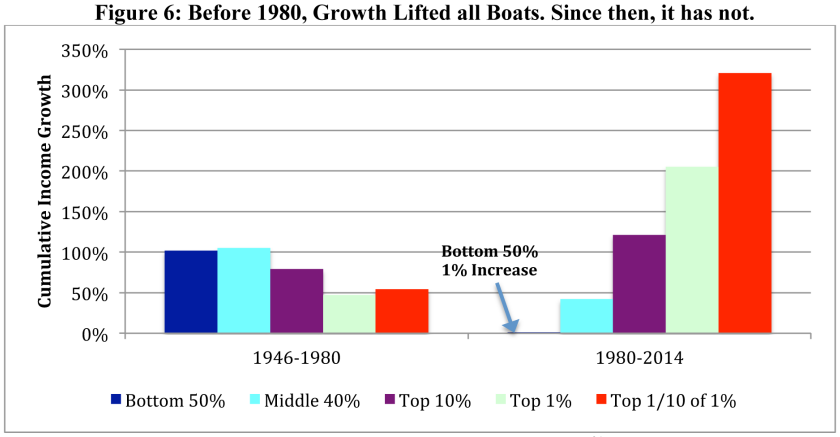
porate tax base. A minimum tax would currently tax income earned in the lowest tax countries. Ninety-eight percent of the profit shifting out of the United States is destined for countries with foreign tax rates below 15%.[20] However, a "global" minimum tax is a far less effective step. Since companies could use taxes paid in higher-tax countries to shield income booked in tax havens from the minimum tax, there would still be a very substantial incentive to earn income in tax havens. The playing field would be more tilted toward both haven income and other types of foreign income; the two streams of income would work together to reduce tax burdens.

In general, making our tax system compatible with the global economy is an important goal. We need a simplified corporate tax system that actually collects the tax that is due. As it is, too many people waste their careers pursuing tax-related gimmicks and shenanigans. Profit shifting costs the U.S. Government over $100 billion each year. Simple reforms like a per-country minimum tax—or better yet, ending deferral—would address that problem and make our corporate tax system more compatible with the global operations of multinational firms.

5. Paying Attention to the Middle Class

The truth is in the distribution tables. Any tax law changes should not worsen income inequality. The tax plans of this committee follow decades of dramatically increasing income inequality, sharply declining shares of GDP that go to labor, sharply increasing shares of GDP that go to corporate profits, and middle class wage stagnation. Our tax policy should be working to counter these trends, making sure that all American workers benefit from the gains in national income that steadily increase our GDP.

Figure 6: Before 1980, Growth Lifted all Boats. Since then, it has not.



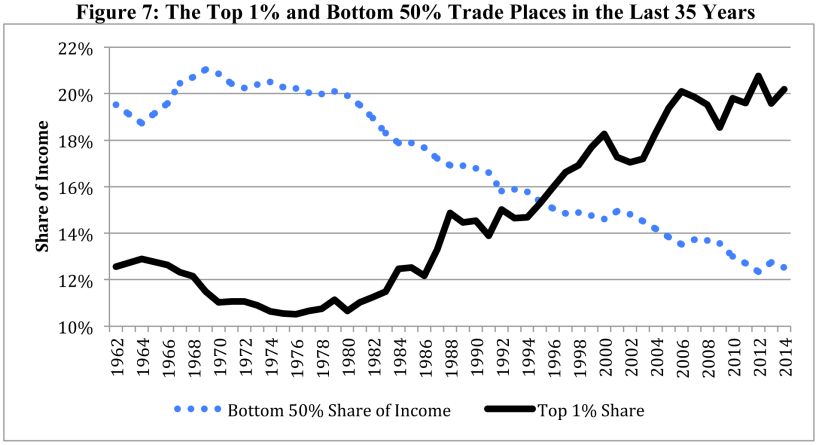
Note: Figures compiled based on data from Piketty, Saez, and Zucman (2016).[21]

In earlier decades, the middle class did better. Figure 6 shows that pre-tax income growth over the period 1946 to 1980 exceeded 100% for the bottom 90% of the population, and income growth was actually lower for the top shares of the population. However, between 1980 and 2014, the growth of the bottom 50% is literally invisible in the chart, at 1%. Growth in incomes for the middle 40% is 42 percent, and it accelerates from there. As a result, there has been an increasing concentration of national income at the top of the income distribution. The top 1% now have a fifth of national income, 50% more income than the bottom half of the income distribution. (See Figure 7.)

[20] *See* Kimberly Clausing, "The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond," 69 *National Tax Journal* 905, 905–934 (2016).

[21] *See* Thomas Piketty, Emmanuel Saez, and Gabriel Zucman, "Distributional National Accounts: Methods and Estimates for the United States," December 2016.

Figure 7: The Top 1% and Bottom 50% Trade Places in the Last 35 Years



Note: Data from World Top Incomes Database. Accessed 14 March 2017.

These figures help explain why typical American households are not content with the pace of economic progress. The standard expectation that every generation would be better off than the prior generation has been disappointed. Nearly 90% of children born in the 1940s out-earned their parents, but that share has fallen steadily. For children born in 1970, only 60% out-earn their parents; for those born in the 1980s, only half do.[22]

Our tax system needs to reflect these changing realities by making sure that tax cuts are directed to those that are *not* in the top 1%, focusing instead on the bottom 80% of the population that has been frustrated by our prior record of economic progress. The tax system can better serve American workers by expanding the earned income tax credit, by providing wage insurance for workers who have lost their job due to technological disruption or due to competitive pressures, and by making sure that tax cuts are larger for the middle class than for the rich. We also need to work to solidify the economic fundamentals of our economy. This requires responsible tax legislation that gives us the revenue we need for vital investments in education, infrastructure, healthcare, and other urgent priorities.

6. Fund the IRS; They Need More Resources to Do Their Job

In order to administer the tax system in a way that is fair to taxpayers and that meets the needs of the country, the IRS needs adequate resources and technology.

7. Finally, a New Revenue Source Can Make Tax Policy Trade-Offs Less Vexing

Whatever happens with tax policy in the months and years ahead, we will likely aim for more ideal tax policy in the future. To do this, we'll need a planet that is fit for habitation. Climate change is a real and pressing problem, but it is also an opportunity for efficient taxation. Normally, taxes burden things we actually want to encourage, like work or savings. But carbon dioxide emissions are wreaking havoc on the world's climate, and a tax on carbon is an ideal way to counter them, without resorting to burdensome regulations. A carbon tax raises a *lot* of revenue; a tax of $25/per metric ton is estimated by the Congressional Budget Office to generate about a *trillion dollars* in revenue over 10 years.[23] And, unlike most sources of revenue, a carbon tax makes the economy *more* efficient by discouraging something that the market, left to its own devices, over-produces.

A carbon tax can help keep other tax rates lower than would otherwise be necessary. Several very prominent Republican economists have recently suggested a

[22] *See* Raj Chetty et al., "The Fading American Dream: Trends in Absolute Income Mobility Since 1940," NBER Working Paper No. 22910, December 2016.

[23] This tax rate is lower than many estimates of the tax rate that would truly cause market participants to find the ideal level of carbon dioxide emissions, but it would be a sizable step in the right direction, and the tax rate could be increased over time. Arguably, the rate should be about twice as high, eventually.

novel way to tax carbon in their "Conservative Case for Climate Action."[24] They propose simply refunding the carbon tax to ordinary Americans in equal amounts. This is a masterful policy that will help workers in the bottom 70% of the income distribution (since they will receive more from the rebate than they pay in tax).[25] The large revenue source keeps overall tax burdens much lighter for those Americans who have struggled the most in recent decades. It will lead to new investments and new jobs in cleaner technologies *and* a healthier planet. A very good idea indeed.

Thank you again for inviting me to testify today. I look forward to your questions.

Further Reading

This testimony draws on several other works by the author, including those below. In some cases, sections of text are excerpted. Interested readers are referred to the following articles by the author for more detail on these arguments.

- "Strengthening the Indispensible U.S. Corporate Tax," Washington Center for Equitable Growth, August 2016, *http://equitablegrowth.org/report/strengthening-the-indispensable-u-s-corporate-tax/*.
- "The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond," 2016, *National Tax Journal,* December, 69(4), 905–934, *https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2685442.*
- "Competitiveness, Tax Base Erosion, and the Essential Dilemma of Corporate Tax Reform," 2016, (6) *BYU Law Review,* 1649–1680, *http://digitalcommons.law.byu.edu/cgi/viewcontent.cgi?article=3075&context=lawreview.*
- "Labor and Capital in the Global Economy," *Democracy: A Journal of Ideas,* 43, 2017, *http://democracyjournal.org/magazine/43/labor-and-capital-in-the-global-economy/*.
- "Is U.S. Corporate Income Double-Taxed?" (with Leonard Burman and Lydia Austin), September 2017, *National Tax Journal,* 70(3), 675–706.

PREPARED STATEMENT OF ITAI GRINBERG, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Chairman Hatch, Ranking Member Wyden, and members of the committee, it is an honor to participate in these hearings on international tax reform. I am a professor of law at the Georgetown University Law Center. I served in the Office of International Tax Counsel in both the George W. Bush and Obama administrations. Before joining the Treasury Department I practiced international tax law at Skadden Arps in Washington, and in 2005 I served as counsel to the bipartisan President's Advisory Panel on Federal Tax Reform.

The interconnectedness of today's global economy and the mobility of capital, intellectual property, and high-skilled labor make all attempts to impose high income tax rates on multinational corporations (MNCs) counterproductive. The global market for corporate control combined with the home-country bias for high-quality headquarters and R&D jobs means that lagging in this area will be increasingly costly in terms of employment and opportunity, especially for younger generations of Americans.

Our singularly high corporate tax rate and worldwide system are severely out of line with international norms. The United States' statutory corporate income tax rate is the highest in the Organisation for Economic Cooperation and Development (OECD), and our effective corporate tax rate is also high.[1] Every other G7 country and 29 of the other 34 OECD member countries allow their resident companies to repatriate active foreign business income to their home country without paying a significant additional domestic tax. This system of taxation is usually referred to as "dividend exemption" or a "territorial tax system."

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[24] *See* Martin Feldstein, Ted Halstein, and Greg Mankiw, "A Conservative Case for Climate Action," *New York Times,* February 8, 2017, *https://nyti.ms/2kMKE4u.*

[25] *See https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-115.pdf.*

[1] For instance, Philip Bazel and Jack Mintz find that the United States has a marginal effective tax rate on corporate investment that is more than 15 percentage points higher than the OECD average and represents the 3rd-highest marginal effective tax rate in the OECD, after only France and Japan. Philip Bazel and Jack Mintz, "2015 Tax-Competitiveness Report: Canada is Losing its Attractiveness," 9:37 SPP Research Papers (Nov. 2016), *https://www.policyschool.ca/wp-content/uploads/2016/12/Tax-Competitiveness-Bazel-Mintz.pdf.*

There is now a widespread consensus that the United States needs to reform its aberrant worldwide corporate tax system and that such reform should involve lowering the tax rate and adopting a territorial tax system. Other countries have been taking these steps for years, while also increasing their reliance on consumption taxes and decreasing their reliance on corporate income taxes. Indeed, since the 1986 Act, other OECD countries have reduced their collective average corporate tax rate by more than 19 percentage points.[2]

The committee has examined these issues since at least 2010, and many hearings have focused on these matters.[3] Substantially reducing the corporate income tax rate and moving to a territorial system are important steps the United States should take. But these steps are not enough.

Rather than restate the rationale for lowering the corporate rate and moving to a territorial system, which has been eloquently explained by many witnesses at earlier committee hearings over the course of this decade,[4] my testimony will focus on one significant issue within international tax reform that has received much less attention in prior hearings and from U.S. policymakers generally. The issue involves rectifying the relative advantages that U.S. law gives to foreign MNCs investing in the United States that make foreign status more attractive than U.S. status.

The current U.S. international tax regime makes foreign ownership of almost any asset or business more attractive than U.S. ownership from a tax perspective, thereby creating tax-driven incentives for foreign takeovers of U.S. firms and foreign acquisition of business units previously owned by U.S. MNCs. It also creates substantial financial pressures that encourage U.S. MNCs to "invert" (move their headquarters abroad), produce abroad for the U.S. market, and shift business income to low-tax jurisdictions abroad. Finally, given a global business environment in which corporate tax residence is increasingly elective, new firms have significant incentives to incorporate their parent firm outside the United States at the moment of formation. The worldwide system and high rate that creates these tax incentives is not in America's interest.

As is the case with our worldwide system and high rate, in failing to address the taxation of foreign direct investment into the United States (known as "inbound taxation"), the United States is a global outlier. In the rest of the world, governments have been focusing their policy efforts in the last decade almost exclusively on inbound taxpayers that minimize their income in local jurisdictions. Especially given this global reality, U.S. corporate tax reform must also focus on how the U.S. tax system disfavors U.S. MNCs relative to the treatment of inbound taxpayers.

In the past, the tax disadvantages of U.S. status were balanced against the non-tax advantages of being a U.S.-resident firm. However, foreign firms are increasingly able to replicate the non-tax benefits of being a U.S. tax-resident MNC. The globalization of securities markets has made it relatively easy to raise funds in foreign capital markets and to access U.S. capital markets as a foreign firm. The globalization of best practices in corporate governance has made U.S. corporate governance rules less of a factor in firm valuations.[5] As a result, the tax disadvantage increasingly outweighs the non-tax advantages of U.S. residency.[6] In our globalized

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[2] *See* "U.S. Tax Code: Love It, Leave It, or Reform It," hearing before the Senate Committee on Finance, 113th Congress 2 (2014) (statement of Peter R. Merrill, Director of the National Economics and Statistics Group at PricewaterhouseCoopers LLP), *https://www.finance.senate.gov/download/merrill.*

[3] Indeed, at the committee's July 2017 hearing, John Talisman, who served as Assistant Secretary of the Treasury for Tax Policy in the Clinton administration, pointed out that he had testified at a hearing in front of the committee in 2011 entitled "How Did We Get Here?" and joked that he wondered why the July 2017 hearing wasn't titled "Why Are We Still Here?", "Comprehensive Tax Reform: Prospects and Challenges," hearing before the Senate Committee on Finance, 115th Congress 1 (2017) (statement of John Talisman). Those of us who have been following these matters for years appreciated the humor, but I feel confident the country would appreciate the benefits of corporate tax reform a great deal more.

[4] *See, e.g.,* "Comprehensive Tax Reform: Prospects and Challenges," hearing before the Senate Committee on Finance, 115th Congress (2017) (statement of Pamela F. Olson), *https://www.finance.senate.gov/imo/media/doc/30827.pdf;* "The U.S. Tax Code: Love It, Leave It, or Reform It," hearing before the Senate Committee on Finance, 113th Congress 9 (2014) (statement of Mihir A. Desai); "Navigating Business Tax Reform," hearing before the Senate Committee on Finance, 114th Congress 11 (2016) (statement of James Hines).

[5] Julie A. Roin, "Inversions, Related Party Expenditures, and Source Taxation: Changing the Paradigm for the Taxation of Foreign and Foreign-Owned Businesses," 2016 *BYU Law Review* 1837, 1852 (Apr. 2017); *see also* Daniel N. Shaviro, "Fixing U.S. International Taxation" (2014).

[6] Indeed, corporations have also become increasingly "decentered" in recent years, such that corporate tax residence need not necessarily dictate the location of business functions. Mihir

economy, the result over time is a long-term trend towards foreign-resident MNCs and away from U.S.-resident MNCs. The inversion phenomenon is just one symptom of that trend.[7] Since 2000, the number of U.S.-resident MNCs among the 500 largest public companies in the world as measured by Forbes has declined by over 25%, from 202 in 2000 to 147 in 2016.

THE ROLE OF U.S. AND FOREIGN MNCS IN THE U.S. ECONOMY

Globally engaged MNCs, whether they be U.S. or foreign-parented firms, provide jobs for a large part of the American work force and higher wage employment than other parts of the American private sector. U.S.-headquartered MNCs employ 26.6 million workers in the United States.[8] Majority-owned U.S. affiliates of foreign MNCs employ another 6.8 million workers in the United States.[9] Together U.S. and foreign-headquartered MNCs represent more than 25% of total private sector payroll employment in the United States.[10] Total compensation per American worker employed by both U.S. and foreign-headquartered MNCs averages about one-third more than the rest of the U.S. private sector.

There are various explanations for why MNCs generally offer better wages and jobs than most purely domestic firms. For instance, multinationals may require a higher-skilled labor force because of the technological requirements and competitive need to produce higher quality goods associated with competing globally. Given that MNCs require a higher-quality product, they may pay efficiency wages—as higher quality products require higher quality workers, MNCs pay more to induce more effort from workers.

U.S. MNCs, however, are more closely tied to the United States than their foreign competitors. The domestic affiliates of U.S. MNCs perform 84.3% of the worldwide research and development undertaken by U.S. MNCs.[11] These domestic affiliates also represented more than two-thirds of worldwide U.S. MNC employment.

THE IMPORTANCE OF ENCOURAGING MNCS TO REMAIN AMERICAN

In order to maximize the opportunity for well-paid employment for future generations of Americans, we need to ensure that multinationals can be U.S.-headquartered and still compete effectively with their foreign MNC competitors. Expansion abroad by affiliates of U.S. multinationals tends to support their U.S.-parent jobs. Economic research shows that more affiliate investment and employment is generally associated with more investment and employment back in U.S. parents. For instance, Mihir Desai and James Hines find based on 1982–2004 U.S. Bureau of Economic Analysis data that on average, a 10% increase in foreign subsidiary sales is associated with a 6.5% increase in U.S. exports.[12] They also find that a 10% expansion of foreign employment by U.S. MNCs is associated with a 3.7 percent expansion of domestic employment by the same firms at the same time. As the Senate Finance Committee's bipartisan international tax working group report highlighted, the data suggests that for each dollar of additional wages paid in U.S. foreign affiliates, U.S. wages increase by $1.84.[13] Relying on still other studies, Greg

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Desai, "The Decentering of the Global Firm," 32 *World Economics* (Special Issue) 1271 (Sept. 2009). However, as discussed below, the BEPS project put a premium on shifting management and research and development jobs to the locations where an MNC wishes to be taxed.

[7] *See, e.g.,* Eric Solomon, "Corporate Inversions: A Symptom of Larger Tax System Problems," 67 *Tax Notes* 1203 (Sept. 24, 2012).

[8] Sarah P. Scott, "Activities of U.S. Multinational Enterprises in the United States: Preliminary Results From the 2014 Benchmark Survey," 96:12 *Survey of Current Business,* Dec. 2016, *https://www.bea.gov/scb/pdf/2016/12%20December/1216_activities_of_us_multinational_enterprises.pdf.*

[9] Sarah Stutzman, "Activities of U.S. Affiliates of Foreign Multinational Enterprises in 2015," 97:8 *Survey of Current Business,* Aug. 2017, *https://www.bea.gov/scb/pdf/2017/08-August/0817-activities-of-us-affiliates-of-foreign-multinational-enterprises.pdf.*

[10] Moreover, both U.S. and foreign multinationals purchase trillions of dollars of intermediate inputs each year from other U.S. companies, helping sustain other private-sector employment in America. Kevin B. Barefoot, "U.S. Multinational Companies: Operations of U.S. Parents and Their Foreign Affiliates in 2010," 92:11 *Survey of Current Business* 51, 52, Nov. 2012, *https://www.bea.gov/scb/pdf/2012/11%20November/1112MNCs.pdf.*

[11] Barefoot, *supra* note 10, at 54.

[12] Mihir Desai, C. Fritz Foley, and James R. Hines, Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," *American Economic Journal: Economic Policy,* no. 1 (Feb. 2009).

[13] U.S. Senate Committee on Finance, "The International Tax Bipartisan Tax Working Group Report" (2015), *https://www.finance.senate.gov/imo/media/doc/The%20International%20Tax%20Bipartisan%20Tax%20Working%20Group%20Report.pdf.*

Mankiw and Phillip Swagel conclude that for U.S. MNCs, "success overseas leads to job gains in the United States." [14]

No study reaches the same conclusion about foreign expansion by foreign MNCs. Indeed, the results of the studies described above regarding the effects of U.S. MNC growth abroad would suggest that when foreign companies expand outside the United States, related headquarters investment and employment would tend to accrue in their home country.[15] Importantly—this turns out to be the case even with formerly U.S.-tax resident corporations that have substantial presence in the United States but change their country of tax residency. Nirupama Rao has shown that former U.S. MNCs that undertake inversions subsequently develop higher shares of their employees and capital expenditures abroad after inversion, relative to similar firms that remain U.S. tax resident.[16] In effect, the data suggests that a tax-motivated inversion may subsequently create other incentives to offshore more jobs, just like being a historically foreign-headquartered MNC exerts a kind of gravitational force that keeps a higher percentage of the best jobs in the firm outside the United States.

GREENFIELD AND BROWNFIELD FOREIGN DIRECT INVESTMENT

Foreign investment into the United States is broadly categorized into two buckets by the U.S. Department of Commerce: the establishment of new U.S. businesses or the expansion of existing U.S. businesses (referred to as "greenfield investment"), and the acquisition of existing U.S. businesses ("brownfield investment"). Greenfield investment in the United States by foreign firms should unquestionably be welcomed by the United States. When a foreign MNC purchases a business unit from a U.S. MNC, or acquires a U.S. MNC, for the reason that the foreign MNC can use that business more productively, and therefore generate higher levels of output and employment from that business, we should also welcome that inbound investment.

Importantly, however, the data suggests that the vast majority of inbound foreign direct investment represents the transfer of ownership of businesses rather than greenfield investment. In 2016, expenditures by foreign direct investors made to acquire U.S. firms totaled $365.7 billion, whereas expenditures by foreign direct investors to establish new U.S. businesses totaled $5.6 billion and expenditures to expand existing foreign-owned U.S. businesses totaled $2.2 billion.[17] In other words, less than 3% of 2016 foreign direct investments were greenfield investments. The Department of Commerce Bureau of Economic Analysis data for earlier years in this century also shows that the vast majority of foreign direct investment consists of acquisitions of existing U.S. businesses rather than the establishment of new U.S. businesses or the expansion of existing U.S. businesses.

What drives foreign direct investor acquisitions is that the domestic business being acquired has greater financial value to a foreign firm than it does to the prior domestic owner. When that higher value is based on the ability of the foreign direct investor to make the domestic business more productive, the acquisition is likely to support American employment. In other cases, though—as shown in Senator Portman's Permanent Subcommittee on Investigations study entitled "Impact of the U.S. Tax Code on the Market for Corporate Control and Jobs," "foreign acquirers that hail from more favorable tax jurisdictions are able to create value simply by

[14] N. Gregory Mankiw and Phillip Swagel, "The Politics and Economics of Offshore Outsourcing" (National Bureau of Economic Research, Working Paper No. 12398, 2006).

[15] It is clear that policymakers in other major developed economies have this intuition. As with some other economic issues, U.S. data in this regard is often more robust than foreign data. Study of Japanese MNCs similarly shows that Japanese outbound investment is correlated with increased Japanese domestic employment. Mitsuyo Ando and Fukunari Kimura, "International Production/Distribution Networks and Domestic Operations in Terms of Employment and Corporate Organization: Microdata Analysis of Japanese Firms," REITI Discussion Paper Series 07–E–063 (2007).

[16] Nirupama Rao, "Corporate Inversions and Economic Performance," 68 *National Tax Journal* 1073 (2015). As Rao's paper highlights, the changes in hiring and investment resulting from inversion are not attributable to the onetime effects on the data due to the inclusion of the foreign acquiring firm's existing workforce and investments. Rather, foreign shares of employment and investment are systematically higher two and more years after inversion, relative to the first year after inversion.

[17] Bureau of Economic Analysis, U.S. Department of Commerce, 17–35, "BEA Expenditures by Foreign Direct Investors for New Investment in the United States," 2014–2016 (2017), *https://www.bea.gov/newsreleases/international/fdi/fdinewsrelease.htm.*

restructuring the affairs of the U.S. target companies to improve their tax profile."[18] In the subset of foreign acquisitions where that greater value in the hands of a foreign firm is driven by increased opportunities for tax minimization, the resulting increase in foreign direct investment (and the resulting apparent "increase" in employment of Americans by U.S. affiliates of foreign firms and "decrease" in employment of Americans by domestic firms) is simply not in the national interest of the United States. Indeed, a tax system that artificially encourages foreign ownership of originally U.S. assets that would otherwise be owned by more productive U.S. owners is not just disadvantageous for the United States—it will tend to reduce global well-being.[19]

FAVORING FOREIGN MNCS OVER U.S. MNCS REDUCES ECONOMIC OPPORTUNITY

While both U.S. MNCs and foreign MNCs support high-value jobs in the United States, U.S. MNCs tend to be more dedicated to U.S. employment. In those cases where a business asset would otherwise be equally productive under U.S. or foreign ownership, one should on average expect that business asset in the hands of a MNC with U.S. tax residence to produce more skilled jobs for Americans than the same business asset owned by a foreign MNC. For more than a generation, the labor market here and globally has been characterized by an increase in returns to skilled vs. semi-skilled and unskilled labor. Since there is no reason to believe this trend is likely to change, fewer skilled jobs located in the United States would reduce the opportunity set for younger Americans, and lead to both greater inequality and lower standards of living for our children and grandchildren.

We may one day reach a point where multinational firms are totally "decentered," such that national residence will have no effect on country of employment. But that day has not arrived. Moreover, there is no reason to believe it is likely to arrive during the probable lifetime of this round of corporate tax reform. Thus, in order to maximize opportunity for our kids, we must level the playing field and change the tax code to stop discouraging the formation, asset ownership by, and continued existence of U.S. MNCs relative to foreign MNCs. To do so, the United States must remove the incentives for tax-motivated foreign takeovers of U.S. firms, corporate "inversions," and initial foreign tax domiciliation to avoid U.S. tax-resident status. To achieve that result it is necessary—but not sufficient—for the United States to lower its corporate rate and move to a territorial system. The United States also has to deal with the problem of under-taxation of foreign-owned U.S. corporations.[20]

OUR UNLEVEL PLAYING FIELD

Most debates on international tax reform have thus far focused on income earned abroad by U.S. MNCs. However, arguably the greatest structural tax disadvantage of being a U.S.-resident corporation relates to the taxation of income earned in the United States. U.S. MNCs are much more constrained than foreign MNCs from stripping income out of the U.S. tax base. A foreign MNC can reduce the amount it owes to the U.S. Government through deductible interest and royalty payments from its U.S. affiliates to its foreign affiliates, as well as by charging its U.S. affiliates prices for goods or services that include the value of foreign-owned intangibles in high-priced products for resale in the United States.[21] A U.S. MNC cannot use deductible related party interest and royalty payments in the same way. U.S. MNCs are also somewhat more constrained in reducing their U.S. tax liability by embedding foreign-owned intellectual property in products sold into the United States.

The relative tax advantages that benefit foreign MNCs are in large measure the result of specific structural features of our tax law. Most notably, royalty and interest income earned by foreign affiliates of U.S. MNCs is generally subject to inclusion

[18] "Impact of the U.S. Tax Code on the Market for Corporate Control and Jobs," Permanent Subcommittee on Investigations, Senate Committee on Homeland Security and Governmental Affairs, 114th Congress 2 (2015) (Majority Staff Report).

[19] As Mihir Desai and James Hines have persuasively shown, "if the productivity of capital depends on the identities of its owners (and there is considerable reason to think that it does), then the efficient allocation of capital is one that maximizes output given the stocks of capital in each country. It follows that tax systems promote efficiency if they encourage the most productive ownership of assets within the set of feasible investors." Mihir Desai and James R. Hines, Jr., "Evaluating International Tax Reform," 56 *National Tax Journal* 487, 494 (2003).

[20] A recent article by Julie Roin addresses the technical questions associated with this problem in depth, and I recommend it to the committee. Roin, *supra* note 5.

[21] Other deductible payment streams, including rents, premiums, and management service fees made from foreign-controlled domestic affiliates to foreign affiliates can also be used by foreign MNCs to strip the U.S. tax base.

on a current basis as part of "subpart F." The subpart F regime applies only to U.S. MNCs. It imposes U.S. tax on certain items of foreign income earned by the foreign affiliates of U.S. MNCs. Planning techniques exist to limit the impact of these rules with respect to income generated by foreign affiliates in sales made outside the United States, but these techniques generally do not work for payments made by U.S. affiliates of a U.S. MNC to its foreign affiliates. For example, the benefits of section 954(c)(6)—which can limit the impact of subpart F with respect to payments made between foreign affiliates—are not available for payments made by a U.S. affiliate of a U.S. MNC to a foreign affiliate of a U.S. MNC. As a result, U.S. MNCs can use section 954(c)(6) to reduce the tax burden on their foreign earnings but not on their domestic earnings.

In contrast, foreign-resident MNCs can strip the U.S. tax base with very few limitations by structuring related party interest and royalty payments with their U.S. affiliates. They do not need to rely on subpart F planning techniques because subpart F does not apply to them. By statute, interest and royalty payments these foreign MNCs make to their foreign affiliates are theoretically subject to U.S. withholding taxes, but such taxes almost never apply under our tax treaties, which generally reduce these withholding taxes to zero.[22]

Another way to see the senselessness of focusing our international tax policy debate primarily on residence country taxation of U.S. MNCs is to consider the so-called "round-tripping" debate. Round-tripping is used in the international tax debate as a pejorative term meant to characterize a strategy employed by a limited group of U.S. MNCs to reduce their U.S. tax liability on U.S. sales by making deductible payments to foreign affiliates owning the U.S. rights to intellectual property incorporated into goods and services sold into the United States. "Round-tripping" by a subset of U.S. MNCs has been treated as a separate question deserving of special scrutiny in the international tax debate for at least the last 6 years. For example, concerns regarding round-tripping motivated the decision to limit the reduced U.S. tax rate on putatively foreign intangible income provided in former House Ways and Means Chairman Camp's tax reform proposal to income derived from foreign customers.[23]

However, the same basic planning technique used by "round-trippers"—owning abroad the U.S. rights to intellectual property associated with the sale of goods and services into the United States—is also routinely used by foreign MNCs. Yet when undertaken by foreign MNCs this same planning technique has received almost no attention, let alone criticism. The lack of attention is despite evidence showing that European MNCs (for example) very disproportionately hold their intellectual property in low- or no-tax jurisdictions.[24] Given the malleability of corporate residence, as well as the evidence that in general U.S. MNCs tend to produce more high-quality jobs in the U.S. than foreign MNCs, why would the Congress attack a tax planning technique when undertaken by U.S. MNCs, but leave it untouched when employed by foreign MNCs?

Another perverse fact is that foreign MNCs can manufacture in the United States and still strip the U.S. tax base, whereas U.S. MNCs cannot. Under subpart F, a foreign affiliate of a U.S. multinational is able to earn IP income from embedded intangibles on both foreign and domestic sales without being subject to current taxation in the United States only if the foreign affiliate conducts the related manufacturing outside the United States. Thus, U.S. law in effect discourages U.S. MNCs from manufacturing in the United States.[25]

Given the fungibility of tax residence for business units (which can be acquired), new businesses (which can incorporate initially abroad), and multinationals as a whole (which are now routinely acquired by foreign firms), differentiating tax burdens based on U.S. tax residence or foreign tax residence is simply untenable. Yet

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[22] 26 U.S.C. § 871 (2012), U.S. Model Income Tax Convention Article 11–12 (Treasury Department, 2006); U.S. Model Income Tax Convention Article 11–12 (Treasury Department 2016).

[23] *See* H.R. 1, 113th Congress, § 4211 (2nd Session, 2014).

[24] *See* Matthias Dischinger and Nadine Riedel, "Corporate Taxes and the Location of Intangible Assets Within Multinational Firms," 95 *Journal of Public Economies* 691 (2011) (examining a dataset of intangible holdings of the affiliates of EU-headquartered firms and finding "a robust inverse relation between the subsidiary's corporate tax rate relative to other group affiliates and its intangible asset holdings").

[25] *See* Paul Oosterhuis and Moshe Spinowitz, presentation at the Brookings Institute/Urban Institute Tax Policy Center/ITPF Conference on Tax Policy and U.S. Manufacturing in a Global Economy: "Tax Incentives to Conduct Offshore Manufacturing Under Current Law" (March 15, 2013).

our law is heavily based on an antiquated residence principle, and penalizes U.S. tax residence relative to foreign tax residence. This legal regime may have been appropriate when it came into being more than half a century ago, when cross-border mergers and acquisitions were rare and, when cross-border acquisitions did happen, they overwhelmingly involved U.S. MNC acquisitions of foreign firms. Now, however, this legal regime makes no sense.

THE GLOBAL CONTEXT

The U.S. debate regarding corporate tax reform is happening in a broader international tax context: 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 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."[26] 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. In particular, countries around the world are moving away from residence country taxation and towards source country taxation in a variety of often uncoordinated ways.

As a result of the BEPS project, transfer pricing norms globally were generally adjusted to, in the parlance of the OECD, "align income taxation with value creation." The key practical consequence of this agreement is to require MNCs to move high-skilled jobs (rather than merely shifting income) if they wish to benefit from the lower corporate tax rates available from America's competitor countries. Thus, a key outcome of the agreements reached in the BEPS project was to increase the negative consequences to American workers if the United States failed to lower our corporate tax rate and adopt a territorial system.

Since the BEPS project ended, countries as diverse as Australia, Chile, France, Germany, India, Israel, Italy, Japan, Mexico, New Zealand, Poland, Spain, and the United Kingdom have taken additional unilateral legislative or administrative actions. These unilateral actions are not limited by or consistent with the BEPS agreements and are designed to increase levels of inbound corporate income taxation. Moreover, a number of these actions have been designed so that, as a practical matter, they are targeted to primarily hit U.S. MNCs.

For example, in the last few years the European Commission invented a new "state aid" theory to target U.S. MNCs.[27] And last month the European Commission went further and considered a joint Franco-German-Italian-Spanish proposal to impose a so-called "equalization levy" on U.S. tech companies based on their gross turnover in EU countries, which is supposed to make up for their paying insufficient corporate income tax. At the September European Union Economic and Financial Affairs Council ("ECOFIN") meeting, finance ministers expressed unanimous support for some form of action to tax "enterprises that use digital technology." The ministers agreed to move forward swiftly and to reach a common understanding at the ECOFIN in December. Moreover, the current presidency of the ECOFIN asserted that "[i]f we can agree on the approach inside the European Union, then we can also affect the global rules in a way that is favorable to us."[28] Less than a week later the European Commission followed up with a statement that "unilateral initiatives in the EU and internationally will continue to develop," and made proposals for various gross-basis taxes on revenues from digital business only.[29] As a practical matter, this proposed tax is quite obviously targeted at U.S. companies.

The strategic questions implied by the unsettled state of international tax affairs should feature as an important consideration in the policy discussions surrounding U.S. international tax reform. Unfortunately, to date many analysts have main-

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[26] 11 Organisation for Economic Co-Operation and Development (OECD), "Action Plan on Base Erosion and Profit Shifting," *https://www.oecd.org/ctp/BEPSActionPlan.pdf.*

[27] For more on this issue, *see* my 2016 testimony before the House Ways and Means Committee, "Global Tax Environment in 2016 and Implications for International Tax Reform," hearing before the Committee on Ways and Means, 114th Congress 2 (2016) (statement of Itai Grinberg).

[28] European Commission press release, September 16, 2017, Economic and Financial Affairs Council, "EU finance ministers agreed to develop new digital taxation rules" (Sept. 16, 2017), *https://www.eu2017.ee/news/press-releases/eu-finance-ministers-agreed-develop-new-digital-taxation-rules.*

[29] Communication from the Commission to the European Parliament and the Council, "A Fair and Efficient Tax System in the European Union for the Digital Single Market," COM (2017) 547 Final (Sept. 21, 2017).

tained the historic American tendency to treat the diplomatic and competitive processes entailed in multilateral discussion of international tax rules as a second-order matter. In effect, some analysts pretend that if the United States takes decisive action the rest of the world will just follow, or behave in ways that will not fundamentally alter the policy consequence of U.S. policy.

Despite being the world's largest economy, in the international tax diplomatic space the United States has been losing for a number of years. We have failed to successfully defend our national interests, and have been repeatedly out-negotiated. One underlying cause of these failures has been our inability to enact international tax reform that defines a corporate tax base that we can successfully defend.

Historically the multilateral international tax architecture was heavily focused on residence country taxation. The international tax architecture around the world is shifting towards greater source-based taxation, but that transition is liable to be long and messy.

If we continue to insist on the idea of worldwide residence country taxation of U.S. MNCs, we will simply make U.S. MNCs uncompetitive outliers subject to foreign revenue grabs. Moreover, with respect to inbound taxation, it is important to understand that we have no international status quo, and we are likely taking the first steps in a multistage, multi-country game.

As a result, the inbound policy result the United States reaches in tax reform in this Congress will almost certainly be revisited repeatedly, spurred on by both unilateral actions by other countries and multinational negotiations. This time the inbound piece of international tax reform will not be a once in a generation event. Therefore, when addressing inbound corporate tax reform in this Congress, policymakers should seek to give the United States leverage. It is important to put the United States in a good position to bargain internationally about a future set of broadly accepted rules that will most likely be agreed to multilaterally at a later date.

THE U.S. RESPONSE MUST BE ADMINISTRABLE UNILATERALLY

In crafting our inbound taxation policy we should keep in mind whether any given regime requires multilateral cooperation to be effective. For example, proposals that are only administrable with significant new information-sharing with foreign sovereigns require international agreement. In the short-term, such agreement seems unlikely.

The difficult international tax diplomatic environment means that for the time being it may be more important that U.S. legal changes be administrable by the U.S. alone, rather than being as intellectually or technically robust as possible. At the same time, changes to our law should not involve technical innovations that we would strenuously oppose if used abroad. For example, it would be difficult for the United States to maintain that virtual permanent establishments are inappropriate abroad and simultaneously move forward with a deemed permanent establishment arrangement as part of income tax reform at home.

To ensure that our policy reflects the principle that we are working to level the playing field, the primary inbound measures the United States adopts should affect all industries and treat domestic and foreign firms equivalently in theory and practice. That must be one of the principles for eventual international agreement, and—unlike Europe—the United States' Wilsonian tradition stands for being a beacon of principle in international relations. Treating U.S. and foreign MNCs equivalently also helps preserve international economic law rules that generally prohibit discrimination against foreigners on the basis of national origin.

Nevertheless, within any inbound piece of tax reform, we also should consider including a punitive measure to discourage the imposition of particularly economically destructive taxes. For example, the gross basis turnover taxes on digital business proposed by the European Commission represent a mercantilist effort to target U.S. firms. The European Commission is proposing to revive a form of particularly inefficient taxation that was largely abandoned long ago. If actions like these are being proposed by our trading partners, we need U.S. legislation to make clear that attacks targeted at U.S. MNCs would have meaningful consequences. In that circumstance the balance of economic power would make it possible to reach a principled global settlement.

In sum, despite the unsettled global environment, the United States needs to act on reforming its inbound rules. What we need for the time being on inbound is a

pragmatic, administrable policy that helps level the playing field between U.S. and foreign MNCs. The policy should be based on a defensible principle—for instance an inbound corporate minimum tax.[30]

A MINIMUM TAX TARGETED AT U.S. MNCS SHOULD NOT BE THE FOCUS OF THE ANTI-BASE EROSION REGIME

One anti-base erosion proposal that has received prominent consideration in recent congresses is some form of minimum tax built onto the infrastructure of subpart F and used to reach intangible income. Unlike an inbound corporate minimum tax, such proposals target U.S. MNCs and only U.S. MNCs. In effect a minimum tax imposed on only U.S. MNCs is just a worldwide system with a lower rate for foreign source income than domestic source income. No other country on Earth has such a system. To the extent we impose such a tax at a significant rate we will continue to discourage U.S. tax residence and encourage foreign tax residence for all cross-border business.

Subpart F-based minimum tax proposals target U.S. MNCs to pay more tax to the United States just as foreign sovereigns are targeting these same MNCs to pay more source country tax. However, because residence taxation is a residual obligation, the end result of enacting a high subpart F based minimum tax would not likely be that U.S. MNCs would pay more tax to the United States.

Rather, because foreign taxes are generally creditable against U.S. tax liability, in a minimum tax system U.S. MNCs will tend to be indifferent to increased foreign taxes relative to MNCs resident in territorial countries. Why take the risk of planning to avoid a foreign tax, when under a minimum tax combined with a foreign tax credit, the ultimate cost of foreign source country income taxes (up to the level of the minimum tax) will generally be borne by the U.S. fisc rather than the company? Moreover, as other countries increase their source-based taxes, a residence-based minimum tax coupled with a foreign tax credit positively encourages other countries to specifically target U.S. MNCs with their own source-based taxes. Thus, the most likely consequence of enacting a significant minimum tax that applies only to U.S. MNCs is that business people and tax professionals will conclude that the best way to protect a business asset from attack by both the U.S. and foreign tax authorities is to take it out of the U.S. tax net, and make that asset tax resident somewhere else. The medium-term consequence of such decisions would be fewer jobs for U.S. workers.

The recently released "Unified Framework for Fixing Our Broken Tax Code" makes two key commitments to protect the U.S. tax base. The framework suggests the committee will "incorporate rules to level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies."[31] It also states that "the framework includes rules to protect the U.S. tax base by taxing at a reduced rate and on a global basis the foreign profits of U.S. multinational corporations." To the extent this means that the committee may include a subpart F-based minimum tax proposal as part of tax reform, it should set the rate as low as possible, provide for foreign tax credit haircuts, and pair that idea with an inbound corporate minimum tax. In this way a subpart F-based minimum tax proposal could incentivize U.S. multinationals to risk tax disputes with foreign sovereigns rather than decreasing tax payments to the United States, while limiting the degree to which a subpart F-based minimum tax would make the playing field less level.[32] Adopting a form of corporate integration that passes the benefit of only U.S. taxes paid by U.S. MNCs through to taxable U.S. shareholders could also help ameliorate the foreign tax payment incentive that could be created by even a low-rate subpart F-based minimum tax.[33]

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[30] Arguing that some part of income in part attributable to intellectual property should be taxed by the source state is not a new idea. *See, e.g.,* Lawrence Lokken, "The Sources of Income From International Uses and Dispositions of Intellectual Property," 36 *Tax Law Review* 233, 243 (1981). Some version of this point arguably dates all the way back to the work of the International Chamber of Commerce in the 1920s. *See, e.g.,* Bret Wells and Cym Lowell, "Income Tax Treaty Policy in the 21st Century: Residence vs. Source," 5 *Columbia Journal of Tax Law* 1 (2014).

[31] "Unified Framework for Fixing Our Broken Tax Code" (Sept. 27, 2017), *https://www.treasury.gov/press-center/press-releases/Documents/Tax-Framework.pdf.*

[32] *See* Daniel Shaviro, "The Case Against Foreign Tax Credits" (N.Y.U. Law and Economic Working Paper No. 208, March 2010).

[33] For further discussion, *see* "Integrating the Corporate and Individual Tax Systems: The Dividends Paid Deduction Considered," before the Senate Finance Committee, 114th Congress

Continued

The most effective anti-base erosion proposal, however, would be to find a way to lower the corporate tax rate even further, and not just meet, but beat our global competitors. When corporate income tax rates are significantly lower than those of competitor countries, other anti-base erosion measures become both less contentious and less important. The most plausible approach to accomplish such an achievement would be to adopt a value-added tax and use there venue to sharply lower both corporate and individual income tax rates. A number of highly esteemed witnesses appearing before the committee have made this point,[34] and Senator Cardin has introduced a bill with some of these admirable features. While adding another tax base is likely outside the scope of the current tax reform effort—as a destination-based tax, the value-added tax naturally taxes an immobile factor and therefore is much less susceptible to base erosion. Moreover, the revenue generated by a value-added tax could be used to cut income taxes sharply across the board without raising concerns regarding fiscal sustainability. Finally, as a tax on consumption, the VAT is just more efficient and pro-growth than business income taxes. It also could be a fairer way to address the intergenerational consequences of our unfunded entitlement liabilities and help ensure greater prosperity and opportunity for our children.

CONCLUSION

As both Chairman Hatch and Ranking Member Wyden have pointed out in the past, the United States corporate and international tax rules are an anticompetitive mess.[35]

Among taxes currently in use by developed economies, the corporate income tax is (as the OECD has pointed out repeatedly)[36] the tax that is the most harmful to economic growth. Unsurprisingly, then, governments around the world have come to view reducing corporate income tax rates and moving to a territorial system as tools to attract investment and jobs.

Lowering the corporate income tax rate and moving to a territorial system are important to maintain U.S. prosperity and improve growth prospects for our economy. The United States cannot stand apart from corporate tax competition in a globalized economy and is falling further behind each year.

To ensure that corporate income tax reform maximizes opportunity for well-paid employment for as many of our children and grandchildren as possible, the United States must also level the playing field between U.S. and foreign-headquartered MNCs. Leveling the playing field requires addressing the relative tax advantages available to foreign-owned U.S. corporations that represent one of the most senseless aspects of our current corporate tax code.

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

WASHINGTON—Senate Finance Committee Chairman Orrin Hatch (R–Utah) today delivered the following opening statement at a hearing on reforming the international code. The goal of the hearing is to examine how Congress can update the United States' system of taxing cross-border income to level the playing field for American companies and keep more jobs and investment here at home.

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2 (2016) (statement of Michael J. Graetz, Wilbur H. Friedman Professor of Tax Law and Columbia Alumni Professor of Tax Law at Columbia University), *https://www.finance.senate.gov/imo/media/doc/16MAY2016Graetz.pdf;* Bret Wells, "International Tax Reform by Means of Corporate Integration," 20 *Florida Tax Review* 70 (2016).

[34] *See, e.g.,* statement of Michael J. Graetz, *id.,* "Comprehensive Tax Reform: Prospects and Challenges," hearing before the Senate Committee on Finance, 115th Congress (2017) (statement of Pamela F. Olson), *https://www.finance.senate.gov/imo/media/doc/Pamela%20Olson%20Testimony.pdf.*

[35] At the committee's 2014 international tax hearing, while Senator Wyden described our system as anti-competitive, Pascal St. Amans—a French socialist who testified in his role as Director of the OECD's Centre for Tax Policy and Administration—went further and chose to describe the U.S. corporate tax system as "diseased." "U.S. Tax Code: Love It, Leave It, or Reform It," hearing before the Senate Committee on Finance, 113th Congress 2 (2014).

[36] *See* Organisation for Economic Co-Operation and Development (OECD), "Tax Policy Reform and Economic Growth," OECD Tax Policy Studies, No. 20 (Nov. 3, 2010); *see also,* Asa Johnansson, Organisation for Economic Co-Operation and Development (OECD), "Public Finance, Economic Growth, and Inequality: A Survey of the Evidence," ECO/WKP (2016) 70 (Nov. 22, 2016); Asa Johansson, Organisation for Economic Co-Operation and Development (OECD), "Tax and Economic Growth," ECO/WKP (2008) 28 (July 11, 2008).

Today's hearing will focus on another piece in the complex tax reform puzzle. But before I get to details of international tax reform, let me briefly address the elephant in the room.

Last week, I joined with the Secretary of the Treasury, the National Economic Council director, the Senate Majority Leader, the House Speaker, and the Chairman of the Ways and Means Committee to put forward a broad unified framework for tax reform.

As the document makes clear, this is just one step in the larger tax reform effort. But, let's not mince words: it is a big step.

I would be hard-pressed to remember the last time the White House and House and Senate leadership were in agreement on an issue as complicated as tax reform. We began discussions earlier this year, and, at that time, there were a number of high-profile differences among us. I'm very pleased that we have been able to bridge so many divides and I am optimistic about our chances going forward.

I want to express my gratitude to the others who worked on the framework and to the members of this committee who have helped us move the tax reform effort forward. I particularly want to acknowledge the work of Senator Grassley, who, as a former chairman and ranking member of the committee, laid much of the groundwork for the ideas we're discussing and for the progress we've made. It was under Senator Grassley's chairmanship that the Finance Committee, in 2003–2004, initiated the last package of international tax reforms.

Now, as some have already pointed out, the framework released last week is not, by design, a complete plan. Of course, that hasn't stopped think tanks and analysts from speculating about its fiscal and distributional impact. We've already seen groups attempting to reverse-engineer a completed tax plan from the framework, generally filling in blanks with their own ideas and assumptions, and reaching conclusions about a plan they've essentially written themselves. Generally speaking, it seems that the blank-filling exercise is designed to cast the framework in the worst possible light.

The framework does not include any specific information about things like the break points for the individual tax brackets, the value and indexing of the enhanced Child Tax Credit, or the precise rate for the top bracket. Without those and other key pieces of information, there is simply no way for any outside party to produce a credible analysis of the framework, let alone a detailed estimate of revenue and the distribution of tax burden.

But, that didn't stop a certain think tank from issuing a "preliminary analysis" of the framework at the end of last week, nor did it stop any of the framework's critics from citing that analysis as authoritative. It's odd, however, that the analysis came with a disclaimer that it was expressing only the views of the authors, not the think tank itself. Even more unusual, no specific authors were listed on the analysis, probably because no respectable academic or researcher was willing to have their name associated with something so haphazardly cobbled together.

But I digress.

As the framework makes clear, this committee will be responsible for writing the Senate tax reform bill and I'm going to work with members of the committee to make sure we are successful. For now, everyone should take every estimate or analysis about the plan from outside groups with an exceptionally large grain of salt.

Moving on, I also want to say that my preference has always been for this to be a bipartisan effort, and I think there are several elements in the framework where Democrats and Republicans can work together and hope we will be able to do so. The subject of today's hearing is a great example of an area where both parties are largely in agreement.

Under our current system, U.S. multinationals that accrue overseas earnings can defer U.S. tax on those earnings until they are brought back to the United States. In 1962, due to concerns that businesses were moving passive and highly mobile income-producing assets offshore, Congress enacted subpart F of the Internal Revenue Code. Under subpart F, income from these sources is immediately subject to U.S. tax, while taxes on active and less-mobile offshore income remain deferred until the earnings are repatriated.

This is a bit confusing in the abstract, so let me provide a hypothetical.

Imagine that an American Company—headquartered in the United States and subject to our corporate tax rates—opens a factory in Germany, incorporating a subsidiary there. The income generated by the subsidiary—legally a German company—will be subject to German taxes paid to German authorities.

So long as the American Company doesn't bring that income back to the United States, its income from the German subsidiary will not be subject to U.S. taxes. And, in fact, we are finding that many American companies have been keeping this type of income offshore in order to avoid our punitive corporate taxes.

Now, imagine if the American Company parked its money in stocks, bonds, or other passive investments and moved the income generated from those assets to an offshore, low-tax jurisdiction. Under subpart F, that type of passive and highly mobile income is immediately subject to U.S. tax, without any deferral.

Now, I know this is a bit arcane. And frankly, I'd be nodding off if I didn't know how this story ended.

As a result of subpart F, American companies have engaged in a number of sophisticated and complex tax planning schemes to keep earnings offshore to avoid the U.S. corporate tax.

According to the Joint Committee on Taxation, American companies are currently holding more than $2.6 trillion in earnings offshore, thanks, in large part, to our worldwide tax system—something often referred to as the "lock-out" effect.

That's $2.6 trillion held by foreign subsidiaries of U.S. corporations that the parent companies are unable to invest here at home. That is income that could be used to create more American jobs and grow wages for American workers. And, that income has attracted the interests of foreign tax authorities, particularly in Europe, who wish to tap into what is, by all rights, part of the U.S. tax base.

I know some of my colleagues have proposed to solve this problem of earnings being locked out of the United States by transitioning to a pure worldwide system with no deferral. And while that would rid us of the lock-out problem, it would significantly increase pressures for American multinationals to invert, or be acquired by foreign-based multinationals.

Many of us have talked at length about inversions in recent years and the problems they pose for our economy and our tax base. Perhaps even worse than an inversion is when a larger foreign corporation simply acquires a smaller American corporation. Either way, the result is the same—a foreign corporation becomes the parent of the restructured multinational group.

Companies take these routes for a number of reasons.

First, they want to escape the high corporate tax rate in the United States, which, as we heard in our last hearing, is the highest in the industrialized world.

Second, they want to minimize the damage caused by our worldwide tax system. If an American multinational can successfully move its tax situs out of the U.S., it will only owe taxes on the earnings accrued here. There is also the matter of earnings stripping, which is another complicated topic that I look forward to our witness panel discussing today.

All of these problems are key for today's hearing because they highlight the shortcomings of our outdated worldwide tax system.

The solution to these and other problems, to put it very simply, is to transition to a territorial-based system like virtually all of our foreign competitors. Under such a system, an American company would owe taxes only on income earned in the United States. Income earned in foreign jurisdictions would only be taxed by those jurisdictions, not here.

This type of reform would have to be accompanied by enforceable anti-base-erosion rules to make sure companies—both domestic and foreign—do not exploit loopholes in order to unduly avoid paying taxes here. That approach is endorsed in the united framework.

It was also suggested in the last Congress by our committee's bipartisan working group on international tax, which was co-chaired by Senator Portman and by current Senate Minority Leader Schumer. Other members of the committee have also made significant contributions in the area of international tax reform, including both Senator Wyden and Senator Enzi.

Finally, as many of you know, I've been interested for some time in the idea of better integrating our individual and corporate tax systems. I continue to believe that corporate integration, by means of a dividends paid deduction, can significantly help with some of our existing problems and I look forward to talking more about that today as well.

Once again, international tax reform is an area that is rife for bipartisanship, if we're willing to work together on goals that members from both parties share. I hope people will note that the international portion of the framework is particularly short on details. That's because these problems can't be solved in a nine-page framework document. That will require the work and effort of this committee.

PREPARED STATEMENT OF STEPHEN E. SHAY,* SENIOR LECTURER ON LAW, HARVARD LAW SCHOOL, HARVARD UNIVERSITY

Good morning, Chairman Hatch, Ranking Member Wyden, and members of the committee. My name is Stephen Shay. Thank you for the opportunity to testify before you today on international tax reform. It is a pleasure and honor to be with the committee once again. By way of background, I am a senior lecturer on law at Harvard Law School. I have served twice in the Treasury Department, the first time in the Reagan Administration [1] and the second time as Deputy Assistant Secretary for International Tax Affairs in the first term of the Obama administration, and practiced international tax law for over 2 decades as a partner at Ropes and Gray LLP in Boston.

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

EXECUTIVE SUMMARY

Objectives for Tax Reform

Tax reform should maintain or enhance our tax system's current level of progressivity in distributing tax burdens and benefits. The most significant social welfare fact today is that the income of middle- and lower-income workers has stagnated in recent decades and a disproportionate share of income growth has accrued to those with highest incomes—the top 1%. While we have recovered from the recession and middle- and lower-income workers have made some gains, the disparity between high-income and middle- and lower-income has grown substantially and income mobility is more constrained than for prior generations.[2] The taxation of cross-border income of U.S. MNCs should be analyzed under the same fairness standards that apply to any other income.[3] In particular, as I discuss later in this testimony, a reduced "holiday" tax rate on U.S. MNCs' pre-effective date offshore earnings will overwhelmingly benefit high-income Americans (and foreigners) and is not justified

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

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

[2] Professor Lily Batchelder's September 13, 2017 testimony before this committee provides an excellent summary of the relevant data and references to literature. Lily L. Batchelder, Professor of Law, New York University, "Opportunities and Risks in Individual Tax Reform," testimony before the Senate Committee on Finance, hearing on "Individual Tax Reform" (Sept. 13, 2017).

[3] *See* J. Clifton Fleming, Jr., Robert J. Peroni, and Stephen E. Shay, "Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income," 5 *Florida Tax Review* 299 (2001).

on any policy ground.[4] Its sole purpose is to provide a one-time source of revenue that disguises the future revenue loss from shifting to a weak territorial system.

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

Objectives for International Tax Reform

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

International tax reform should assure that the tax rules for foreign multinational companies on U.S. business activity do not provide them an advantage in relation to U.S. companies. Tax reform should undertake a fundamental review of U.S. source taxation of cross-border activity having a U.S. destination including remote digital sales into the United States. In addition, tax reform should strengthen U.S. corporate residence and earnings stripping rules.

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

BACKGROUND TO TAX REFORM

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

In the face of the pressing needs for public investment in human capital and infrastructure, and demographic trends that cannot be reversed, we will be forced to spend more in the future. It would be foolhardy to adopt a revenue-losing tax reform, particularly one that would benefit those with high incomes, in the unsupported hope, based on tooth fairy economics, that short-term growth will outweigh longer term effects on interest rates and inflation.[6] When spending exceeds reve-

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

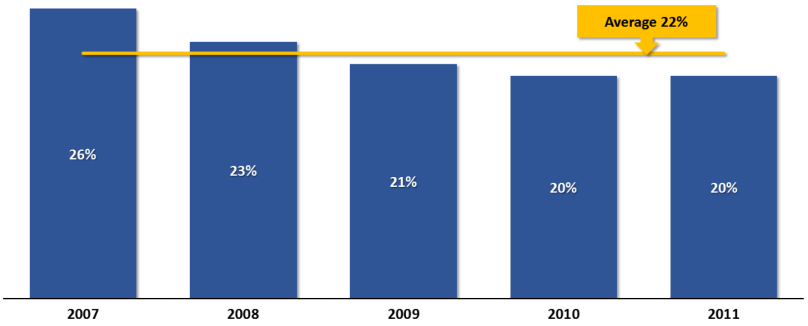
[5] U.S. Treasury, Office of Tax Analysis, "Average Effective Federal Corporate Tax Rates," Table 1 (April 1, 2016).

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

nues, the debt issued to pay the difference simply represents future taxes. What is needed is to re-build the income tax base so that it can raise revenues necessary to fund expenditures while honoring ability to pay principles. If the income tax base proves over time to be unable to support U.S. needs, then it would be necessary to employ additional revenue instruments.

U.S. companies are not over-taxed, domestically or abroad. The U.S. Treasury estimated the average effective "actual" tax rate on U.S. companies, *excluding foreign subsidiaries,* for 2007 to 2011 to be 22%. The Treasury's measure of the average effective "actual" tax rate is corporate-level tax actually remitted (after credits for foreign taxes paid on foreign income earned directly and credits for foreign taxes deemed paid on actual foreign dividends) as shown on tax filings divided by book or financial statement income (rather than taxable income). The average rate of tax is appropriate for measuring cash flows (used in valuations) and distributional burdens.[7] It also is the most appropriate measure for evaluating whether to make a new direct investment in one country or another country—a discrete choice between two mutually exclusive locations.[8]

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



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

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

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

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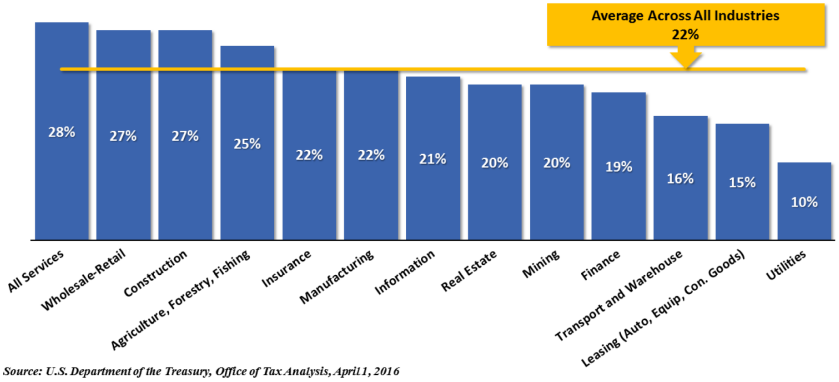
[7] U.S. Department of the Treasury, Office of Tax Analysis, "The Case for Responsible Business Tax Reform," 21 (Jan. 2017) (hereinafter, Treasury, "Responsible Business Tax Reform"); Don Fullerton, "Which Effective Tax Rate?", 37 *National Tax Journal* 23, 30 (1984).

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

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

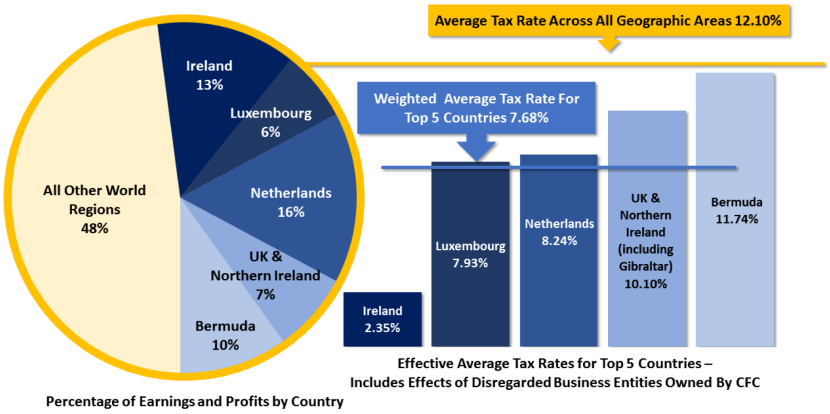
Average Effective "Actual" Federal Corporate Tax Rate (ATR)
U.S. Corporations with Positive Income and > $10M Assets –
By Industry Average 2007-2011



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

But what about foreign subsidiaries of U.S. companies? Are they unable to compete in the countries in which they operate? The preceding corporate average actual effective tax rates *do not* reflect the *even lower* average effective *foreign* tax rates that controlled foreign corporation (CFC) subsidiaries of U.S. MNCs pay on their foreign income. In 2012, the most recent year for which IRS CFC data is publicly available, *52%* of all U.S. CFCs' earnings and profits before tax was generated by companies in five tax haven or low-tax countries.[10] Moreover, the ratio of these CFCs' foreign taxes paid (as reflected on IRS tax filings) to earnings and profits before taxes (under U.S. tax principles) was 12.10% in 2012.[11]

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



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

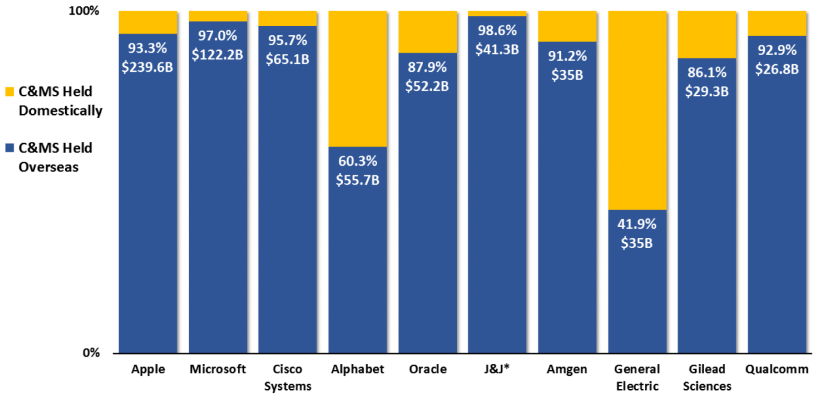
The CFC data undercut the claim that U.S. MNCs' foreign subsidiaries are overtaxed on their foreign income. The low effective tax rates on the earnings of foreign subsidiaries contradicts the claim that the subsidiaries cannot compete globally because of taxes.

The very low average taxes paid on foreign subsidiary income are a major factor for retaining the low-taxed earnings to maximize after-tax profits reported on finan-

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

cial statements by relying on the claim to auditors that these amounts are "indefinitely reinvested" in investments that do not trigger deemed repatriation under U.S. tax rules.[12] This position is maintained even though large amounts (approximately 40%) of these retained earnings are held offshore in U.S. dollar cash or marketable securities.[13] Bloomberg assembled these amounts for public companies with the 50 largest reported cash holdings.[14] The amounts and ratios of offshore to total cash for the 10 companies with the highest cash holdings (totaling *US$702 billion* for these companies alone) are shown in the next chart.

Largest Holdings of "Overseas" Cash and Marketable Securities



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

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

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

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

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

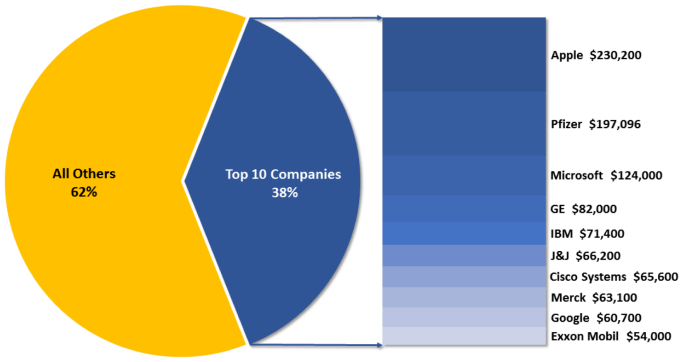
[13] *The Financial Times* has run a series of articles examining the investment strategies employed with respect to these cash and securities holdings and implications for financial markets. *See, e.g.,* Eric Platt, "Corporate America's patchy disclosure on cash piles raises risks," *Financial Times*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

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

[15] Treasury, "Responsible Business Tax Reform," *supra* note 7, at 38.

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

38% held by 10 Companies (US $ Millions)



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

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

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

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

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

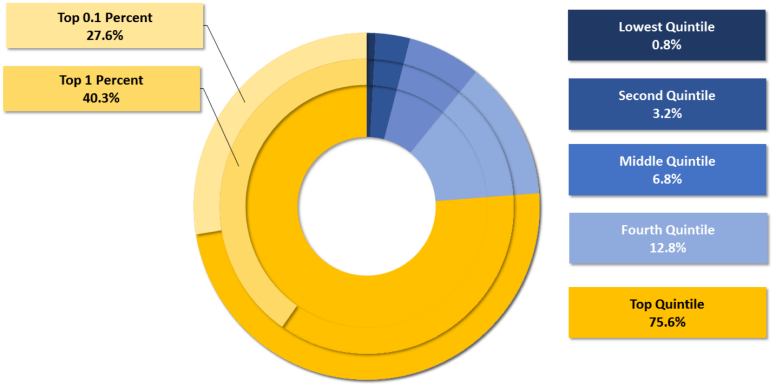
[17] *See* Steven M. Rosenthal, "A Tax Break on Repatriated Earnings Will Not Trickle Down to U.S. Workers," *TaxVox: Individual Taxes* (Sept. 25, 2017), available at *http://www.taxpolicycenter.org/taxvox/tax-break-repatriated-earnings-will-not-trickle-down-us-workers* (last viewed Sept. 27, 2017).

[18] Donald B. Marron, institute fellow, Urban Institute and Urban-Brookings Tax Policy Center, testimony before the Senate Committee on Finance, hearing on "Business Tax Reform" 3 (Sept. 19, 2017).

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

[20] Tax Policy Center, "Share of Change to Corporate Income Tax Burden by Expanded Cash Income Percentile," T17–0180 preliminary results (June 6, 2017), available at *http://www.*

Distribution of Offshore Earnings Amnesty Tax Rate Benefit



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

DIRECTIONS FOR TAX REFORM

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

Improve Taxation of Foreign Business Income

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

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

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taxpolicycenter.org/model-estimates/distribution-change-corporate-tax-burden-june-2017/t17-0180-share-change-corporate, last viewed Sept. 27, 2017.

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

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

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

1. To avoid gaming, a U.S. territorial system should apply to both foreign branch income and dividends received from foreign subsidiaries.
2. There should be no deferral; the minimum tax should apply to the foreign-source income of U.S. MNCs as the income is earned either directly or by foreign affiliates.
3. The minimum tax should be a relatively high percentage of the regular U.S. tax rate (no less than 60% and preferably 80%).[25] The minimum tax should be applied on a *country-by-country* and *not a global* basis as is suggested in the GOP framework. Allowing blending of high and low foreign taxes will in some cases incentivize high-taxed foreign investments and shifting of U.S. income to be low-taxed foreign income in other cases.
4. A foreign tax credit should be allowed against the minimum tax but only in the ratio that the U.S. minimum tax rate bears to the regular U.S. corporate tax rate.[26] Only the pro-rated amount of foreign taxes allocable to minimum taxed income on a country-by-country basis should be creditable against the U.S. tax on that income. Cross-crediting should be severely limited or there again will be incentives to mix and match investment by the level of tax on the return from the investment.
5. A U.S. territorial system should exempt only dividends paid out of foreign-source *active* business income that has borne a meaningful tax and only foreign-source branch income that has the same characteristic. No sound policy objective is achieved by going further and exempting other income. An exemption should *not* apply to foreign-source income that was treated as a deductible payment in the foreign country—royalties, rents, and interest should be fully taxed and only withholding taxes on that income allowed as a credit against the U.S. tax on that income. Consistent with practice in other developed countries, current taxation of passive income (under subpart F) should be retained so that the exemption does not encourage tax avoidance on passive income.[27]
6. Corporate overhead, interest, and research and development deductions should be properly and fully allocated to exempt income and disallowed. Limiting the exemption to 95% (or some other percentage) of otherwise qualifying income as a substitute for properly allocating deductions between exempt income and non-exempt income inappropriately expands the exemption subsidy to domestic income. Foreign losses should be prorated between exempt foreign income and taxable income. The portion allocable to exempt foreign income should be disallowed; only losses allocable to taxable income should be deductible.

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

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

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

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

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

[27] With respect to private equity and other investment funds, subpart F should be modified so that it applies at the level of the fund (whether the fund is a domestic or a foreign partnership) and U.S. investors can no longer escape current taxation of subpart F income by being less than 10 percent owners of the fund.

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

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

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

Strengthen U.S. Corporate Residence Rules

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

Strengthen U.S. Source Taxation Rules

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

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

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[28] *See* J. Clifton Fleming, Jr., Robert J. Peroni, and Stephen E. Shay, "Getting Serious About Cross-Border Earnings Stripping: Establishing an Analytical Framework," 93 *North Carolina Law Review* 673 (2015).

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

CONCLUSION

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

There is no normative reason to privilege foreign business income beyond allowing a credit for foreign income taxes. My recommendation is to tax foreign business income broadly and allow a credit for foreign income taxes. I encourage you not to gamble with a territorial system with weak protections and not to give away tax benefits to the undeserving rich and foreigners. If any group of taxpayers does not bear its share of tax, others must make up the difference sooner or, if the deficit is debt-financed, later. Neither the tooth fairy nor dynamic scoring will alter this fundamental reality.

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

PREPARED STATEMENT OF BRET WELLS, PROFESSOR OF LAW AND GEORGE R. BUTLER RESEARCH PROFESSOR OF LAW, LAW CENTER, UNIVERSITY OF HOUSTON

My name is Bret Wells, and I am the George R. Butler professor of law at the University of Houston Law Center. I would like to thank Chairman Hatch, Ranking Member Wyden, and the other members of the committee for inviting me to testify. I am testifying in my individual capacity, and so my testimony does not necessarily represent the views of the University of Houston Law Center or the University of Houston. I request that my full written testimony be included in the record.

Before addressing international taxation, I want to make a preliminary statement about the related topic of business tax reform. As to business tax reform, Chairman Hatch is to be commended for his work on corporate integration as part of tax reform—specifically, his partial dividends paid deduction proposal. A partial dividends paid deduction regime provides a corporate tax deduction that can approximate the stock ownership held by U.S. taxable investors.[1] The existing scholarship makes a compelling case that significant efficiencies can be achieved through corporate integration.[2] By limiting the dividend deductibility to the amount of equity held by U.S. taxable shareholders, the partial dividends paid deduction regime preserves corporate level taxation for earnings in an amount broadly equal to the equity ownership of nontaxable shareholders. A partial dividends paid deduction regime narrows the distinction between the tax treatment of debt and equity. A partial dividends paid deduction regime, in combination with a dividends and capital gains preference, in tandem can result in a combined tax rate on corporate business profits that approximates the individual tax rate, thus eliminating the disparity in tax rates between C corporations and pass-through entities. Thus, a partial dividends paid deduction regime is a critical step in the right direction and should be part of the final business tax reform legislation.

Now, I want to address outbound international taxation. This committee is well aware that our major trading partners have all opted for some variant of a territorial tax regime and that the divergent approach taken by the United States poses competitiveness concerns.[3] This reality creates an urgent need for this Congress to

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

[2] *See, e.g.,* Michael J. Graetz and Alvin C. Warren, "Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and the American Law Institute Reports" (1998); *see also* staff of the Joint Committee on Taxation, "Overview of Approaches to Corporate Integration," JCX–44–66 (May 13, 2016); Republican staff of the Senate Finance Committee, "Comprehensive Tax Reform for 2015 and Beyond" at 122–237, 113th Congress, S. Prt. No. 113–31 (Dec. 2014).

[3] *See* Republican staff of the Senate Finance Committee, "Comprehensive Tax Reform for 2015 and Beyond" at 249–293, 113th Congress, S. Prt. No. 113–31 (Dec. 2014); *see also* staff of the Joint Committee on Taxation, "Background and Selected Issues Related to the U.S. International Tax System and Systems That Exempt Foreign Business Income," JCX–33–11 (2011) (analyzing nine major trading partners of the United States that provide for an exemption system); staff of the Joint Committee on Taxation, "Present Law and Issues in U.S. Cross-Border Income," JCX–42–11 (2011) (reviewing policy considerations between a territorial and worldwide tax system).

consider how to structure a territorial tax regime that provides parity with the tax systems of our major trading partners but at the same time protects the U.S. tax base from inappropriate profit shifting strategies. Under current law, the U.S. subpart F regime provides a fairly narrow set of exceptions to the deferral privilege, and these anti-deferral provisions serve as an important backstop to prevent tax avoidance of U.S. origin profits by U.S.-based multinational enterprises. Another means to address the tax avoidance concerns that underlie the U.S. subpart F regime would be to adopt greater source taxation measures to protect the U.S. tax base. Relying on a source taxation solution to address the profit shifting problem is consistent with a territorial tax regime and has the favorable benefit of implementing base protection measures that apply across-the-board to both U.S.-based multinational enterprises and foreign-based multinational enterprises. In contrast, solutions that rely on residency taxation principles (such as the U.S. subpart F regime) only protects against the profit shifting strategies of U.S.-based multinational enterprises. Thus, I favor source taxation measures over an expanded subpart F regime exactly because subpart F measures create divergent and discriminatory tax results for U.S.-based multinational enterprises and leaves in place the inbound earning stripping advantages for foreign-based multinational enterprises. Thus, for competitiveness reasons, this Congress must consider a territorial tax regime, and as part of that consideration Congress must utilize tax base protection measures that are even-handed.[4] Expanding residency-based solutions via an expansion of the U.S. Subpart F regime creates artificial winners and losers based on the ultimate place of residence of the global parent company. The United States needs an international tax system that protects U.S. taxation over U.S. origin profits and is consistent with the tax regimes of our major trading partners.

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

1. EARNING STRIPPING IS MULTIFACETED AND REQUIRES A COMPREHENSIVE SOLUTION

For corporate tax reform to be sustainable in a global environment, the United States tax system must be designed to ensure that business profits earned within the United States are subject to U.S. taxation regardless of where a multinational corporation is incorporated. Today's tax system does not achieve this objective, and its failure to do so creates earning stripping opportunities for foreign-based multinational enterprises that allow them to achieve a lower tax burden with respect to their U.S. operations than can be achieved by U.S.-based multinational enterprises conducting those same operations.[5] Thus, U.S.-based multinational enterprises are competitively disadvantaged by our own tax system.

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

[4] For a more detailed analysis of my views on a territorial tax regime and the earning stripping issues inherent in such a regime, *see* Bret Wells, "Territorial Taxation: Homeless Income is the Achilles Heel," 12 *Houston Business and Tax Law Journal* 1 (2012).

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

[6] By Homeless Income, I mean to refer to that category of a multinational corporation's consolidated income that has been removed from the tax base of the country of origin via a related-party tax deductible payment and relocated to an offshore affiliate's country of residence that chooses not to tax this extra-territorial income or provides concessionary taxation to this category of income. Thus, the income is "homeless" in the sense that it lost its tax home in the country of source. The origins of the homeless income mistake is dealt with extensively in my

Continued

of the U.S. affiliate: (1) related party Interest Stripping Transactions; (2) related party Royalty Stripping Transactions;[7] (3) related party Lease Stripping Transactions; (4) Supply Chain restructuring exercises; and (5) related party Service Stripping Transactions.

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

2. CORPORATE INVERSIONS ARE NOT A STAND-ALONE PROBLEM BUT MERELY THE ALTER EGO OF THE INBOUND EARNING STRIPPING PROBLEM

Corporate inversions are a telltale symptom of the larger inbound earning stripping cancer. Thus, corporate inversions cannot be handled as a stand-alone problem. Again, my first key point bears repeating: the current tax system provides significant earning stripping advantages that afford a better tax result for the U.S. activities of foreign-based multinational enterprises than exist for U.S.-based multinational enterprises that conduct similar U.S. activities.[8] This reality causes U.S.-based multinational enterprises to want to become foreign-based multinational enterprises, or in other words to enter into a corporate inversion transaction so that the post-inversion company can avail itself of the same earning stripping opportunities as its foreign-based competitors without the impediment of the U.S. subpart F regime.

This is the point to be learned from the corporate inversion phenomenon:[9] corporate inversions are an effort by U.S.-based multinational enterprises to become foreign-based enterprises exactly because the inbound earning stripping advantages available to foreign-based multinational enterprises are coveted by U.S.-based companies.[10] Thus, instead of attacking the corporate inversion messenger in isolation, Congress should focus its attention on the inversion message, namely that the earning stripping techniques available to foreign-based multinational enterprises, if left unchecked, create an unlevel playing field that motivates U.S.-based multinational corporations to find pathways to successfully engage in corporate inversions. Said differently, corporate inversions tell Congress that it must solve the inbound earn-

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earlier writings in Bret Wells and Cym Lowell, "Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin," 65 *Tax Law Review* 535 (2012); Bret Wells and Cym Lowell, "Income Tax Treaty Policy in the 21st Century: Residence vs. Source," 5 *Columbia Tax Journal* 1 (2013).

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

[8] The U.S. subpart F rules serve as a backstop to prevent a U.S.-based multinational enterprise from stripping U.S. source profits via inbound Interest Stripping, Royalty Stripping, and Lease Stripping transactions. For a more detailed analysis of my views on how the U.S. subpart F regime serves as a backstop to prevent U.S.-based multinational enterprises from benefitting from these earnings stripping techniques and how this subpart F backstop regime does not apply to foreign-based multinational enterprises, *see* Bret Wells and Cym Lowell, "Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin," 65 *Tax Law Review* 535 (2012); *see also* Bret Wells, "Territorial Taxation: Homeless Income is the Achilles Heel," 12 *Houston Business and Tax Law Journal* 1 (2012).

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

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

ing stripping problem on a holistic basis if it wants to eliminate the tax incentives for these transactions. Corporate inversions are simply the alter ego of the inbound earning stripping problem and should not be viewed as a separate policy problem.

3. A BASE PROTECTING SURTAX SHOULD BE PART OF INBOUND INTERNATIONAL TAX REFORM

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

If appropriately designed, a base protecting surtax would be applied on the payer in each of the five types of earning stripping transactions. As such, it is not a withholding tax on the payee. The base protecting surtax collects a surtax upfront on the payer's share (not the payee's share) of the residual profits that are earned by the multinational enterprises from within the United States and remitted as a tax deductible payment to a jurisdiction outside of the U.S. tax base. Thus, the surtax protects the U.S. tax base from being reduced by reason of earning stripping transactions and as such would provide tax revenue for tax reform. Moreover, by eliminating the tax benefits associated with earning stripping transactions, Congress will eliminate the fuel that drives the corporate inversion phenomenon. And finally, a comprehensively applied base protecting surtax levels the playing field between U.S.-based multinational enterprises and foreign-based multinational enterprises.

CONCLUSION

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

APPENDIX A

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

1. *Base Protecting Surtax on Base Erosion Payments.* A related-party U.S. payer of a base erosion payment would be subjected to a Base Protecting Surtax on the earnings that are transferred to a foreign affiliate in an amount equal to the amount that would have been collected had those earnings instead been distributed as a partially deductible dividend. The purpose of the Base Protecting Surtax is to collect, as a surtax, a tax calculated on the gross amount

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

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

of the earning stripping payment so that an equivalent tax is collected for what would have been due if the base erosion payment instead had been remitted as a tax deductible dividend to the foreign affiliate. The rebuttable presumption is that the base erosion payment represents, in its entirety, a transfer of residual profits.

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

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

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

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

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

PREPARED STATEMENT OF HON. RON WYDEN,
A U.S. SENATOR FROM OREGON

The Trump team says their international tax framework is about creating jobs and firing up the country's economic engine, but the details show that's just part of the con job being pulled on the middle class. Behind the scenes, the administration recently scrubbed from the Treasury website a 2012 paper showing that workers do not primarily benefit from a corporate rate cut—that trickle down economics are a fantasy. Apparently that mainstream economic analysis had to be purged since it didn't jibe with the Trump Team's patter.

They claimed the study was out of date, but they didn't find reason to take down any of the other papers that date back as far as the 1970s. This sure makes it look like the Trump team is afraid of a well-informed public. And the con job isn't just about hiding inconvenient facts. The administration is currently working to pick apart the rules that were designed to combat the inversion virus and the decimation of our tax base.

People at town halls tell me they want tough policies in place to stop companies from shipping jobs overseas. Especially in towns where mills and factories are shuttered and Main Street is vacant, Americans are desperate for more red, white, and blue jobs with good wages. And they want corporations to pay their fair share. What's on offer in the Trump plan is likely to disappoint.

The Republican tax framework okayed the entire corporate wish list. A massive rate cut. A pure territorial system. But there was barely a nod to tough rules to prevent companies from sending jobs abroad or running away to set up HQ on some zero-tax island. Base erosion, a minimum tax—these vital parts of the international tax debate appear to be an afterthought. This is an invitation for corporations to game the system, and the tax lobby must be licking its chops.

Bottom line, the President is giving multinationals a green light to pay no taxes. Then for the benefit of people reading the news, there's a lot of happy talk about jobs, economic growth, and the biggest tax cut ever.

It's not hard to predict what will happen if this multi-trillion dollar tax giveaway to the wealthy and corporations is enacted, our tax base continues to erode, and the deficit skyrockets. Lawmakers will come after Social Security, Medicare and Medicaid yet again. And this isn't without precedent—privatizing Social Security was the first priority of the Bush administration's second term after its big, unpaid-for tax cuts. Let's remember that every percentage point decrease in the corporate tax rate results in a loss of $100 billion in revenue. Perhaps that's the kind of issue that caused Senator Corker to say that he's got big concerns over the deficit.

Democrats have reached out to the majority with our principles for tax reform. There are a lot of members on this side with big ideas of how to help the middle class, create jobs, and bring some fairness to the tax code through bipartisan reform. That's the kind of reform that Ronald Reagan signed into law back in 1986, but the framework that was released last week is nowhere near what Reagan accomplished. And it's nowhere near the reforms built on fairness and fiscal responsibility that my colleagues Dan Coats, Judd Gregg, and I worked to write into our bipartisan plans more recently.

As I wrap up, international taxation is going to be a key part of the tax reform debate, and it involves a lot of extraordinarily complex questions. The committee has an excellent panel of witnesses here today who can address international tax much more thoughtfully than the Trump framework does. So I look forward to the discussion.

COMMUNICATIONS

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The American Council of Life Insurers (ACLI) is pleased to submit this statement for the record for the October 3, 2017 Senate Finance Committee hearing regarding international tax reform. We thank Chairman Hatch and Ranking Member Wyden for holding this hearing.

The American Council of Life Insurers (ACLI) is a Washington, DC-based trade association with approximately 290 member companies operating in the United States and abroad. ACLI advocates in state, federal, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers' products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing 95 percent of industry assets in the United States.

As the Committee considers updating the United States' international tax system in order to make our nation more competitive in the global economy and preserve our tax base, there are industry-specific matters to consider for life insurance companies with global interests that relate directly to our growth and competitiveness overseas. Our hope is that international tax reform reflects policies that treat our active business income on par with the income of non-financial services companies, though such income would likely be treated as "passive income" if earned by a non-financial services company. Our bricks and mortar and working capital "assets" are unique to this industry, thus meriting attentive consideration.

Locally Regulated Business With Existing Robust Anti-Base Erosion Rules

U.S.-based global life insurance companies operate where our customers are. U.S.-based global life insurance companies are highly regulated in the countries in which we do business and by federal and state regulators in the United States, and our local investments are heavily regulated and used to support our long-term product guarantees. The industry has long been subject to robust anti-base erosion rules—the active financing exceptions to Subpart F, or "AFE" rules. These rules apply at the entity level to ensure that each company is a properly regulated insurance company and that a substantial portion of our business is with local customers. The rules also apply similarly to test that our investments and related income are qualifying insurance investments and income. For the most part, these rules have reflected the way we do business.

As the committee contemplates shifting from our current complex international tax rules to a territorial system, the industry applauds the stated goals of lower corporate tax rates, the ability to be more competitive globally and, of course, future tax structure simplicity. Additionally, we ask that several sector-specific issues be considered.

Transition Tax Should Apply Lower Rate to Reserves Required to Stay Local

First, under the recently released "United Framework For Fixing Our Broken Tax Code" (9/27/17) (the "Tax Framework proposal"), the transition to a new territorial tax system includes a one-time deemed repatriation tax with bifurcated taxes for foreign earnings held in illiquid versus cash or cash equivalent foreign earnings. Earnings and profits ("E&P") invested in cash deposits and marketable investment assets of insurance companies that support their regulatory required reserves are,

as a practical matter, invested in assets that are similarly illiquid. The transition tax should be so applied and a practical method for doing so can be found under the current AFE rules.

Transition Tax Should Apply on One-CFC Basis

Second, the amount of E&P and foreign tax credits subject to the deemed repatriation tax should be calculated on a "one-CFC basis," so that all of the foreign entities owned by members of a U.S. group are treated as a single foreign corporation. Under such a proposal, the aggregate amount of foreign earnings subject to the tax would be reduced by any earnings deficits. In addition, the pool of foreign taxes deemed to have been paid in respect of those earnings would reflect all taxes paid by companies whose earnings deficits were taken into account in determining the amount deemed to have been repatriated.

Pro-Competitive Reforms to Active Finance Rules Advisable

Third, as noted previously, the current international tax system applies the anti-base erosion Subpart F AFE rules to insurance companies. To the extent this set of rules remains intact in a new territorial system, three improvements should be considered. First, the AFE rules should be reformed to allow related-party reinsurance premiums to qualify as exempt from Subpart F as long as the related insurance company paying the reinsurance premium qualified under the AFE rules, and the insurance contract being reinsured was treated as qualifying and thus an exempt contract under the AFE. This would correct the current fact that U.S. tax law discourages the ability of U.S.-based global insurance companies to pool and diversify risks of their foreign affiliates by reinsuring risks to affiliated companies, which restriction runs counter to international norms, sound business practice, the way in which our global competitors operate their global insurance businesses and the expectation of regulators.

The second AFE-specific proposal is that the rules for calculating reserves of qualifying foreign insurance companies should be modernized and simplified. Under the AFE rules, foreign subsidiaries of U.S. life insurance companies must use U.S. tax principles to calculate reserves for purposes of determining the amount of investment income that qualifies under the AFE, rather than using the actual amount of local country reserves. This recalculation requirement was originally designed as an anti-abuse rule, but this requirement is too restrictive and overly complex, failing to take account of the capital requirements that insurance companies must satisfy in order to operate a business competitively in a local jurisdiction. Congress should further encourage the IRS to provide more generally applicable guidance that would apply on a country-by-country basis to allow local country reserves or capital requirements to be utilized for purposes of calculating the investment income that would be exempt from Subpart F.

Minimum Tax Application

We understand the need for anti-base erosion measures as part of a reformed international tax system. As the AFE rules serve that purpose for our industry, it would be unnecessary and overly complicated to apply another layer of restrictive rules to income that is already qualifying under the AFE, such as a minimum tax. If a minimum tax were to apply to our industry, such a tax would create tremendous anomalies unless it was computed on a global basis, as is suggested by the Tax Framework proposal, rather than on a CFC-by-CFC basis.

The American Council of Life Insurers appreciates the opportunity to file this statement for the record, along with an attached, more detailed, description of the issues outlined here. The life insurance industry stands ready to work with you in the interest of international tax reform whose goals—producing economic growth and ensuring competitiveness—are worthy.

INTERNATIONAL TAX REFORM PRIORITIES FOR U.S.-BASED GLOBAL LIFE INSURANCE COMPANIES

October 3, 2017

The following proposals reflect the fact that U.S.-based global life insurance companies operate through local companies where our customers are, that we are highly regulated in the countries in which we do business and by federal and state regulators in the United States, and that our local investment income is heavily regulated and used to support our long-term product promises, or "guarantees."

In addition, it is important to note the industry is already subject to robust anti-base erosion rules—the active financing exceptions to Subpart F, or AFE rules—that have existed in their current form since 1998, and that are now permanent. These rules apply at the entity level to ensure that each company is a properly regulated insurance company and that a substantial portion of our business is with local customers. The rules also apply similarly to test our income as qualifying insurance income. For the most part, these rules reflect the way we do business. However, one proposed exception is described below, and relates to our ability to reinsure and get coordinated capital and investment efficiencies for our local country businesses.

As tax reform turns to the priorities of anti-base erosion, growth and global competitiveness, our priorities reflect a desire to make the technical rules workable and fair for our industry. The following recommendations reflect policies that treat our active business income on par with the income of non-financial services companies, though such income would likely be treated as passive income if earned by a non-financial services company.

a. Application of lower split-rate transition tax to insurance company earnings that can't be repatriated

The Unified Framework for Fixing Our Broken Tax Code (the "Framework") released by President Trump and Congressional Republican leaders on September 17, 2017, recommends that Congress include a territorial tax system as part of a comprehensive tax reform bill. The Framework proposes a transition rule from the current worldwide system that would treat foreign earnings accumulated under the existing system as being repatriated, and that foreign earnings held in "illiquid assets" would be taxed at a lower rate than earnings held as cash or cash equivalents. Under the Tax Reform Act of 2014 (H.R. 1) introduced by House Ways and Means Committee Chairman Dave Camp (R–MI), accumulated post-1986[1] undistributed earnings and profits (E&P) of CFCs would be subject to a similar one-time transitional tax. The tax rate would be 8.75% for E&P held in cash or cash equivalents, and 3.5% for the remainder. The purpose of the lower rate for non-cash and cash equivalents is to "moderate the tax burden on illiquid accumulated E&P that has been reinvested in the foreign subsidiary's business," according to the section-by-section summary of the bill provided by committee staff. The House Republican Blueprint included a similar proposal. While E&P invested in cash deposits and marketable investment assets of insurance companies that support their regulatory required reserves is, as a practical matter, invested in assets that are similarly illiquid, the bill did not apply the lower rate to such E&P. We believe it should apply to such cash and investments that support regulatory required insurance reserves. A practical method for doing so can be found under the AFE rules.

Proposal: A method to identify these earnings for insurance groups can be found within the AFE rules that exempt certain insurance income from inclusion under the subpart F rules. Specifically, an insurance company's non-cash items could be defined in H.R. 1's section 965(c)(2)(B) by limiting the "liquid item" to the extent that the insurance company has cash and investments in excess of the amount of reserves determined in section 954(i) with modifications. Thus, the amount that would be subject to the higher split-rate is an amount in excess of 110% of reserves for a life insurance company, which is as defined in sections 954(i)(2)(A) and 954(i)(2)(B)(i) and (ii).

The term "qualified insurance company" would be made by reference to section 953(e)(3) without regard to section 953(e)(3)(B) (imposing a 50% limitation focused on home country risk) and the term "exempt contract" would be made by reference to section 953(e)(2) without regard to section 953(e)(2)(B) (imposing a 30% limitation focused on home country income).

While the higher split-rate might apply to the amount of a CFC's E&P held in cash or cash equivalents, that amount, in the case of a regulated insurance company, should exclude an amount attributable to assets that are necessary for any regulated insurance company to support its insurance obligations. Such an amount, like a manufacturer's plant and equipment, is recognized as being required to operate

[1] The Camp proposal literally referred to E&P earned after December 31, 1986 as being subject to the one-time transitional tax. Post-1986 undistributed earnings as defined in section 902(c)(3) only includes earnings in the first taxable year that a foreign corporation has a 10 percent U.S. shareholder. The one-time tax should only apply to post-1986 undistributed earnings. The U.S. shareholder paid for the E&P earned prior to a U.S. shareholder owning the foreign company, which should not be subject to the one-time tax.

the local business and regulatory restrictions govern when a distribution of such amount is permissible.

By removing the home country limitations of section 953(e), section 965 is able to focus on the amount of cash and cash-like items that insurance companies must maintain to satisfy their regulatory capital reserves and risk profiles. These home country limitations are important for determining whether an insurance company's income should be excluded from subpart F income because the income is active and maintained in the local home country, but section 965 has a different focus. Section 965 seeks to determine, in part, the amount of aggregate earnings that are not freely distributable (and thus illiquid) so that an appropriate lower split-rate can apply to those illiquid earnings. Maintaining these home country limitations in section 965 would exclude earnings of insurance companies that are not freely distributable because of local regulatory requirements.

Revisions to H.R. 1's language under section 965(c)(2)(B) for determining the cash portion have been provided to Senate Finance Committee staff.

b. Netting entities with positive and negative E&P pools as part of the transition to a new territorial tax system

Since foreign insurance companies are per se corporations for U.S. tax purposes, and are subject to local regulatory requirements, we cannot avail ourselves of the ability to create larger or combined entities via check the box elections, and we face regulatory restrictions on whether and how we can organize or restructure our regulated entities to similarly combine companies having positive accumulated E&P with others having E&P deficits. This is important for purposes of the transition tax on previously untaxed foreign earnings.

The Camp bill appropriately allowed for the netting of positive and negative earnings so that the one-time tax is applied to net E&P. In so doing, however, the Camp bill effectively put a limit on the amount of foreign tax credits that could be utilized as part of this process, potentially imposing double tax on some of the earnings subject to the transition tax simply because positive and negative E&P pools are allowed to be netted. Groups with no foreign subsidiaries having negative E&P would not face this haircut on their foreign tax credits, and those that are able to combine foreign CFCs through self-help would also not be subject to the haircut. In addition, the Camp bill failed to take account of so-called trapped foreign tax credits relating to CFCs that paid foreign taxes in years when they had positive earnings but happen to have a negative E&P pool at the time of the effective date of the transition tax. These trapped credits should also be allowed to be utilized; otherwise, they would never be allowed to be utilized going forward in the new territorial system.

Another oversight in the Camp bill is that the netting of positive and negative E&P was at the first-tier U.S. parent level and not at the consolidated U.S. parent level. Therefore, a U.S. consolidated group with two U.S. subsidiaries that have CFCs cannot net the E&P of all CFCs. The insurance industry is subject to foreign regulations that restrict the ability of the U.S. group to own all CFCs by the same U.S. entity.

Proposal: The amount of E&P and foreign tax credits subject to the deemed repatriation tax should be calculated on a "one-CFC basis," so that all of the foreign entities owned by members of a U.S. group are treated as a single foreign corporation. Under such a proposal, the aggregate amount of foreign earnings subject to the tax would be reduced by any earnings deficits. In addition, the pool of foreign taxes deemed to have been paid in respect of those earnings would be all taxes paid by companies whose earnings deficits were taken into account in determining the amount deemed to have been repatriated.

c. The AFE rules should be reformed to allow related-party reinsurance premiums to qualify

An insurer's business is to accept others' risks and manage, under the supervision of regulators, the cost of maintaining sufficient capital to bear those risks. Insurers manage exposure to these risks by pooling and diversifying risks (often through reinsurance), and by aligning investment strategies with potential insurance liabilities. While reinsurance is a key function for an insurance company, U.S. tax law discourages the ability of U.S.-based global insurance companies to pool and diversify risks of their foreign affiliates by reinsuring risks to affiliated companies. It does so by treating premiums paid between affiliates in order to reinsure contracts as premium income that is taxed currently by the United States; the income is not eligible for deferral under the AFE rules. This restriction runs counter to inter-

national norms, sound business practice, the way in which our global competitors operate their global insurance businesses and the expectation of regulators. Pooling risk allows an insurance company to hold less capital as a result of the diversification of risk and manage investments in a more efficient manner.

Proposal: As part of the reform of the U.S. international tax rules, this restriction in the AFE rules should be fixed. Specifically, reinsurance premiums should be exempt from Subpart F as long as the reinsurer is a regulated insurance company, the related insurance company paying the reinsurance premium qualified under the AFE rules, and the insurance contract being reinsured was treated as qualifying and thus an exempt contract under the AFE. By limiting this rule to exempt contracts, the reinsurance of U.S. risks will continue to be subject to Subpart F. The Framework includes rules to protect the U.S. tax base by including a minimum tax on the foreign profits of U.S. multinational companies. To the extent the change in the AFE rules that we are suggesting in regards to related party reinsurance transactions outside the United States, it may be appropriate to apply such a minimum tax to premium income related to reinsurance that qualifies for this modified AFE treatment.

d. Modernize and simplify rules for calculating reserves of qualifying foreign insurance companies

Under the AFE rules, foreign subsidiaries of U.S. life insurance companies must use U.S. tax principles to calculate reserves for purposes of determining the amount of investment income that qualifies under the AFE, rather than using the actual amount of local country reserves. This recalculation requirement was originally designed as an anti-abuse rule, to prevent companies from aggressively overstating local country reserves in order to maximize the amount of investment income that could be subject to deferral from U.S. tax. However, in significant foreign markets subject to developed and modern insurance regulation and oversight, this requirement is too restrictive and overly complex. It fails to take account of the capital requirements that insurance companies must satisfy in order to operate a business competitively in a local jurisdiction. Moreover, since the financial crisis of 2008, foreign regulators are using or moving towards a risk-based capital approach, wherein an insurance company's required capital is evaluated and measured taking into account the types of risks it has assumed (by looking at net premiums written—total premiums less reinsurance that has been ceded—in the local country and loss reserves). Then, the overall capital of the local company, including reserves and policyholder surplus, is taken into account to determine the company's risk-based capital position.

Thus, the level of regulatory capital that is required to be retained in a country, and that cannot be repatriated, is different from the level based on a calculation of reserves utilizing U.S. tax principles.

Present law does provide some relief for U.S. life insurance companies, by authorizing the Secretary to permit U.S. life insurance companies to request a ruling from the IRS to use foreign statement reserves. However, the ruling process is limited and is tremendously time consuming for both the IRS and taxpayers.

Proposal: Congress should further encourage the IRS to provide more generally applicable guidance that would apply on a country-by-country basis to allow local country reserves or capital requirements to be utilized for purposes of calculating the investment income that would be exempt from subpart F. Alternatively, the guidance could approve common reserving methods that the IRS has already reviewed and approved via the ruling process. The guidance would be issued only after the industry demonstrates to the satisfaction of the Secretary that adequate evidence exists that the local country regulator and regulation is robust and meaningful or that the reserving method is commonly accepted.

e. Anti-base erosion proposals and the AFE rules

The AFE rules define an active foreign insurance company for U.S. tax purposes and would define insurance income qualifying for a new dividend exemption system if the Subpart F rules were retained. The AFE rules are robust and restrictive, requiring qualifying income to have a significant nexus to the country where the CFC is organized or does business. We understand the need for anti-base erosion measures as part of a reformed international tax system. For our industry, the AFE rules serve that purpose; it would be unnecessary and overly complicated to apply another layer of restrictive rules to income that is already qualifying under the AFE, such as a minimum tax (except in the case of premiums related to reinsurance between

affiliates, as noted in the AFE reform proposal related to reinsurance, suggested above).

Proposal 1: Any minimum tax that is imposed on earnings of a CFC that would otherwise qualify for the territorial system should exclude from its base earnings that already qualify under the AFE rules.

Proposal 2: If a minimum tax were to apply to our industry, such a tax would create tremendous anomalies unless it was computed on a global basis, as is suggested by the Framework, rather than on a CFC-by-CFC basis, as was the case with "Option C" in the final 2014 Camp bill. That bill raised the following issues:

- The tax base for determining Option C was earnings that exceed 10% of the basis in the entity's tangible property. In an attempt to capture more mobile income including intangibles related income, this definition also captured the earnings of an entity with little or no tangible assets, including financial services companies. Option C failed to recognize that an insurance company's tangible asset and brick and mortar is its cash and investments that support its regulatory required reserves and capital.
- The CFC-by-CFC effective tax rate calculation requiring the use of U.S. tax concepts to compute the effective tax rate for the entity was never fleshed out in detail. For insurance companies, however, it is clear that there would be cases in which companies that pay a high effective tax rate in a local country would still suffer a minimum tax. This is because of significant differences in the calculation of taxable income between U.S. tax rules and local country tax rules, with the most likely differentiator being the calculation of insurance reserves and the timing of recognition of gains and losses on investments.

A. PHILIP RANDOLPH INSTITUTE ET AL.

100 GROUPS OPPOSING A TERRITORIAL TAX SYSTEM PROPOSED BY PRESIDENT TRUMP AND REPUBLICAN LEADERS

October 2, 2017

Dear Member of Congress:

We urge you to reject a proposal to give U.S. multinational corporations a huge tax break for sending jobs offshore and a huge loophole to help them avoid paying taxes.

President Trump and Republican leaders in Congress want to allow multinational corporations to pay no U.S. taxes on their offshore profits. This is called a "territorial tax system."

It is an incredibly bad idea. Ending taxation of offshore profits would give multinational corporations an incentive to send jobs offshore, thereby lowering U.S. wages. It would also be a giant loophole for corporations to use accounting gimmicks to move their profits to tax havens, resulting in the loss of billions of dollars in tax revenue for the United States.

Ending taxation of offshore profits would rig the rules in favor of multinational corporations, give them a competitive advantage over domestic businesses, and make our tax system more complicated.

We cannot afford to give multinational corporations a giant loophole to avoid paying their fair share of taxes at a time when we need more revenue to create jobs rebuilding infrastructure, educating our children, expanding healthcare coverage, researching new medical cures, and ensuring a secure retirement.

Voters are unalterably opposed to a territorial tax system. Three-quarters of Americans say they would oppose a tax system that does not tax offshore profits. A June 2017 Hart Research poll found that 32 percent of respondents believe that foreign profits of U.S.-based companies should be taxed at a *higher* rate than their U.S. profits while another 40 percent believe they should be taxed at the same rate. Only 8 percent believe foreign profits should be taxed at a lower rate, and only 4 percent said they should not be taxed at all—which is what a territorial tax system would do.

Please see this fact sheet *(http://bit.ly/2hCiVn9)* from the Institute on Taxation and Economic Policy for a more detailed explanation of why a "territorial tax system" would rig the rules for multinational corporations and against American businesses and working people.

We urge you to reject this terrible idea.

Sincerely,

A. Philip Randolph Institute
ActionAid USA
Agenda Project
Alliance for Retired Americans
Amalgamated Transit Union
American Family Voices
American Federation of Government Employees (AFGE)
American Federation of Labor and Congress of Industrial Organizations (AFL–CIO)
American Federation of Musicians of the United States and Canada
American Federation of State, County, and Municipal Employees (AFSCME)
American Federation of Teachers
Americans for Democratic Action (ADA)
Americans for Tax Fairness
Asia Initiatives
Asian Pacific American Labor Alliance
As You Sow
Brotherhood of Railroad Signalmen
Campaign for America's Future
Center for Biological Diversity
Center for Community Change
Center for Popular Democracy
Center of Concern
Citizens' Environmental Coalition
Coalition of Black Trade Unionists
Coalition of Labor Union Women
Coalition on Human Needs
Communications Workers of America
Congregation of Our Lady of Charity of the Good Shepherd, U.S. Provinces
Demand Progress
Earth Action, Inc.
EG Justice
Economic Policy Institute Policy Center
Fair Share
Financial Accountability and Corporate Transparency (FACT) Coalition
Financial Transparency Coalition (FTC)
Fix Democracy First
Food and Water Watch
Franciscan Action Network
Friends of the Earth
Global Financial Integrity
Health Care for America NOW!
Hip Hop Caucus
I.A.T.S.E., International Alliance of Theatrical Stage Employees
Institute for Agriculture and Trade Policy
Institute for Policy Studies—Inequality Program
Institute on Taxation and Economic Policy
International Association of Machinists and Aerospace Workers
International Association of SMART, Sheet Metal, Air, Rail, and Transportation Workers
International Brotherhood of Boilermakers
International Brotherhood of Teamsters
International Corporate Accountability Roundtable (ICAR)
International Federation of Professional and Technical Engineers (IFPTE)
International Labor Rights Forum (ILRF)
International Longshoremen's Association
International Union, United Automobile, Aerospace, and Agricultural Implement Workers of America, UAW
Islamic Society of North America
Jobs with Justice
Jubilee USA Network
Main Street Alliance
MomsRising
National Advocacy Center of the Sisters of the Good Shepherd
National Education Association
National Employment Law Project

National Federation of Federal Employees
National Organization for Women
National Priorities Project
National Women's Law Center
NETWORK Lobby for Catholic Social Justice
New Rules for Global Finance
Other98
Our Revolution
Oxfam America
Patriotic Millionaires
Pax Advisory
People Demanding Action
People's Action
Power Shift Network
Pride at Work
Progressive Change Campaign Committee
Progressive Congress Action Fund
Public Citizen
Responsible Wealth
Revolving Door Project
Rights and Accountability in Development (RAID)
RootsAction.org
Service Employees International Union
Social Security Works
Tax Justice Network USA
Tax March
The Hedge Clippers
The Language of Connection
The Leadership Conference on Civil and Human Rights
Unitarian Universalist Legislative Action Network
United Food and Commercial Workers International Labor Union
United for a Fair Economy
United Steelworkers (USW)
UNITE HERE
Wall-of-Us
Woodstock Institute
Working America
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14 October 2017

Senate Committee of Finance
Dirksen Senate Office Bldg.
Washington, DC 20510–6200
U.S.A.

Re: 3 October 2017 Full Committee Hearing on "International Tax Reform"

Dear Chairman Hatch and other Committee Members,

On behalf of the Association of Americans Resident Overseas (AARO), I wish to make the following statement for the record with regard to the 3 October 2017 full committee hearing on "International Tax Reform."

The full committee hearing on tax reform was an important step in the on-going effort to carry out reform of the United States' international tax system. The focus of this hearing was on taxation of corporations. In his opening statement, Chairman Hatch touched on a number of problems with the existing system. He then said this:

> All of these problems are key for today's hearing because they highlight the shortcoming of our outdated worldwide tax system.
>
> The solution to these and other problems, to put it very simply, is to transition to a territorial-based system like virtually all of our foreign competitors. Under

> such a system, an American company would owe taxes only on income earned in the United States. Income earned in foreign jurisdictions would only be taxed by those jurisdictions, not here.

Chairman Hatch then added:

> Finally, as many of you know, I've been interested for some time in the idea of better integrating our individual and corporate tax systems.

AARO agrees with Chairman Hatch that international tax reform should include individual taxation. AARO's position on individual international tax reform, as stated on our website, is this:

TAXATION: We believe that the United States puts itself at a competitive disadvantage by taxing its citizens abroad on the basis of their nationality. The ability to send an employee abroad to manage, direct, instructor train the employees of a foreign subsidiary is crucial to successful competition in today's global economy. The U.S. should put U.S. persons on a par with citizens of other countries and adopt Residence-Based Taxation (RBT). The current system of Citizenship-Based Taxation (CBT) imposes the risk of double taxation on people already taxed in the countries where they live and work. In addition, the compliance costs for U.S. persons abroad are as daunting as the enforcement costs for the IRS.

The Trump administration's interest in reforming taxation so as to create more jobs for Americans is best served by creating more jobs for Americans not only within the United States but also overseas. Switching from citizenship-based taxation of U.S. citizens to territorial-based taxation would put Americans interested in working overseas on an "even playing field" and would encourage U.S. companies operating overseas to hire more Americans.

It is a shame when Americans qualified for overseas executive positions, special skills positions or other good jobs are passed over by U.S. companies in order to avoid the cost of grossing up salaries and/or making double declarations. Had Americans been hired for these jobs rather than foreigners, a good deal of their earnings would sooner or later flow back to America; a large proportion of Americans overseas have close relatives Stateside and plan to retire back in their homeland.

As Chairman Hatch concluded in his opening statement, "International tax reform is an area that is rife for bipartisanship." As a non-partisan group of U.S. citizens living and working around the world, AARO urges all members of the Committee to include territorial-based taxation of American individuals as an essential part of the reform.

I thank you for your attention and would be most happy to discuss this with the Committee staff if there are any questions or concerns.

Sincerely yours,

Neil Kearney
President, Association of Americans Resident Overseas

CENTER FOR FISCAL EQUITY

Statement of Michael G. Bindner

Chairman Hatch and Ranking Member Wyden, thank you for the opportunity to submit these comments for the record to the Committee on Finance. As usual, we will preface our comments with our comprehensive four-part approach, which will provide context for our comments.

- A Value-Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25%.
- Employee contributions to Old-Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and

the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

Attacking unions for the past 30 years has taken its toll on the American worker in both immigration and trade. That has been facilitated by decreasing the top marginal income tax rates so that when savings are made to labor costs, the CEOs and stockholders actually benefit. When tax rates are high, the government gets the cash so wages are not kept low nor unions busted. It is a bit late in the day for the Majority to show real concern for the American worker rather than the American capitalist or consumer. The current plan will make things worse.

Reversing the plight of the American worker will involve more than trade, but we doubt that the Majority has the will to break from the last 30 years of tax policy to make worker wages safe again from their bosses. Sorry for being such a scold, but the times require it.

The main international impact in our plan is the first point, the value-added tax (VAT). This is because (exported) products would shed the tax, *i.e.,* the tax would be zero rated, at export. Whatever VAT congress sets is an export subsidy. Seen another way, to not put as much taxation into VAT as possible is to enact an unconstitutional export tax.

The second point, the income and inheritance surtax, has no impact on exports. It is what people pay when they have successfully exported goods and their costs have been otherwise covered by the VAT and the Net Business Receipts Tax/Subtraction VAT. This VAT will fund U.S. military deployments abroad, so it helps make exports safe but is not involved in trade policy other than in protecting the seas.

The third point is about individual retirement savings. As long as such savings are funded through a payroll tax and linked to income, rather than funded by a consumption tax and paid as an average, they will add a small amount to the export cost of products.

The fourth bullet point is tricky. The NBRT/Subtraction VAT could be made either border adjustable, like the VAT, or be included in the price. This tax is designed to benefit the families of workers, either through government services or services provided by employers in lieu of tax. As such, it is really part of compensation. While we could run all compensation through the public sector and make it all border adjustable, that would be a mockery of the concept. The tax is designed to pay for needed services. Not including the tax at the border means that services provided to employees, such as a much-needed expanded child tax credit—would be forgone. To this we respond, absolutely not—Heaven forbid—over our dead bodies. Just no.

The NBRT will have a huge impact on international tax policy, probably much more than trade treaties, if one of the deductions from the tax is purchase of employer voting stock (in equal dollar amounts for each worker). Over a fairly short period of time, much of American industry, if not employee-owned outright (and there are other policies to accelerate this, like ESOP conversion) will give workers enough of a share to greatly impact wages, management hiring and compensation and dealing with overseas subsidiaries and the supply chain—as well as impacting certain legal provisions that limit the fiduciary impact of management decision to improving short-term profitability (at least that is the excuse managers give for not privileging job retention).

Employee-owners will find it in their own interest to give their overseas subsidiaries and their supply chain's employees the same deal that they get as far as employee-ownership plus an equivalent standard of living. The same pay is not necessary, currency markets will adjust once worker standards of living rise.

Over time, this will change the economies of the nations' we trade with, as working in employee owned companies will become the market preference and force other firms to adopt similar policies (in much the same way that, even without a tax benefit for purchasing stock, employee-owned companies that become more democratic or even more socialistic, will force all other employers to adopt similar measures to compete for the best workers and professionals).

In the long run, trade will no longer be an issue. Internal company dynamics will replace the need for trade agreements as capitalists lose the ability to pit the inter-

est of one nation's workers against the others. This approach is also the most effective way to deal with the advance of robotics. If the workers own the robots, wages are swapped for profits with the profits going where they will enhance consumption without such devices as a guaranteed income.

If Senator Sanders had been nominated and elected, this is the type of trade policy you might be talking about today. Although the staff at the Center supported the Senator, you can imagine some of us thought him too conservative in his approach to these issues, although we did agree with him on the $15 minimum wage. Economically, this would have had little impact on trade, as workers at this price point often generate much more in productivity than their wage returns to them. This is why the economy is slow, even with low wage foreign imports. Such labor markets are what Welfare Economics call monopsonistic (either full monopsony, oligopsony or monopsonistic competition—which high wage workers mostly face). Foreign wages are often less than the current minimum wage, however many jobs cannot be moved overseas.

As we stated at the outset, the best protection for American workers and American consumer are higher marginal tax rates for the wealthy. This will also end the possibility of a future crisis where the U.S. Treasury cannot continue to roll over its debt into new borrowing. Japan sells its debt to its rich and under-taxes them. They have a huge Debt to GDP ratio, however they are a small nation. We cannot expect the same treatment from our world-wide network of creditors, an issue which is also very important for trade. Currently, we trade the security of our debt for consumer products. Theoretically, some of these funds should make workers who lose their jobs whole—so far it has not. This is another way that higher tax rates and collection (and we are nowhere near the top of the semi-fictitious Laffer Curve) hurt the American workforce. Raising taxes solves both problems, even though it is the last thing I would expect of the Majority.

We make these comments because majorities change—either by deciding to do the right thing or losing to those who will, so we will keep providing comments, at least until invited to testify.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

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U.S. Senate
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Dirksen Senate Office Building
Washington, DC 20510–6200

October 3, 2017

Re: Senate Finance Committee hearing on "International Tax Reform"

Dear Chairman Hatch, Ranking Member Wyden, and all Members of the Committee, Democrats Abroad greatly appreciates you holding this important hearing on international tax reform and allowing for stakeholders to submit testimony into the record. Like you, Democrats Abroad believes that comprehensive tax reform is long overdue for middle-class Americans, working-class families, small businesses, job creators, and especially so for American taxpayers living and working abroad.

As you know, millions of U.S. citizens reside overseas, normally for family reasons, but also for work, education or adventure. As Americans, we are all subject to tax-filing requirements in both our country of residence and to the U.S. even though our use of the services provided by our federal taxes is comparably negligible. Furthermore, the U.S. is only one of two countries in the world still taxing non-resident citizens based on the outdated system of citizenship-based taxation.

Fortunately, with Congress and the Administration ready to move forward together on the most significant tax reform in three decades, we believe that lawmakers are presented with an ideal opportunity to correct this injustice to Americans abroad and restore fairness to the taxation playing field.

Democrats Abroad joins the rest of the Americans abroad community in our strong support for a tax reform package which includes:

- Reforms to the U.S. tax code which reduce inequality, boosts opportunity, and raises revenue to meet public demands primarily from those with the greatest ability to pay;
- Residency-based taxation as a replacement for the current system of citizenship-based taxation;
- Safeguards to prevent tax abuse by those seeking to hide offshore income;
- Relief from foreign financial account reporting for Americans abroad genuinely residing in their country of residence;
- Simplified and improved tax filing for Americans living abroad; and
- Deficit-neutrality and revenue-neutrality to ensure tax cuts are fully paid for and Congress does not add to our nation's existing debt.

Itai Grinberg, your witness in today's hearing, previously wrote a paper on international taxation in which he stated, "It is inappropriate for regulatory rules to make it difficult for [Americans living abroad] to maintain residence country financial accounts." [1] We strongly agree with Mr. Grinberg's assessment in that everyday Americans abroad experience financial hardship which results in not being able to save for retirement or utilize financial services in the same manner as Americans living within U.S. borders.

Although we are disappointed that the Senate has decided to advance the FY18 budget resolution with reconciliation instructions on tax reform, we are encouraged by this hearing that all perspectives will be considered by the Senate in crafting tax legislation.

Thank you for your consideration of this submission for inclusion into the hearing record. If you or your staff have any questions regarding this letter or if you would like to discuss an expanded outline of our tax reform recommendations, please feel free to contact me or Ms Carmelan Polce, Chair of the Democrats Abroad Taxation Task Force, at cpolce@tpg.com.au.

Respectfully submitted,

Julia Bryan
International Chair, Democrats Abroad
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October 3, 2017

The Honorable Orrin Hatch
Chairman
U.S. Senate
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219 Dirksen Senate Office Building
Washington, DC 20510–6200

The Honorable Ron Wyden
Ranking Member
U.S. Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510–6200

RE: October 3rd hearing on "International Tax Reform"

Dear Chairman Hatch and Ranking Member Wyden, we are writing on behalf of the Financial Accountability and Corporate Transparency (FACT) Coalition to thank

[1] Grinberg, Itai, 2012, "Beyond FATCA: an evolutionary moment for the international tax system," 27 January, *Georgetown University Law Center,* p. 59. *http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1162&context=fwps_papers.*

you for holding a public hearing on the international aspects of tax reform and to offer our recommendations on how to improve the American tax system.

The FACT Coalition is a non-partisan alliance of more than 100 state, national, and international organizations working toward a fair tax system that addresses the challenges of a global economy and promoting policies to combat the harmful impacts of corrupt financial practices.[1]

While the problems with the tax code span across many areas, we especially appreciate this hearing's focus on updating our international tax system and reforming the tax code so that it strengthens American business. The tax treatment of multinational corporations is one of the areas of the tax code most in need of substantial reform. In fact, a prominent tax economist estimates that up to $135 billion is lost each year to offshore corporate tax avoidance.[2] The ability of companies to defer paying taxes on their offshore earnings has allowed them to accumulate a stunning $2.6 trillion in earnings "offshore" on which they are avoiding $750 billion in taxes.[3]

Allowing multinational corporations to continue to engage in large-scale offshore tax avoidance hurts small and wholly domestic businesses. Every dollar companies avoid in taxes must be paid in one form or another. On the one hand, offshore tax avoidance means that we are short on the revenue to make needed public investments in things like infrastructure, education, and health care that make our economy competitive over the long term. On the other hand, small and domestic businesses are disadvantaged because they are the ones left picking up the tab for all the tax avoidance by their multinational competitors. In fact, one study found that the total potential burden on small businesses for the cost of federal tax avoidance could be as high as $4,481 per company on average.[4]

We, as a coalition, believe that any tax reform effort should take four critical steps to dramatically cut back on the gaming by multinationals.

1. Stop Giving Multinationals an Advantage over Wholly Domestic and Small Businesses

We should immediately close the loophole that allows companies to defer paying taxes by moving their profits offshore. As U.S. citizens, you and I—and every domestic company—pay taxes on what we earn, regardless of where we earn it. None of us can defer our tax obligations. But multinational companies can create foreign subsidiaries, divide themselves in ways that game the system, and defer paying all or most of the taxes due on their foreign earnings. It's not fair, and it's anti-competitive. They use our roads and bridges to ship their goods, recruit from our colleges and universities, and are protected by our laws and our military. They should not, through loopholes and accounting gimmicks, defer paying their share and leave the rest of us to pick up the tab.

Also, we should not favor multinationals over wholly domestic and small businesses by giving them a special rate. Shockingly, some—including the so-called "Big Six"—have proposed a lower tax rate for those companies that shift jobs and money overseas.[5] That makes no sense.

2. Stop U.S. Companies From Claiming Foreign Residence Simply to Dodge Taxes

Some large U.S. companies buy up smaller, foreign companies, move their legal residence to one of the tax haven countries (a paper transaction, no moving van required) and claim they are no longer U.S. residents to avoid paying taxes. They still have access to our markets and many of the privileges they enjoyed as U.S. companies, but stop paying the taxes needed to support that access. That means you and

---

[1] For a full list of FACT Coalition members, visit *https://thefactcoalition.org/about/coalition-members-and-supporters/*.

[2] Kimberly A. Clausing, "Profit shifting and U.S. corporate tax policy reform," Washington Center for Equitable Growth, May 2016, *http://equitablegrowth.org/report/profit-shifting-and-u-s-corporate-tax-policy-reform/*.

[3] Institute on Taxation and Economic Policy, "Fortune 500 Companies Hold a Record $2.6 Trillion Offshore," March 28, 2017, *https://itep.org/fortune-500-companies-hold-a-record-26-trillion-offshore/*.

[4] Alexandria Robins and Michelle Surka, "Picking Up the Tax 2016," U.S. PIRG, November 29, 2016, *http://www.uspirg.org/reports/usp/picking-tab-2016*.

[5] Speaker Ryan Press Office, "Unified Framework for Fixing our Broken Tax Code," Office of the Speaker of the House, September 27, 2017, *https://www.speaker.gov/sites/speaker.house.gov/files/Tax%20Framework.pdf*.

I are left paying their share. We should strengthen "anti-inversion" and earnings stripping rules to prevent that type of gaming.

3. Ensure Multinationals Play by the Rules by Publicly Reporting Their Profits and Taxes Paid

Multinational companies do not publicly report on where they are making their money or what taxes they are paying to whom. We have no idea exactly how they are gaming the system—what they tell us versus what they tell other countries. They should have to write it down in one place and report it on a country-by-country basis, so that the public can see what they are really paying.[6]

4. Don't Make Things Worse

Our current system allows U.S. companies to delay paying taxes on U.S. profits they shift overseas. That's bad enough. Some in Congress have proposed allowing the profit-shifting without ever having to pay what they owe. That's the ultimate loophole. If we move toward what's called a "territorial tax system," which really means giving multinational corporations a zero tax on profits they shift abroad, the only companies left paying U.S. corporate income taxes would be those too small to game the system. It also means that multinational companies would face an incentive to offshore jobs to countries with lower tax rates than the U.S. That is why more than 100 organizations sent a letter to Congress on Monday urging legislators to reject a "territorial tax system."[7]

If there is one thing that policymakers, the media, and the public can agree on, it is that the tax code is long overdue for a substantial overhaul. We appreciate the diligent work you and committee staff have put into exploring these issues and hope to work with you moving forward on tax reform.

For additional information, please contact Clark Gascoigne at cgascoigne@thefactcoalition.org or Richard Phillips at rphillips@itep.org.

Sincerely,
Gary Kalman
Executive Director

Clark Gascoigne
Deputy Director

Richard Phillips
Policy and Communications Co-Chair

LETTER SUBMITTED BY GINA M. HUNT

October 1, 2017

U.S. Senate
Committee on Finance
Dirksen Senate Office Bldg.
Washington, DC 20510–6200

RE: Full committee hearing, "International Tax Reform," October 3, 2017

Dear Sirs and Madams,

I am writing you today to request that you consider changing international tax laws governing American citizens living abroad, not just those governing American businesses and corporations abroad. I don't imagine that you have any idea what it is like for the 9,000,000 of us, so I respectfully request that you read and consider every communication sent to you from one of us.

I earned a salary of just over €50,000 last year and paid 40% of that in French taxes. That means that I netted somewhere around $35,000 USD—way, way, way under your salary, I am certain. I point this fact out because I need you to realize that I am not a rich person living abroad but a middle-class one. I own no home anywhere and have very little in total assets. And yet, I am required to file taxes in the U.S. every year because of citizen-based taxation. I also have my meager

[6] The FACT Coalition, "FACT Sheet: Public Country-by-Country Reporting," September 27, 2017, *http://thefact.co/aldnl.*

[7] Clark Gascoigne, "Over 100 Organizations Urge Congress to Reject Giant Tax Loophole for Offshoring and Tax Avoidance," The FACT Coalition, October 2, 2017, *http://thefact.co/3Kzko.*

French bank accounts reported to the U.S. Government every year because of FATCA.

I never owe anything in U.S. taxes, but the paperwork is complicated nonetheless. It is costly to have it completed correctly, and that's the least of the problems with these issues. If I were to make twice as much as I make now, I still would not be rich, and yet, I would have to pay income taxes on some of that income in both France and in the U.S. How can that be justified? It can't. And citizens who are unaware of the requirement to file or citizens who don't file for any reason can be fined outrageous fines even though they owe nothing in U.S. taxes. That is simply abusive.

As for FATCA, this is a clear violation of our 4th amendment rights, plain and simple. It is also the reason that 1 in 10 Americans living abroad cannot get a bank account, and that number is growing daily. Think about that for a minute. Could you function in your daily life without a bank account? Of course you couldn't.

You see, the rich can get around these things. They can pay accountants and lawyers and find a way around anything they want to find a way around. The banks find a way around steep fines charged by the U.S. Government for reporting mistakes that they may make and the like by refusing to open bank accounts for Americans.

But some Americans, those of us who are middle-class and who are the vast majority of Americans living abroad cannot afford to pay our way out of this noose that the U.S. Government has put around our necks and is tightening every day. So for the past several years, more and more Americans have renounced their American citizenship. In 2016, a record number of Americans renounced. Think about that for a minute. Record numbers of Americans renouncing citizenship. I never thought I'd see that day, and I am heartbroken that it is here. They aren't the rich, as some might have you believe. Again, the rich can get around oppressive regulations. These people are the backbone of America—the middle class, and they are renouncing citizenship because they feel that they have no other choice. This is nothing short of tragic.

You have the opportunity to fix this nightmare imposed on us by the Obama administration. Repeal FATCA. It is not catching fat-cats; it is pushing middle-class Americans over the edge. Change the U.S., the only country in the world other than Eritrea to impose citizen-based taxation, to a system of residency-based taxation. We should pay taxes where we live, and believe me, we do, but citizen-based taxation and FATCA are cruel and unusual tax regulations that are punishing law-abiding, middle-class Americans just because they live outside of the U.S. We are the 9,000,000 unpaid ambassadors of the U.S. We are hard-working Americans. And we deserve a government that does not treat us as criminals and ignore our constitutional rights.

Thank you.

Regards,

Gina M. Hunt

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The Investment Company Institute ("ICI")[1] appreciates the opportunity to provide the Committee its comments regarding international tax reform. ICI applauds the

[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$20.5 trillion in the United States, serving more than 100 million U.S. shareholders, and US$6.7 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

Committee for its efforts to improve and simplify the tax code in a manner that spurs U.S. economic growth and job creation.

As the Committee is aware, an important component of any comprehensive tax reform initiative is updating our international tax system to make our nation more competitive in the global economy and to encourage foreign investment in the United States.

ICI supports changes to the Internal Revenue Code ("Code") that would increase foreign investment in U.S. regulated investment companies ("RICs"), more commonly known as mutual funds. Specifically, ICI proposes an investment vehicle that would encourage foreign investment in RICs by reducing the disparate tax treatment between U.S. and foreign funds and thereby allow RICs to compete more effectively with foreign funds for foreign investors.

Foreign Investment in U.S. RICs Should Be Encouraged

ICI strongly supports increasing the international competitiveness of U.S. mutual funds. Almost 47 percent of all mutual fund assets are held by U.S.-domiciled funds.[2] The percentage of global fund industry assets held by U.S. funds, however, has declined as investment markets have globalized.

Changes taking place in Asia, Europe, and elsewhere are providing many significant opportunities for growth in the asset management industry. "Cross-border mutual funds" (*i.e.,* mutual funds that are domiciled in one country but offered for sale in other countries) have enjoyed explosive growth. At the end of 2016, there were more than 100,000 foreign mutual funds and ETFs in existence, compared to fewer than 10,000 mutual funds and ETFs domiciled in the United States.[3] Today virtually no U.S. mutual fund is marketed or offered on a cross-border basis, even though many cross-border mutual funds invest in U.S. assets.

The U.S. tax laws require U.S. mutual funds to distribute essentially all their income and gains on an annual basis to avoid double taxation. This distribution requirement creates a substantial barrier to marketing U.S. funds abroad because foreign investors incur a home-country tax when such income and gain is distributed to them. Foreign investors may also be subject to higher tax rates if their home country treats capital gain dividends paid by RICs as dividends that are not eligible for preferential capital gains tax rates. Many foreign funds, in contrast, are permitted to retain (or "roll up") their income without either current taxation of the fund or any obligation to distribute the income to investors.

U.S. mutual funds could compete effectively against foreign mutual funds if they were not required to distribute their income currently to their foreign investors. U.S. products would offer several advantages to foreign investors. First, the size and sophistication of U.S. funds allow them to invest more efficiently and operate at lower cost than their smaller foreign counterparts. Second, the protection afforded by U.S. securities regulation is considered state of the art, including in particular the protections afforded by the Investment Company Act of 1940. Third, the U.S. has a deep pool of highly skilled workers to run its investment products. Fourth, the U.S. already has underlying retail investment products in place for all major asset classes that would make the IRIC attractive to foreign investors.

Investment Vehicle to Encourage Foreign Investment in U.S. RICs

ICI proposes an investment product called an International Regulated Investment Company ("IRIC") that is designed to reduce U.S. tax disadvantages that prevent U.S. mutual funds from competing effectively against foreign mutual funds. Prompt enactment of legislation creating IRICs is critical if U.S. mutual funds are to compete in the rapidly globalizing investment markets. If the IRIC proposal is not enacted, U.S. funds (particularly at small and medium sized fund companies) will continue to cede ground to foreign funds.

The IRIC provides foreign investors with a feeder vehicle through which they can access a U.S. mutual fund without triggering certain negative tax consequences in their home countries. An IRIC would be a U.S. mutual fund that could be acquired only by foreign shareholders (only nonresident alien individuals and their foreign estates, and qualified foreign pension funds) and that would invest only in the shares of a single U.S. mutual fund that qualifies as a RIC under Subchapter M of the Internal Revenue Code. The IRIC would register with the Securities and Exchange Commission under the Investment Company Act of 1940.

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[2] *https://www.ici.org/pdf/2017_factbook.pdf,* Table 65.
[3] *Id.,* Table 66.

The IRIC would not be required to distribute its income or capital gain annually. IRIC investors, however, would effectively pay the same annual U.S. income tax as if they had invested directly in the RIC shares held by the IRIC. Instead of tax being collected on distributions by the RIC to the foreign investor, however, the tax would be paid by the IRIC on the distributions it receives from the underlying RIC. The tax rate applied to the IRIC's taxable income would be 30 percent (the current rate applied to taxable distributions, such as dividends, paid to foreign persons) or 15 percent (if all the IRIC's shareholders were entitled under applicable tax treaties with the U.S. to a rate of 15 percent or less) and the IRIC made a "treaty IRIC" election to pay tax at that rate.

Thus, the same U.S. tax revenue would be collected, but the foreign investor would not be subject to tax in his or her home country until the IRIC shares were sold (absent a current inclusion tax regime comparable to the PFIC regime in the U.S.). The RIC in which the IRIC invests would remain subject to the Internal Revenue Code's distribution requirements, as under present law.

Conclusion

ICI commends the Committee for its goal of modifying the international provisions of the Code in a manner that will improve U.S. competitiveness abroad and thereby enhance foreign investment in the U.S. The proposal that ICI advances is consistent with this goal and, if adopted, will increase foreign investment in U.S. RICs.

ICI would be pleased to work with the Committee on the IRIC proposal or other legislation that would level the playing field so U.S. mutual funds are able to better compete in the rapidly globalizing investment markets.

LETTER SUBMITTED BY JEFFERY M. KADET

October 13, 2017

U.S. Senate
Committee on Finance
Dirksen Senate Office Bldg.
Washington, DC 20510–6200

Dear Sirs:

I respectively submit the attached memorandums. I would be please to respond to any questions that you might have.

Yours very truly,

Jeffery M. Kadet

MEMORANDUM 1
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 persons who understand what "deferral" and "territorial" really mean work for either the multinationals (MNCs) that would benefit from adopting territoriality or 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 imple-

mented (*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 and concise terms why a residence-based system is vastly superior to a territorial system.[1]

The chart below summarizes the content of this letter.

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 corporations 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 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% (or in the future some lower rate) 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 elimi-

[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.*

nate 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 roughly $3 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 out of the U.S. 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. These complications are necessary to counteract the increased game playing that the territorial system incentivizes.

It should be added here that the efforts of lobbyists to gut any safeguards against future profit shifting (*e.g.,* stronger subpart F rules, a minimum tax, etc.) and the creativity of MNCs and their legal, accounting, and tax advisors to come up with new schemes mean that game playing under a territorial system will reach new heights. This will result in the exact opposite of any tax policy simplification goals.

It completely solves the "trapped cash" problem—Under the deferral system, returning foreign earnings to the U.S. 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 years[2] unbelievably fails to do this. *The mechanism that was chosen (a 95% dividend-received deduction) would continue to cause actual dividends to trigger tax to the extent of the 5% taxable portion.*[3] This may seem small. It will, though, impede dividend payments and continue the trapped cash problem. This issue is fixable if Congress decides on a 100% dividend received deduction. If it does so, though, it must at the same time put in strong rules to deny any tax deduction for interest costs and all other expenses that are directly or indirectly attributable to foreign investment or foreign business, the profits of which would be exempt under the territorial system. Getting back to simplification, such expense disallowance rules and the need to counteract the accounting games that MNCs will play to minimize the disallowed expenses means more complication and less simplification.

A residence-based system totally eliminates the trapped cash problem.

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 naive to think that such strong rules would be put in place. First, the rules under consideration within Congress 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 the continued and accelerated export of jobs along with erosion of the U.S. tax base.

MEMORANDUM 2
CONCERNING INTERNATIONAL TAX REFORM

Taxation of Accumulated Deferred Foreign Income as of the Transition Date

The Committee's work to develop international tax reform will undoubtedly include some transition from the present deferral system to some other system. As an integral part of that transition, it is expected as well that proposals will include 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%.[4]

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 and the House Republican Blueprint bottoming out at 3.5% on earnings reinvested into non-liquid assets.

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[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–WY).

[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.*

[4] ". . . 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.*

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 major 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.

Whatever the Committee proposes needs an administratively workable mechanism that neither clobbers the former nor rewards the latter.

Two Approaches for an Administratively Workable Mechanism [5]

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.[6] Clear legislative instructions would not only provide necessary guidance to 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 6 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 proposals 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" ap-

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[5] *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.*

[6] *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 (February 15, 2016).

proach, 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 proposals should include an interest charge to the extent of any installment payments.

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Modernization of Rules Governing Foreign Insurance Operations of U.S. Companies

Executive Summary

Current Tax Rules for U.S. Reinsurers Operating Abroad Do Not Achieve Their Goal and Must Be Updated

The Active Finance Exception (AFE), adopted in 1998, was intended to make U.S. insurers with foreign operations more competitive in foreign markets. Changes in foreign regulations, developed in the nearly 20 years since the AFE rules were adopted, often impose high costs on reinsurers seeking to comply with AFE requirements. Worse yet, the AFE requirements are, in many respects, inconsistent with typical reinsurance group operations in international markets. As a result, many insurers' foreign subsidiaries do *not* qualify for the AFE exception.

Without the deferral of tax provided by the AFE, foreign reinsurance subsidiaries of an American insurer bear a higher tax burden than their local competitors and are placed at a competitive disadvantage. AFE rules must be updated if U.S. insurers with foreign operations are to be competitive internationally.

AFE rules should be revised to promote U.S. reinsurers' growth and competitiveness in international markets:

1. The related party reinsurance disallowance should be revised or eliminated so that internal reinsurance from members of a worldwide group does not disqualify a global reinsurance company from AFE status (as it does under current law).
2. The home country requirements should be repealed or revised.
3. The insurance rules should exclude the full amount of investment income from assets held to satisfy foreign regulatory capital requirements.
4. Property-casualty (P&C) insurance companies should be allowed to compute reserves using local rules, as life insurers can under current law.
5. If a minimum tax on foreign earnings is adopted in tax reform, it should exclude any insurance income that cannot be repatriated due to local regulatory requirements.

DISCUSSION

Reinsurance Association of America

The Reinsurance Association of America (RAA), headquartered in Washington, DC, is the leading trade association of property and casualty reinsurers doing business

in the United States. The RAA is committed to promoting a regulatory environment that ensures the industry remains globally competitive and financially robust. RAA membership is diverse, including reinsurance underwriters and intermediaries licensed in the U.S. and those that conduct business on a cross border basis. The RAA represents its members before state, federal and international bodies.

Background

Reinsurance is a transaction in which one insurance company indemnifies, for a premium, another insurance company against all or part of the loss that it may sustain under its policies of insurance. Reinsurers play a critical role in the insurance industry, and thus the economy, through their ability to mitigate risk for individual insurance companies. Reinsurance enhances the solvency of direct insurers and thereby helps to protect insured individuals and businesses.

Reinsurance is a global business, with U.S. companies writing substantial foreign business, and foreign reinsurers writing substantial U.S. business. By assuming a variety of risks, diversified by line-of-business and geographic location, a reinsurer creates a more resilient portfolio, and one more likely to withstand the volatility of the property-casualty insurance business. A widely diversified portfolio enables a reinsurer to use its capital more efficiently, and thereby to hold down costs for primary insurers and policyholders.

After the 2008 financial crisis, insurance and reinsurance companies have become subject to increasing levels of regulation, such as stricter, risk-based capital requirements (EU Solvency II) and greater internal controls such as Own Risk and Solvency Assessments (ORSA). Compliance costs for local regulation have increased dramatically since the AFE was enacted in 1998. In the Senate Finance Committee's *International Tax Working Group Report* (2015), these problems were identified as requiring modification.

Modernizing the Active Finance Exception rules for foreign operations of U.S. insurers is consistent with the Administration and Congress's goals of simplifying the tax code, reducing the regulatory burden on American taxpayers, and growing the American economy. It will make U.S. reinsurers more competitive in foreign markets and expand jobs at U.S. headquarters that oversee foreign operations.

Modernization of Insurance Tax Rules

- ***Related party insurance income*** is excluded from qualifying insurance income under current law. This prohibition penalizes a reinsurance company for following standard industry practice. In order to operate efficiently, reinsurers must pool their global risks in order to achieve risk diversification and to manage capital more efficiently.
  - ***The law should recognize that reinsurance from members of a worldwide group is not a related party risk if the underlying risks are from unrelated parties.***
- ***The 30% home country requirement for "Exempt Insurance Contract" and 50% home country requirement for "Qualifying Insurance Company" status in AFE prevent foreign reinsurers from qualifying under AFE.***
  - The EU has become more integrated, and EU passporting rights now allow insurers regulated in one EU country to freely operate through the EU. The transfer of risks from many EU countries to a regional headquarters—standard industry practice—means that an EU headquartered company cannot meet the AFE's same country requirements.
  - This freedom to operate through the EU from a single country causes the 30% home country requirement for an "exempt contract" and the 50% requirement for a "Qualifying Insurance Company" to be overly restrictive.
  - These requirements are inconsistent with reinsurance company business models. Insurance groups in Europe, Asia and South America, as well as the EU, pool risks at a regional headquarters company, yet foreign subsidiaries of U.S. insurers following industry "best practices" cannot satisfy the home country requirements because they transfer non-home country risks. U.S. insurers should be allowed to compete internationally without tax penalties.
  - ***The home country requirement should be repealed or revised.***
- ***AFE Should Recognize Regulatory Capital Requirements:*** Current APE rules limit the amount of investment income excluded to ⅓ of premiums earned for P&C and health insurance, and 110% of reserves for life and annuity con-

tracts, computed using U.S. tax principles. After the 2008 financial crisis, many foreign regulators imposed risk-based capital requirements for greater amounts than permitted under current AFE rules.

- The investment income from these assets is not available to the U.S. parent—the U.S. parent is being taxed on income it cannot receive.
- ***The AFE rules should exclude investment income from the full amount of assets held to satisfy regulatory capital requirements.***

- ***Translation of Foreign Reserves:*** Current law's requirement that foreign insurance reserves must be restated using U.S. tax accounting principles, with respect to the computation of both underwriting income and investment income, should be streamlined to avoid burdensome recalculations.
  - The need to allow "more realistic assessment of insurance company reserves" was specifically mentioned in the 2015 *International Tax Working Group Report* (p.79).
  - Life insurance companies are permitted to elect to use foreign reserves; P&C companies should also be permitted to use foreign reserves.
  - ***The law should permit property-casualty insurers and reinsurers to compute reserves based on local regulatory principles, as life insurers can under current law.***
- ***Tax on Deemed Repatriated Foreign Earnings:*** Since insurers and reinsurers are subject to regulatory restrictions on their ability to repatriate earnings, any one-time tax on accumulated foreign earnings should exclude income which cannot be repatriated due to local regulatory requirements.
  - If there are two rates for the tax, as proposed in the Camp bill (H.R. 1, 2014), income associated with the insurance business (reserves and capital or "surplus"), should be taxed at the lower rate, since it is used for the active conduct of an insurance business.
- ***Minimum Tax:*** If a minimum tax on future foreign earnings is adopted, income from insurance business should not be taxed twice, once as "insurance in come" and, in addition, as "intangible income," as was possible in the Camp bill.

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The Tax Innovation Equality (TIE) Coalition [1] is pleased to provide this statement for the record of the Finance Committee's hearing on International Tax Reform. The TIE Coalition comprises leading U.S. technology and bio-pharma companies that rely on and invest in intellectual property and intangible assets. Such investments help make companies innovative, successful and globally competitive. The TIE Coalition supports comprehensive tax reform that will 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).

Unfortunately, some past proposals would tax IP income adversely compared to income from other types of assets, creating an unfair advantage for companies who don't derive their income from IP, and significantly disadvantaging 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 that proposal, Chairman Camp chose the anti-base erosion option known as Option C. The problem with Option C is that it would tax IP-based income at significantly higher rates than non-IP income, significantly disadvantaging U.S. IP-based companies who compete globally, which would result in more inversions of U.S. companies and more foreign acquisitions of U.S. companies. The TIE Coalition is *opposed* to

[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 *www.tiecoalition.com.*

Option C because it would have a devastating impact on both innovative technology companies and the nation's leading biopharmaceutical companies.

Section 4211 of H.R. 1 specifically targets "foreign base company intangible income" for higher taxation by creating a new system in which that income will be *immediately* taxed in the U.S. at much higher rates (15% or 25%) rather than the 1.25% tax rate for all other foreign income, which is only taxed upon distribution back to the U.S. The provision does not provide a definition of an intangible asset generating IP-based income subject to Option C. Instead it uses a formula which essentially provides that if a company earns more than a 10% return on its foreign depreciable assets, the income over the 10% threshold will be considered "intangible income" and subject to the higher immediate U.S. tax. Many innovative companies have higher margins and earn more than 10% on their depreciable assets, so they will be disproportionately affected by this adverse provision.

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. *See:* "Why Tax Reform Should Support Intangible Property in the U.S. Economy" by Matthew J. Slaughter, *http://www.tiecoalition.com/wp-content/uploads/2015/07/IP-White-Paper_January-2015.pdf.* According to the study, "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." (Executive Summary)

The study found that Option C in the Camp legislation would fundamentally (and adversely) change the measurement and tax treatment of IP income earned by American companies abroad and 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. As a result, the study found that Option C "would aggravate the nettlesome issue of corporate inversions and would create additional incentives for foreign acquisitions of U.S.-based IP-intensive companies." (Executive Summary)

According to the Slaughter study, since globally engaged U.S. companies have long performed the large majority of American's IP discovery and development, it is increasingly important to America's economic success that these companies operate profitably overseas. 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" (page 30). The Slaughter study concludes that the overseas operations of these companies complement their U.S. activities and support, not reduce, the inventive efforts, related jobs, and positive economic impact of their U.S. parents on the U.S. economy.

In addition to Option C, other international tax reform proposals have singled out income from IP for adverse treatment. In 2012, Senator Michael Enzi (D–WY) introduced an international tax reform bill, S. 2091. While the Enzi bill did not propose lowering the corporate tax rate, it did propose a territorial system with a 95% dividends received deduction (DRD) for qualified foreign-source dividends. Unfortunately, while the bill reduced the scope of the current law Subpart F regime in some respects (by eliminating the current foreign base company sales and services income rules under Section 954), it proposed creating a new category of Subpart F income under which all income of a controlled foreign corporation (CFC) would be immediately taxable in the U.S. at the full U.S. rate unless the CFC's effective tax rate (ETR) exceeded half of the maximum U.S. corporate rate. Under Senator Enzi's bill, the ETR in the foreign country would have to be more than 17.5% to qualify for territorial tax treatment with a 95% DRD and avoid immediate taxation at the maximum U.S. tax rate.

However, "qualified business income" (as defined in the bill) would be excluded from this punitive tax treatment and qualify for the 95% DRD. But, "qualified business income" specifically would *not* include "intangible income" as defined in Section 936(h)(3)(B). As such, Senator Enzi's proposal effectively repeals deferral for intangible income earned by CFC's and denies territorial tax treatment with the 95% DRD for intangible income, clearly discriminating against income from intangible assets. In addition to discriminating against income from intangible assets, the Enzi bill would result in significant additional disputes between the IRS and taxpayers

regarding how much income is from intangible property as broadly defined in Section 936(h)(3)(B).

In designing a competitive territorial tax regime, both Congressman Camp and Senator Enzi decided that anti-base erosion provisions needed to be included to protect the U.S. tax base, but they both chose options that discriminate against IP income. The TIE Coalition has offered several anti-base erosion proposals that do *not* discriminate against income from intangibles. Two anti-base erosion measures that we could support are Option D and Option RS. If base erosion is a concern, it is a concern for *all* income, not just income from intangibles.

Option D proposes a territorial system with a graduated DRD based upon the effective tax rate paid by the CFC. The general rule of a 95% DRD would apply to foreign source dividends paid from a CFC that has an effective tax rate equal to or greater than 15%. But if the effective tax rate of the CFC is less than 15%, the DRD exemption would be reduced using a simple sliding scale. Under Option D, if the CFC tax rate is at least 7.5% but less than 15%, the DRD would drop to 85%. If the CFC effective tax rate is less than 7.5%, the DRD would be 75%. If the CFC effective tax rate is less than 7.5% and the CFC is domiciled in a jurisdiction that does not have a tax treaty/possession status/TIEA (or similar relationship) with the U.S., the DRD would be 60%. *All* low-tax active foreign income is treated similarly. Income from intangibles is not singled out for especially harsh treatment.

Under Option RS, low-taxed foreign income of a CFC would be subject to immediate U.S. tax unless it is derived from a substantial local business in the foreign jurisdiction where the income is reported and subject to tax in that jurisdiction. Income would be considered low-taxed if the foreign effective tax rate (ETR) is 15% or less. The substantial local business activity test would be met if *all three* of the following tests are met: (1) the income is derived in the active conduct of a trade or business in the foreign country; (2) substantial local activities are conducted in the foreign jurisdiction; and (3) the income is treated as taxable in the foreign country.

Both of these options would address the policy concerns about the possible erosion of the U.S. tax base by companies shifting income to low tax jurisdictions, but they would not single out income from intellectual property for special treatment. Targeting income from intangible property has sometimes been justified by describing it as "highly mobile" income, but that description is not accurate. Transferring an intangible asset out of the U.S. is a taxable event under IRC Section 367(d) so that any company transferring an intangible asset to a foreign entity must pay an immediate tax on the transfer as if the property had been sold. Determining the value of an intangible asset can be difficult but companies and the IRS have been doing these valuations for years with greater and greater sophistication and accuracy. Moving intangible assets is not an easy or invisible process, and describing intangible assets as "highly mobile" gives the impression that somehow title to these assets can simply be transferred around the globe with no U.S. tax consequences, when in fact the transfer of intangible assets to a foreign entity is already subject to immediate taxation under Section 367(d).

In conclusion, the TIE Coalition supports comprehensive 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. At a time when many other countries are adopting tax rules designed to attract IP companies to their shores, it would be especially harmful to the U.S. economy to adopt a tax policy that will hurt, not help, American IP companies who compete globally. Now is not the time to drive high paying American jobs overseas.

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