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THE U.S. TAX CODE: LOVE IT, LEAVE IT, OR REFORM IT

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

JULY 22, 2014

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PUBLISHING OFFICE

93–597—PDF WASHINGTON : 2015

For sale by the Superintendent of Documents, U.S. Government Publishing Office
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THE U.S. TAX CODE: LOVE IT, LEAVE IT, OR REFORM IT

TUESDAY, JULY 22, 2014

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

The hearing was convened, pursuant to notice, at 9:50 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Ron Wyden (chairman of the committee) presiding.

Present: Senators Schumer, Stabenow, Menendez, Cardin, Brown, Hatch, Grassley, Enzi, Thune, Burr, Portman, and Toomey.

Also present: Democratic Staff: Michael Evans, General Counsel; Todd Metcalf, Chief Tax Counsel; Jocelyn Moore, Deputy Staff Director; and Joshua Sheinkman, Staff Director. Republican Staff: Chris Campbell, Staff Director; Tony Coughlan, Tax Counsel; Chris Hanna, Senior Advisor for Tax Reform; Jim Lyons, Tax Counsel; Shawn Novak, Senior Accountant and Tax Advisor; Mark Prater, Deputy Staff Director and Chief Tax Counsel; and Jeff Wrase, Chief Economist.

OPENING STATEMENT OF HON. RON WYDEN, A U.S. SENATOR FROM OREGON, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The Finance Committee will come to order.

The U.S. tax code is infected with the chronic diseases of loopholes and inefficiency. These infections are hobbling America's drive to create more good-wage, red, white, and blue jobs here at home. They are a significant drag on our economy and are harming U.S. competitiveness. The latest outbreak of this contagion is the growing wave of corporate inversions, where American companies move their headquarters out of the United States in pursuit of lower tax rates.

The inversion virus now seems to be multiplying every few days. Medtronic, Mylan, Mallinckrodt, and many more deals have either occurred recently or are currently in the works. Medtronic's proposed $42-billion merger with Covidien was record-breaking when it was announced in June. But the ink in the record book had barely dried when AbbVie announced its intention on Friday to acquire Shire for almost $55 billion.

According to the July 15th edition of *Marketplace*, and I am going to quote here, "What's going on now is a feeding frenzy.... Every investment banker now has a slide deck that they're taking to any possible company and saying, 'You have to do a corporate inversion now because, if you don't, your competitors will.'"

The Congress has been aware of the inversion virus for a long time. In fact, it passed legislation purporting to solve the problem a decade ago. But the underlying sickness continues to gnaw away at our economy with increasing intensity.

The American tax code is an anticompetitive mess. Accountants, lawyers, and fast-buck artists looking for tax shelters feed off it. This mess is driving American investment dollars overseas, and, according to the Joint Committee on Taxation,* it is costing American taxpayers billions.

On a bipartisan basis, the Finance Committee must respond now. First, let us work together, colleagues, to immediately cool down the inversion fever. The inversion loophole needs to be plugged now. Second, let us use the space created by these immediate steps to apply the indisputable, ultimate cure: comprehensive tax reform.

Now, I have 9 long years of sweat equity in the cause of tax reform. With former Senator Gregg and current Senators Begich and Coats, we have produced what still is the Senate's only bipartisan Federal income tax overhaul in almost 30 years. Now, I would be the first to say that Senators here have differing views about how to go about enacting tax reform. Let us, however, recognize that what really counts is that the Finance Committee is not back here once again discussing inversions a decade from now.

Comprehensive tax reform has to happen soon. The outbreak of inversions shows that, without curing the disease once and for all, the illness is going to keep plaguing the American economy. It is going to get tougher to create those good-wage, red, white, and blue American jobs. Our tax base is going to keep eroding. Cash piles trapped overseas will grow. Investment will be driven elsewhere.

Now, the Finance Committee invited a number of CEOs from the inverting companies to join our discussion today. None accepted our invitation. I hope that these executives will soon change their minds and be willing to answer questions that Finance Committee members have about this issue.

The fact is, without immediate comprehensive tax reform, an antidote to the inversion virus is needed now to protect the American economy. This wave of inversions may be good for shareholders and investment bankers and private equity firms, yet the barrage is bad for America. America's free enterprise system is at its best when there is a level playing field, and inversions bestow tax favors on some parties that further distort the free market.

Absent tax reform being enacted immediately, colleagues, what happens if the inversion virus leads to 20 more inversions over this summer? Many inversions to this point have happened in the medical field, but the *Wall Street Journal* just reported that there is evidence of inversions spreading to manufacturing and retail.

How many more infections can America's economic body endure? Global markets are expanding. Stockpiles of cash sitting overseas grow at record levels. Foreign competitors get more aggressive in chomping at the bit to get a deal on the backs of the American tax-

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*For more information, *see also,* "Present Law and Background Related to Proposals to Reform the Taxation of Income of Multinational Enterprises," Joint Committee on Taxation staff report, July 21, 2014 (JCX–90–14), *https://www.jct.gov/publications.html?func=startdown&id=4656K.*

payer. The time for action is now. Our committee needs to move on a bipartisan basis to close the loopholes that are fueling the growth of the inversion virus. Then the Finance Committee needs to cure the disease once and for all with comprehensive tax reform.

I just want all colleagues to know that I am going to be working with each of you on a bipartisan basis to accomplish both of these tasks.

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

The CHAIRMAN. Let me recognize my colleague and friend, Senator Hatch.

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

Senator HATCH. Thank you, Mr. Chairman.

I appreciate you holding today's hearing. I think we can all agree that addressing the shortcomings of our international tax system is a critical step on the road toward comprehensive tax reform. And, as we consider reforms to our tax code, our primary goals should be to make the U.S. a better place to do business and to allow American companies to more effectively compete with their foreign counterparts in the world marketplace.

Sadly, when it comes to our international tax system, much of the attention gets placed elsewhere. For example, in 2013 the OECD launched its Base Erosion and Profit-Shifting, or BEPS, project. While we appreciate the OECD's efforts at bringing tax authorities together to discuss and work through issues, many of us have expressed concern that the BEPS project could be used by other countries as a way to increase taxes on American taxpayers.

The issues under negotiation with the BEPS project are complex and can have far-reaching and negative consequences. And, while I think we should be willing to work through these issues until an international consensus is reached, we should not be rushed into accepting a bad deal just for the sake of reaching an agreement.

I think we are right to expect that the Treasury Department will aggressively represent American employers and their workers in the BEPS negotiations, while responsibly consulting with Congress as the discussions proceed. Hopefully, in the end, the focus of these discussions will return to base erosion principals instead of ways foreign countries can raid the American Treasury or American businesses.

Of course, while the BEPS negotiations are important, the most high-profile international tax issue today happens to be corporate inversions. It seems that almost every day we are hearing about a U.S. multinational opting to invert to a foreign jurisdiction. As I have said publicly on multiple occasions, I am greatly concerned about these corporate inversions. Ultimately, the best way to solve this problem will be to reform our corporate and international tax system in a manner that will make our multinationals competitive against their foreign counterparts. That will mean, among other things, a significant reduction in the corporate tax rate and major changes to make our international tax system more competitive.

Over the past few months, we have seen a handful of legislative proposals to address the issue of inversions. Most of them are puni-

tive and retroactive. Rather than incentivizing American companies to remain in the U.S., these bills would build walls around U.S. corporations in order to keep them from inverting. I think that is not only stupid, I think it is going to result in consequences that nobody wants.

This approach, in my view, completely misses the mark. While it may put a stop to traditional inversions, it could actually lead to more reverse acquisition inversions, as our U.S. multinationals would under this approach become more attractive acquisition targets for foreign corporations. Whether it is traditional corporate acquisition inversion or a reverse acquisition inversion, the result is the same: continued stripping of the U.S. tax base.

In fact, the approach in the proposed anti-inversion legislation is so misguided it reminds me of an old joke. A drunk is looking for something under a street light. A police officer walks up to him and asks what is he looking for. The drunk says, "My keys." The police officer helps the drunk look for a few minutes without success and finally asks, "Did you lose your keys here?" The drunk says, "No, I lost them across the street." The officer responds, "Then why are you looking for them on this side of the street?" The drunk replies, "Because the light is better over here."

Once again, the ultimate answer to this problem—and the only way to completely address the issue of inversions—is to reform our tax code. However, as I have also said publicly, there may be steps that Congress can take to at least partially address this issue in the interim. And, while I do not support the anti-inversion bills we have seen thus far, I personally am open to considering alternative approaches, although I do have a few stipulations as to what proposals I will consider.

For example, whatever approach we take, it should not be retroactive or punitive, and it should be revenue-neutral. Our approach should move us toward or at last not away from a territorial tax system and should not enhance the bias to foreign acquisitions. Most importantly, it should not impede our overall progress toward comprehensive tax reform. Toward that end, it should not be inconsistent with our House colleagues' approach.

I think there is a growing chorus out there among some of my friends on the other side of the aisle to use corporate inversions as a political wedge issue in this election year. In fact, I was recently the recipient of a very politically toned letter from Treasury Secretary Lew on this issue. I hope that is not the direction we take. If we actually want to accomplish something on this issue, we are going to have to work together.

As you can see, Mr. Chairman, we have a lot to discuss today.

I want to thank you for holding this important hearing, and I look forward to hearing from this very distinguished panel.

The CHAIRMAN. Thank you very much, Senator Hatch.

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

The CHAIRMAN. Let me just reiterate that I am very much interested in working with you and our colleagues on both sides of the aisle to address both of these issues: the immediate challenge we are facing with this growing inversion virus and then, of course,

the ultimate cure, which is comprehensive tax reform. So I look forward to working with you and our colleagues.

We now have six witnesses. Our first witness is Mr. Robert Stack, who is the Deputy Assistant Secretary for International Tax Affairs at the Treasury Department.

Our next witness will be Mr. Pascal Saint-Amans, director of the Centre for Tax Policy and Administration at the Organisation for Economic Co-operation and Development.

Our third witness will be Dr. Mihir A. Desai, who is professor of finance at Harvard Business School and a professor of law at Harvard.

Our fourth witness will be Dr. Peter Merrill, who is the director of the National Economics and Statistics Group at PricewaterhouseCoopers.

Our fifth witness will be Dr. Leslie Robinson, who is an associate professor of business administration at the Tuck School of Business at Dartmouth.

Our final witness will be Mr. Allan Sloan, who is the senior editor at large for *Fortune* magazine.

Our thanks to all of you for coming. It is our custom that your prepared statements will be made a part of the hearing record in their entirety, and, if you could use your 5 minutes to summarize, that would be very helpful.

I know Senators have many questions. We are going to have some votes at 10:45. So this is going to be a bit of a juggling act, and we will try to handle this as well as the chaotic Senate schedule allows.

So, Mr. Stack, welcome.

STATEMENT OF ROBERT B. STACK, DEPUTY ASSISTANT SECRETARY FOR INTERNATIONAL TAX AFFAIRS, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. STACK. Thank you, Chairman Wyden, Ranking Member Hatch, and distinguished members of the committee. I appreciate the opportunity to appear today to discuss these important international tax issues to which your committee has already devoted substantial effort.

I would like to begin by describing the work we are doing in the G–20/OECD Base Erosion and Profit-Shifting, or BEPS, project and then link that discussion to a consideration of the need for international tax reform, as well as measures outlined in the administration's fiscal year 2015 budget proposals to address U.S. base stripping, including through so-called inversion transactions.

In June 2012, at the G–20 Summit in Las Cabos, Mexico, the leaders of the world's largest economies identified as a significant concern the ability of multinational companies to reduce their tax bills in high-tax countries by shifting income into low- and no-tax jurisdictions. The result was the G–20/OECD BEPS project and the BEPS action plan endorsed by G–20 leaders last September in Saint Petersburg.

The BEPS action plan outlines 15 specific areas where governments need to work to change the tax rules that encourage companies to shift their income at the expense of the global tax base and our own tax base. The BEPS project is expected to release its first

set of recommendations this fall and is set to conclude its work with final recommendations at the end of 2015.

The United States has a great deal at stake in the BEPS project and a strong interest in its success. Our active participation is crucial to protecting our own tax base from stripping by multinational companies. Because the United States provides a foreign tax credit to U.S. companies for taxes they pay overseas, the United States also has a strong interest in rules that enjoy a broad international consensus. In addition, as home of some of the world's most successful and vibrant multinationals, we have a stake in ensuring that companies and countries play by tax rules that are clear and administrable and that companies can avoid unrelieved double taxation, as well as time-consuming, expensive tax disputes. Failure in the BEPS project could well result in countries taking unilateral, inconsistent actions, thereby increasing double taxation, the cost to the Treasury, and the number and expense of tax disputes.

I am happy to report that the OECD BEPS project has had a promising beginning, and there are areas where commendable work is being done to resolve gaps in existing international rules. I have outlined those areas in my written submission. As the work moves into 2015, there is more that can be achieved and, also, several areas where we must guard against bad outcomes. And echoing Senator Hatch, those bad outcomes would include international norms that increase tax disputes because they are vague and easily manipulated by tax authorities, or international norms that could erode the U.S. tax base or increase double taxation.

The United States needs to remain deeply engaged in moving the BEPS project to a successful conclusion between now and the end of 2015. While the international discussions over BEPS are ongoing, it is worth acknowledging steps the United States could take today to reform our own tax system to improve competitiveness, secure our tax base, and reduce incentives for profit-shifting by U.S. firms.

As the President has proposed, we should reform our business tax system by reducing the rate, broadening the base, and imposing a minimum tax on foreign earnings. But such reform would only be a start, because, even with lower U.S. rates, U.S. multinationals would continue to aggressively seek ways to lower their tax bills by shifting income out of the United States.

So what tools do we have at our disposal? The administration's fiscal year 2015 budget contains a series of common-sense proposals to protect our U.S. tax base which can be enacted as part of reform or in the context of our current system. They are outlined in some detail in our budget and in my written testimony, but let me highlight just two here.

One proposal would strengthen our interest-stripping rules and level the playing field by limiting the ability of U.S. subsidiaries of a foreign multinational to deduct a disproportionate amount of the group's global interest expense to the United States. It is especially disconcerting to observe that among the foreign multinationals that can most aggressively take advantage of the deficiencies in our interest-stripping rules are so-called inverted companies—that is, foreign-parented companies that were previously U.S.-parented.

A second proposal in our budget would deal with inversions. As underscored by Secretary Lew's July 15th letter to Congress, I want to emphasize the serious need for the United States to directly address the potential loss of Federal tax revenue from corporate inversion transactions and the need to enact our budget proposal or a similar one aimed at curbing them.

Once companies invert, there is a permanent loss to the U.S. income tax base, since it is safe to assume these companies are not coming back to the United States. These inversion transactions are on the increase and, indeed, we are aware of many more inversions in the works right now. Letting our corporate tax base erode through inversions will worsen our fiscal challenges over the coming years and will reward countries that practice race-to-the-bottom tax competition in an effort to lure away our large U.S. multinationals.

As the Secretary indicated in his June 15 letter, Congress should pass anti-inversion legislation immediately with an effective date of May 2014.

Thank you for the opportunity to speak to you today. I look forward to answering your questions.

The CHAIRMAN. Thank you very much, Mr. Stack. That is very helpful.

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

The CHAIRMAN. Our next witness will be Mr. Pascal Saint-Amans. We welcome you.

STATEMENT OF PASCAL SAINT-AMANS, DIRECTOR, CENTRE FOR TAX POLICY AND ADMINISTRATION, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, PARIS, FRANCE

Mr. SAINT-AMANS. Thank you, Mr. Chairman. Chairman Wyden, Ranking Member Hatch, distinguished members of the committee, thank you for the opportunity to testify today here.

The OECD was founded in the aftermath of World War II under the leadership of the United States. It is a country-driven organization with 34 countries, the U.S. being the largest member and playing a key role, and it works by consensus. It does a lot of work on tax, and in the tax area we do consult extensively.

On the project related to Base Erosion and Profit-Shifting, we have consulted civil society, businesses, all stakeholders. In this project, we have issued a number of discussion drafts. More than 3,500 pages of comments have been received and have been taken into account. We have conducted five public consultations, as well as webcasts which have been looked at by more than 10,000 viewers.

In the area of tax, the OECD facilitates cooperation in tax administration between its member countries to eliminate double taxation. As you know, taxation is at the core of countries' sovereignty, and each country is free to set up its corporate tax system the way it chooses, but, as a result, there are risks of double taxation which are not conducive to cross-border investment.

Since the 1920s, a common set of standards has been agreed to, and the OECD has abated this work since the 1950s. In particular, we have come up with a model tax convention and transfer-pricing

guidelines. These rules have worked well, but they have also not kept pace with the economic changes and globalization. As a result, they have been good at eliminating double taxation, but they have also facilitated unintended double non-taxation. This is an issue for most governments across the world for many reasons.

Low taxation in itself is not a problem. On the contrary, the OECD favors low corporate tax, low rates, and broad bases. But this is an issue because, as long as countries decide to have a corporate income tax, the corporate income tax needs to be paid by all taxpayers. And there is a need now to, one, make sure that the rules make sense. The current rules are no longer adapted to globalization, and there is the gain through artificial settings.

There is a divorce now between the location of the activity and the location of the profits, which can be booked in a jurisdiction where absolutely nothing is happening. As a result, the sovereign right of countries is undermined. This is a global issue; this is not an issue targeted to U.S. companies. U.S. companies only account for less than a quarter of the Fortune Global 500 companies. So it is a global issue concerning U.S. and non-U.S. companies.

Second, there is a need to level the playing field. An uneven playing field between companies is not conducive to the right location of capital. Companies operating at the domestic level are at a competitive disadvantage because they cannot use the loopholes in the international tax framework.

Three, there is a need to reduce uncertainty. Uncertainty is bad for companies, it is bad for the investment climate, and there is increased uncertainty because these rules do not make a lot of sense.

A number of tax administrations are trying to dispute the position of companies that are legal. The tax administrations are frustrated, and a number of countries are walking away from the consensus, from the common interpretation of the rules, and that results in uncoordinated unilateral measures to protect their tax base, but that increases uncertainty. Therefore, we need to address these serious risks for businesses.

The response from governments has taken place in the context of the G–20, which has been called on to address the issue of Base Erosion and Profit-Shifting. We have brought all the G–20 and the OECD countries onto an equal footing to find ways to address this issue of the tax framework by consensus in 2 years' time so that principles can be agreed upon quickly to reduce the risk of uncertainty. We need a principled approach and a cost-effective approach to limit the compliance burden for companies and to reduce controversy.

This is not a revenue-grabbing exercise and should not be a revenue-grabbing exercise, but a useful consensual exercise for the common principles to be more accepted by ensuring consistency in the cross-border environment, increasing substance requirements, and promoting transparency. The objectives are to secure the consensus and, therefore, reduce uncertainty and improve the way we can solve disputes.

We have come up with an action plan of 15 measures which are described in my written testimony. Some of them are about neutralizing hybrid mismatches, reducing the abuse of tax treaties, or improving transfer-pricing rules.

As a conclusion, I would say that the issue of Base Erosion and Profit-Shifting is widely shared across countries, and, here in the U.S. in particular, we are aware that you are planning to address the U.S. tax system, and we hope that the work we are doing at the international level, with your support and the engagement of the U.S. Treasury, can be useful to promote growth and jobs here in the U.S. by fixing some of the issues of the U.S. tax system. The work of the OECD in that context, we hope, is particularly timely, and we hope that it will inform your debate.

We, of course, are fully available to respond to your questions and further assist you.

The CHAIRMAN. Thank you, Mr. Saint-Amans.

[The prepared statement of Mr. Saint-Amans appears in the appendix.]

The CHAIRMAN. Let us now go to Dr. Desai. Welcome.

STATEMENT OF MIHIR A. DESAI, Ph.D., MIZUHO FINANCIAL GROUP PROFESSOR OF FINANCE, AND PROFESSOR OF LAW, HARVARD UNIVERSITY, CAMBRIDGE, MA

Dr. DESAI. Thank you. Chairman Wyden, Ranking Member Hatch, and members of the committee, it is a pleasure to appear before you today to discuss international tax reform. I am a professor of finance at Harvard Business School and a professor of law at Harvard Law School.

Recent merger transactions highlight long-simmering problems in the U.S. corporate tax code, particularly with respect to its international provisions. My comments attempt to outline briefly the origins of these transactions, the range of alternative solutions, guidelines for evaluating alternative reforms, and some reforms that should be avoided.

The last 12 months have witnessed a remarkable wave of merger transactions that facilitate the expatriation of U.S. corporations. Such transactions reflect the effects of policies and of the changing structure of multinational firms. From a policy perspective, the transactions highlight the increasing costs of employing a worldwide tax regime, when most other large capital-exporting countries no longer maintain such regimes, and a corporate tax rate that stands well above rates employed by other OECD countries. From a firm point of view, the transactions highlight the increased mobility of activity in today's economy, the growing de-centering of firms whereby headquarter locations have been split up and reallocated around the world, and the growing importance of non-U.S. markets for U.S. firms. Rather than questioning the loyalties of executives, it is critical to understand these underlying structural and secular forces.

While these transactions naturally attract growing attention, inversions are merely the most visible manifestation of these developments. In addition to inversions, these forces are giving rise to incorporation decisions by entrepreneurs that anticipate the burdens of being a U.S. corporation, merger patterns that reflect the penalties of being domiciled in the United States and the importance of offshore cash for U.S. corporations, investment patterns by U.S. and foreign companies and profit-shifting activities that are not

value-creating, and the consequent negative impact of all of these distortions on the U.S. labor force.

While it is tempting to limit attention to the more sensational effects and characterize them as tax-avoiding paper-shuffling, this would effectively be missing the forest for the trees. Reforms should be focused exclusively on advancing U.S. welfare, with particular attention on reforms that will improve American wages. These goals are mistakenly thought to be achieved by limiting the foreign activities of U.S. firms, as foreign activities can be viewed as diverting economic activity away from the U.S.

In fact, the evidence suggests the opposite. As firms expand globally, they also expand domestically. Indeed, American welfare can be advanced by ensuring that investments in the U.S. and abroad are owned by the most productive owner and that American firms flourish abroad, a goal advanced by the territorial regime that has now been adopted by most comparable countries.

While the developments described above have crystallized the case for international tax reform, with an increasing attention on switching to a territorial regime, there is still tremendous variation in proposals for territorial regimes. Some proposals, including those with an alternative minimum tax on foreign profits, are tantamount to a back-door worldwide regime with even more complexity than today's system.

Revenue consideration should figure largely in tax reform today, but should be accorded secondary status in this setting given the very limited revenue provided by current international tax rules and the remarkable complexity and distortions required to secure any such revenue. Additionally, it is not clear that policies should prioritize revenue considerations in other countries.

More broadly, the corporate tax is ripe for reform. In addition to international reforms and a rate reduction, reform should address the two other major developments in the corporate tax arena: the growing prominence of non-C corporate business income and the disjunction between profits reported to capital markets and to tax authorities.

A useful blueprint for reform would include moving to a territorial regime, unencumbered by excessive complexity; considerably lower rates in the range of 18 percent to 20 percent; better alignment of book and tax reporting of corporate profits; and by some taxation of non-C corporation business income. This combination of reforms has the potential of addressing significant changes in the global economy in a revenue-neutral way that will advance U.S. welfare. More fundamental reforms, including those that replace the corporate tax with a consumption tax are preferred, if feasible.

Legislation that is narrowly focused on preventing inversions or specific transactions runs the risk of being counterproductive. These transactions are nested in a broader set of corporate decisions leading to several unintended consequences.

For example, rules that increase the required size of a foreign target to ensure the tax benefits of an inversion can deter these transactions, but can also lead to more substantive transactions. More substantive transactions are likely to involve the loss of U.S. activity as American firms will be paired with larger foreign acquirers that demand the relocation of more activity abroad, in-

cluding headquarters functions. Similarly, specific regulations targeted at inverting firms may also lead to foreign firms leading some transactions to avoid those regulations.

While it is tempting to address specific transactions in advance or in lieu of broader reform, it is useful to recall that the last wave of anti-inversion legislation likely spurred these more significant recent transactions and reduced the prospect of reform in these intervening years.

Members of the committee, I admire your foresight in addressing these issues. These highly visible manifestations of the structural problems in the corporate tax provide a significant opportunity for genuine reform.

I would be delighted to answer any questions.

The CHAIRMAN. Thank you very much, Professor.

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

The CHAIRMAN. We now welcome Dr. Peter Merrill and look forward to your comments.

STATEMENT OF PETER R. MERRILL, Ph.D., DIRECTOR, NATIONAL ECONOMICS AND STATISTICS GROUP, PRICEWATERHOUSECOOPERS, WASHINGTON, DC

Dr. MERRILL. Chairman Wyden, Ranking Member Hatch, members of the committee, thank you for the opportunity to testify today.

My name is Peter Merrill. I am a principal with PricewaterhouseCoopers. I hold a Ph.D. in economics. The focus of my practice is economic effects of tax policy. I am appearing today on my own behalf. The views I express are my own.

I have been asked to compare how the U.S. rules for tax on international income compare with the rules of other countries. In my testimony, I will focus on two features of the U.S. corporate tax system that fall far outside international norms: the high corporate rate and the worldwide system of taxation. These features of the U.S. tax system make it more difficult for U.S. companies to compete in global markets.

U.S. multinationals face ever-growing competition from abroad. Over the last 15 years, the number of U.S. companies in the Forbes Global Top 500 list has dropped by a third from 200 to 135. Loss of global market share by U.S. companies is due to a variety of factors. The out-of-step U.S. tax system is seen by many as a hindrance rather than a help.

The top U.S. corporate statutory rate, including State tax, is 39.1 percent. This is the highest rate among major economies, more than 14 points above the average for the other OECD countries, and almost 10 points higher than the average for the other G–7 countries.

After the Tax Reform Act of 1986, the U.S. had a relatively low corporate tax rate. However, since then, the other OECD countries have reduced their rates by a collective average of 19 points, while the U.S. Federal corporate tax rate was increased in 1993 to 35 percent, where it has remained since. And, while it is widely recognized that our statutory corporate tax rate is high, studies show our effective tax rate also is high by international standards.

In addition, the U.S. has a worldwide system under which foreign income earned by foreign subsidiaries of U.S. companies is subject to U.S. tax when received by the U.S. parent. Unlike the United States, all other G–7 countries and 28 of the other 33 OECD countries have adopted territorial tax systems.

As a result of these trends, U.S. multinationals increasingly face foreign competitors that are taxed under territorial systems. Within the OECD, 93 percent of the foreign competitors on the Global Top 500 list were based in countries that use territorial tax structures. The significance of this is that foreign competitors of U.S. multinationals can invest their foreign profits at home without an added home country tax.

Turning to recent reforms, in 2009, three OECD countries adopted territorial tax systems: the U.K., Japan, and New Zealand. The U.K. adoption of a territorial system was the first step in a multiyear reform package which also included lowering the corporate income tax rate from 28 percent to 21, with a further reduction to 20 percent scheduled next year.

The British government articulated the rationale for these reforms as follows, quote: "The government wants to send out the signal loud and clear that Britain is open for business. In recent years, too many businesses have left the U.K. amid concerns about tax competitiveness. It's time to reverse this trend. That is why the government is prioritizing corporate tax reform."

Japan's adoption of a 95-percent dividend exemption system had been advocated by the Ministry of Economy, Trade, and Industry to encourage a repatriation of foreign earnings. In addition, since 2012, Japan's combined corporate tax rate has been cut 5 points to 35.6 percent, and Prime Minister Abe's cabinet has recently approved a phased reduction to below 30 percent.

Also in 2009, New Zealand switched back to a territorial tax system after a 21-year period in which it had operated under a worldwide system without deferral, thereby bringing New Zealand's tax system back in alignment with international norms.

In closing, the combination of our high corporate rate and worldwide system creates an incentive for U.S. multinationals to reinvest foreign earnings outside the United States. According to a recent study co-authored by Laura D'Andrea Tyson, former chair of President Clinton's Council of Economic Advisers, switching to a territorial system, even without reducing the U.S. tax rate, would, on an ongoing basis, increase annual repatriations by over $100 billion a year and create 150,000 new jobs per year.

Reforming the U.S. system to align with international norms would enhance the ability of U.S. companies to compete abroad and create jobs at home.

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

The CHAIRMAN. Dr. Merrill, thank you very much.

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

The CHAIRMAN. Dr. Robinson?

STATEMENT OF LESLIE ROBINSON, Ph.D., ASSOCIATE PROFESSOR OF BUSINESS ADMINISTRATION, TUCK SCHOOL OF BUSINESS, DARTMOUTH COLLEGE, HANOVER, NH

Dr. ROBINSON. Chairman Wyden, Ranking Member Hatch, and distinguished members of the committee, it is an honor to appear today to testify on the important topic of international corporate taxation.

I am an associate professor at the Tuck School of Business at Dartmouth College. I teach financial accounting and taxation, and my research centers on multinational corporations.

It is clear that reform is needed. The international system is one of the most technically complex areas of the U.S. tax code, but raises little revenue. My testimony summarizes, in my view, what the academic literatures in economics, finance, and accounting collectively offer in terms of evaluating the range of alternative solutions.

The top U.S. Federal corporate income tax rate is 35 percent. This is the highest rate of all OECD countries and far exceeds the 23.5-percent average.

Proponents of adopting a territorial system in the U.S. often cite competitiveness issues. A common assertion is that U.S. firms are at a competitive disadvantage because they face larger tax burdens operating under a worldwide system than their competitors operating under territorial systems. Generally speaking, this is because U.S. firms face a high home country tax on foreign profits, whereas their competitors face no home country tax on foreign profits.

Yet, no country operates either a pure worldwide or a pure territorial system. When loopholes exist that facilitate the indefinite deferral of the home country tax on foreign profits under a worldwide system, the pendulum swings back to a pure territorial system. Likewise, as eligibility for the foreign dividend exemption under a territorial system is appropriately restricted, the pendulum swings back to a pure worldwide system. This means it is possible for a well-designed territorial system to be at least as, if not more, burdensome than the poorly designed U.S. worldwide system that we have today.

Evidence suggests that U.S. firms are adept at indefinite deferral. One study finds that financially unconstrained U.S. firms shift as much income as firms operating under territorial systems. Also, there is no evidence that the global tax burden of a firm depends on how foreign profits are taxed in the home country of its parent.

There is some evidence that certain location decisions differentially impact firms' global tax burdens depending on the home country. For example, a firm resident in home country X realizes a larger reduction in its global tax burden by operating in source country A than a firm resident in home country Y, also operating in source country A, whereas the opposite may be true for these two firms when operating in source country B. This suggests that the burden of an international tax system depends significantly on anti-abuse provisions that selectively narrow or broaden the tax base with respect to certain types of income earned in specific locations rather than whether the tax system is worldwide versus territorial.

Similarly, other research shows that decisions about headquarter relocations, tax haven operations, and ownership structures depend on the existence and strength of anti-abuse legislation. Maintaining our current worldwide system with deferral, or introducing a territorial system, leaves the need for anti-abuse provisions that are difficult to administer and enforce.

Another consideration is eliminating implicit costs. Avoiding repatriation, which triggers the home country tax on foreign profits under our current system, prompts firms to allocate economic resources in an inefficient manner. Examples include making value-decreasing foreign acquisitions or the inability to respond to domestic investment opportunities. Maintaining a worldwide system but eliminating deferral would greatly reduce these costs. Adopting a territorial system may not.

Firms operating under territorial systems face implicit costs when attempting to circumvent anti-abuse legislation, which serves as a backstop that otherwise imposes a home country tax on foreign profits that have not been subject to a robust tax system abroad. To my knowledge, there is no estimate of these costs, but my expectation is that they would be greater than under a worldwide system without deferral.

My overall assessment is that our international tax system can be adequately reformed. We need not entirely abandon our current system in favor of a fundamentally different system. Limiting deferral and lowering the statutory rate would generally reduce incentives to shift income, eliminate the implicit costs of avoiding repatriation, and reduce complexity and uncertainty for firms.

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

The CHAIRMAN. Dr. Robinson, thank you.

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

The CHAIRMAN. Our final witness is Mr. Allan Sloan.

STATEMENT OF ALLAN SLOAN, SENIOR EDITOR AT LARGE, *FORTUNE* MAGAZINE, NEW YORK, NY

Mr. SLOAN. Chairman Wyden, Ranking Member Hatch, members of the committee, I am flattered to be here, and I am honored and especially pleased to be hitting cleanup, which is my normal role in journalism.

Before I proceed, I have to say that I am speaking for myself alone. I am not speaking for *Fortune* magazine, my employer. I am not speaking for *Fortune's* owner, Time, Inc. I am not speaking for the *Washington Post*, which has run my material for more than 20 years.

I, like Senator Hatch, am appalled to see that inversions are becoming a partisan wedge issue. I do not like this. Now, at *Fortune* several weeks ago, we put an American flag on the cover. We called inversion positively un-American, but we were not being partisan. We were being Americans.

Fortune is divided between Republicans and Democrats. We are acting collectively, not in the social sense, but in the societal sense. This is not a Republican problem. It is not a Democratic problem. It is a problem for everybody. It is for all of us. And, if you do not stop inversions now with some sort of band-aid, by the time you get

around to doing it, there will be tens of billions of dollars of taxes that will have been lost and will never be recovered.

Now, I have been writing about inversions and researching them for months, and I have heard the argument that, well, inversions are a symptom; you cannot deal with them unless you deal with the whole problem, and, if you deal with the whole problem, you deal with inversions.

Well, I happen to have a daughter who is an emergency room doctor, and, when someone shows up at the ER bleeding, the first thing they do is they put on a tourniquet, they stabilize the patient, and then they try to deal with the underlying problem. They do not say, "Well, gee, we have to deal with the underlying problem first."

You have an emergency here. It may not seem that way, but you have the beginning of, I think, a massive flood of inversions unless you stop this. Now, I know very little about tax, I know very little about law, but I do know something about Wall Street and manias. And I look at this, this inversion thing, and it reminds me of the dot-com bubble, where people did things that were just crazy, but everyone was doing them. And all these people with degrees and a lot of money and fancy suits were whispering in your ear, "Well, you have to do this," so people did it, and it was just a disaster.

I have written about Wall Street for large parts of my career, and they gave us the Internet bubble, they gave us toxic sub-prime securities, and now they are giving us inversions. It is a product. It is the latest thing that is good for Wall Street.

There is this whole rationale that surrounds it, but I do not think it is good for society. It just does not work. And I do not pretend to understand anything about the international tax system, except that I do not understand it. I am a simple person; I am a recovering English major; I am not a legal person. I mean, if I were you—which will probably never happen, because you have to be nice to people, and I do not do that well—I would adopt one of the Levin bills. And Sandy Levin will probably be angry with me, but I would adopt the Carl Levin version, the one that has an expiration in it, because, if you can just stop these things for a while, you can buy time to fix the system. If you sit around and say, "Well, in a few years we will do this, it will all be fine," by then, the patient will have lost so much blood, it is going to be very, very hard to do anything remotely revenue-neutral in a tax reform.

The other complaint, again, I have heard endlessly is, oh, it is so unfair to make this May 8th, which is the date in the Levin transaction, which also, I believe, happens to be the date that Senator Wyden published his op-ed in the *Wall Street Journal*, which messed me up because he wrote what I was going to write. So I was furious, but I came here anyway. [Laughter.]

So the May 8th deadline was known. If you look at the contracts of some of these deals, there are provisions in there in case the anti-inversion stuff changes. So it is not as if this is unprecedented or unfair. I mean, everybody knows this. You changed the rules retroactively in 2004, and, as best I could tell, there were no earthquakes or brimstone or fire from the sky.

So, please, if you can act like Americans, which I know you can, instead of squabbling, and you get the Senate to go along and deal

with the House, we can put on the tourniquet, we can stop the patient from bleeding out, then we can fix the system, and that is what I hope you will do.

Thank you for your time. I am happy to answer any questions.

The CHAIRMAN. Mr. Sloan, thank you.

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

The CHAIRMAN. Colleagues, we will stick to 5 minute rounds, and we will get as many members in as we can.

I am going to ask one question of all of you. I am going to start with you, Mr. Stack.

I have been about as big a flag-waver for comprehensive tax reform as anybody around here, and I am going to continue to keep pushing for bipartisan tax reform as aggressively as possible. The reality is, nobody believes that you can get comprehensive tax reform passed this year. And, with the investment bankers in that inversion feeding frenzy, there may be 25 more inversions during that time.

So I am just going to go down the row here this morning and ask each of you: will that be a bad thing for America?

Mr. Stack?

Mr. STACK. Yes, Senator. That is a bad thing for America. That money is not just a one-time hit. That is a hit we take the year a company inverts, and it is a cost we incur throughout the 10 years of a budget window.

In addition, I just want to add, companies not only reduce their U.S. tax bill on day 1 when they invert, but they also adopt techniques to keep stripping out of the U.S. for each of the next 10 years as well. So we get hit with a double-whammy. It has a long-term effect. It is permanent. And so the cost of waiting, I think, is very high.

The CHAIRMAN. Mr. Saint-Amans?

Mr. SAINT-AMANS. I also think it is bad. It is a symptom of, indeed, a disease. Either you trap cash growth, which compels these companies to reinvest in the U.S.—and I think that is one of the challenges of the U.S. tax code today—or the result is inversions, meaning that you lose the control of these companies which invert in another country, and that is a loss for the U.S.

So overall it is bad, and it is a symptom of an issue in the tax code.

The CHAIRMAN. Dr. Desai?

Dr. DESAI. I think in the short run, it will feel good to do something. I think in the long run, it is not clear whether it will help the country, and I think the reason for that is it will have all these unintended consequences.

I think there are a lot of medical analogies that are being thrown around today, which I think are helpful. Rather than a tourniquet, we might have a bleeding patient, and these things might just anesthetize the patient.

The CHAIRMAN. So I think I am going to take that as a "no."

Dr. Merrill?

Dr. MERRILL. On this one, I very much agree with the comments of Pascal, which is that these transactions are a symptom of a very broken system.

Certainly I can understand the desire to put on the tourniquet, but, if you leave it on too long without resolving the underlying problem, you get gangrene. So I can understand the desire to do something in the short term, but there is the risk of unintended consequences. So fixing the system is ultimately the only real answer to stop the problem.

The CHAIRMAN. So you are in the middle of all this. We will put you down in that way.

My concern about that position, for both of you, is that tax reform is moving slowly, but inversions are moving rapidly. And that is a prescription for chaos, and that is why I want to see us address both of the issues in a bipartisan way.

Dr. Robinson?

Dr. ROBINSON. I do not have any data on this, but I do remember reading about inversions, companies leaving other countries, such as the U.K., and then, when the tax system is reformed, they have come back again. So I do not have any data on that, but my sense is that these companies may not be lost forever.

I also think, as far as I understand inversion transactions, it only affects the tax on the future income. It does not impact the tax on the accumulated earnings. So, in that respect, I do not think we run the risk of waiting to solve the real problem and sort of letting the markets play out as they do.

The CHAIRMAN. You think it would be a bad thing.

Mr. Sloan?

Mr. SLOAN. I think letting 25 companies invert and then fixing the tax code is a recipe for disaster. I know a little bit about how inversion works, and Mr. Stack is absolutely right that the problem is not so much what happens to foreign profits, but that it becomes much, much easier to move money, to earnings-strip out of the United States, and you have to stop this.

And, at some point when we are not on the clock, I will bandy medical analogies with my colleagues, but this is not the time. So I will just let that go, and we will deal with that later.

The CHAIRMAN. Let me see if I can get one other question in, and I will make this for you, Dr. Desai, given what you said.

Let us take Walgreen's. Walgreen's is an American icon. It is located in the heart of our country, and they are talking about inverting right now.

Should Americans be concerned about the prospect that, if Walgreen's inverts, they will strip profits out of the United States and put them into tax havens? Is that something Americans ought to be concerned about?

Dr. DESAI. Without question, absolutely. There is no question about that. The secondary question is, what we do about it, but absolutely we should be concerned about that.

The CHAIRMAN. Very good.

Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

This question is for Dr. Robinson and Dr. Merrill.

Dr. Robinson, in your written testimony, you write that, quote, "There is no evidence to support the assertion that U.S. multinational corporations are at a competitive disadvantage because they face larger corporate tax burdens than their competitors under

a worldwide rather than territorial tax system." You then cite three studies in support of your statement, including one study that finds that U.S. multinationals have effective tax rates that are 4 percent lower than multinationals based in the European Union. But are there not studies that show that U.S. multinationals are subject to higher effective tax rates than foreign-based multinationals? That seems to indicate that the U.S.—well, let me put it this way.

Let me give you an example. Dr. Merrill cites numerous studies showing that in his written testimony. The Congressional Research Service released a report earlier this year studying effective tax rates. In one part of the report, CRS notes that the effective corporate tax rate in the United States is 27.1 percent as compared to the rest of the OECD countries that have an unweighted average of 23.3 percent.

Now, that seems to indicate that the U.S. corporate effective tax rate is almost 4 percentage points higher, not lower, than the other OECD countries, at least by one measure. Now, would you please comment on this?

I would also like Dr. Merrill to comment on the effective tax rates faced by U.S. multinationals as compared to foreign-based multinationals.

Dr. ROBINSON. Right. So the studies that I quote in my written testimony measure accounting effective tax rates from firms' financial statements. So I am not sure what Dr. Merrill is going to follow up with in terms of his study. It may be a difference in how tax rates are measured.

But in the accounting literature, there have been a number of studies, published and unpublished, that have searched extensively for differences in the accounting effective tax rates of firms resident in worldwide versus territorial countries that also looked at, as I mentioned, the effect on these effective tax rates of specific location decisions. And there is not, at least to my knowledge, in the accounting literature, as measured by an accounting effective tax rate, any evidence to suggest that U.S. firms have higher rates.

Senator HATCH. Dr. Merrill?

Dr. MERRILL. In my written statement, there is a comparison of six different studies that compare effective tax rates of U.S. and foreign companies. None of the studies is specifically focused on the foreign income of multinational companies, and perhaps this is what Dr. Robinson's comment is referring to.

The studies I refer to look at U.S. versus foreign companies, including accounting data. One of the studies was published by the Business Roundtable. It compares the financial statement accounting tax rate of companies in 58 different countries. The U.S. had a higher than average book effective tax rate than the other multinationals in that study.

The World Bank does a study. We help them with that. It compares taxes in 183 countries, looking at purely domestic companies. And there are several other studies that I have cited that had a focus primarily on domestic investment. And so there are a range of studies.

I must say that, looking at a broad range of studies, almost every study I have seen has shown that, when you do an international comparison of the U.S. effective tax rates versus foreign, whether

it is from financial statements, whether it is done through marginal or average effective tax rates, accounting studies, the U.S. consistently comes up above average.

So I put that in my testimony, because it is commonly thought that effective tax rates of U.S. companies are low, but by international standards, according to all the studies I have seen, except for actually the ones in Leslie's testimony, the U.S. comes up in the top quartile.

Senator HATCH. Thank you.

Do I have time to ask one more?

The CHAIRMAN. Yes, of course.

Senator HATCH. This question is for Dr. Desai. It seems that a discussion of international tax reform can at times result in a debate of capital export neutrality versus capital import neutrality.

Such a discussion usually is not helpful, in my opinion, and typically ends up going nowhere. But you have developed an interesting new theory of international taxation—capital ownership neutrality—the idea being that a tax system should not distort the ownership of assets. And, in fact, capital ownership neutrality seems to fit in nicely with the acquisition inversions that we are seeing today in which a U.S. corporation acquires a smaller foreign corporation and inverts as part of the acquisition.

Now, my question is this. If a U.S. corporation wants to acquire a foreign corporation, it seems that the U.S. corporation is at a disadvantage if it is competing against a foreign corporation based in a country with a territorial-type tax system. As we know, most developed countries have adopted territorial types of tax systems. In fact, 28 of the 34 OECD countries have territorial-type tax systems.

Is it accurate that the U.S. corporation is at a disadvantage?

The CHAIRMAN. Doctor, if you could, please give us a brief answer, because I want to recognize Senator Grassley.

Dr. DESAI. Absolutely. So, yes. Along with Jim Hines, I developed capital ownership neutrality, and the central idea is what you said, which is, what matters is not where the dollars go, but who owns what. And, in the context that we are talking about, it is clear these inversions are manifestations of the fact that U.S. firms are not good owners because of tax provisions of assets around the world, and it is better to be domiciled somewhere else.

So I think it is a clear manifestation of the patterns that give rise to why territoriality makes sense.

The CHAIRMAN. Thank you very much.

Senator Grassley?

Senator GRASSLEY. Mr. Chairman, here is what I would like to do with my time, my 5 minutes. I would like to ask Mr. Stack a question to begin with, let him think about it for 4½ minutes, and I want to read a statement and then stop so he can answer my question. [Laughter.]

The CHAIRMAN. Colleagues, at this point, we have had a vote called, and I think it is the consensus of the members that we will have to break, since there are three. So we will get as far as we possibly can.

Senator Grassley?

Senator GRASSLEY. Mr. Stack, this is the question I would like to have you think about. Treasury recently informed me that it has

finally begun work on a report mandated by the American Job Creation Act to study the 2004 anti-inversion provisions. When does the Treasury Department expect to finish its study of the 2004 inversions legislation? And before enacting such important legislation, should not Treasury at least complete the report mandated to study the issue?

Like most of my colleagues here today, I have deep concerns about the practice of companies moving overseas for the primary purpose of avoiding U.S. taxes. Average Americans and companies that remain in America are rightfully outraged when companies leave the United States, leaving the rest of us to foot the bill. That is why, in the early 2000s, I led an effort to prevent companies from simply setting up a filing cabinet and a mailbox overseas to escape millions of dollars of Federal taxes.

In 2004, when I was chairman, I was successful in enacting for the first time reforms that established rules governing inversions. Under these reforms, an inverted company continues to be treated as a domestic company until there is a significant change in ownership or substantive business activities are located in the foreign country. A second feature of these reforms prevents an inverted company from skipping town without first paying taxes on untaxed earnings.

Prior to these changes, all the company had to do was move its tax home out of the United States and file papers with a tax haven. There were no rules or standards for determining whether a transaction had substance or was purely a tax avoidance scheme. A number of companies took advantage of the lack of rules and standards to move to the Cayman Islands or Bermuda, as examples. These inversions were purely on paper, with no substantive change of current operation.

The 2004 provisions have successfully curtailed abuses targeted by the legislation. As the nonpartisan Congressional Research Service has said, these reforms, quote, "effectively ended shifts to tax havens where no real business activity took place."

Now, this is not to say that inversions no longer take place. The 2004 reforms were never intended to establish a Berlin Wall that forever trapped companies in the United States regardless of business needs. These reforms were targeted at and put an end to egregious abuses epitomized by Ugland House, which serves as mailbox headquarters for thousands of corporations. The inversions currently in the news mainly involve a large U.S. multinational merging with a significant, though smaller, foreign company, usually European. These are not the traditional tax haven countries with little or no corporate tax, but major U.S. trading partners with competitive tax systems and rates.

There is little question that lowering one's tax bill continues to be a factor in companies deciding to invert. However, unlike transactions in the early 2000s, these are substantive transactions that come with both risks and benefits for companies involved. As a result, factors other than taxes likely play a role in deciding to invert.

I do not condone that behavior. One area that should be studied further is the role that tax rules that allow inverted companies to strip income out of the U.S. play in a company's decision to invert.

I am going to stop and ask Mr. Stack to answer my question on the study that we asked for.

Mr. STACK. Sure. Senator, as we mentioned in our letter to you of last week, now that we have gotten great guidance out in various areas of inversions, we are working on the study.

I apologize. I cannot give a specific time frame for completing it, but I would say that, given the pace of inversions which has picked up recently, we would not think there would be a need to await the study to bring back our full attention to this issue which is happening before our eyes.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Grassley.

Senator Brown?

Senator BROWN. Thank you, Mr. Chairman.

I want to talk for a moment—and this is a question for you, Mr. Stack—about earnings stripping.

Companies are using inter-company debt to lever up their U.S. subsidiary and deduct interest of up to 50 percent of free tax earnings, as you know, shifting profits to the lower-tax country. The second element of this tax arbitrage is shifting intellectual property and the attributed profits to tax havens.

My question is, what do we do right now to create a kind of temporary tripwire that will allow legitimate mergers, but prevent those arbitrage-driven inversions?

Mr. STACK. Thank you, Senator. One of the reasons we singled out these kind of anti-stripping proposals in our budget was because, even without reform, these things are going on now, and they are going on particularly in cases where we have inversions.

So, whether it be interest stripping, making it harder to take intangibles out of the United States, or changing the treatment of instruments that you can take a deduction on here and have a no-income inclusion somewhere else, we think these are all urgent needs that would protect our base even before we do tax reform and will also protect our base while the inversion wave is happening, and they are very important.

Senator BROWN. Mr. Chairman, I want to ask a question of Mr. Sloan. I also want to make one comment.

The more we read about this—and I appreciate that the chairman has brought this out, I think, more effectively than anybody in the Senate. People in this country increasingly think the system is rigged. People in this country increasingly see large companies find ways of avoiding taxes. People struggle to pay their own taxes. People see these large companies having benefitted from a manufacturing tax credit, an R&D tax credit infrastructure in our country, using legal means—nobody is arguing, most of us are not arguing they are not using legal means—to find a way to avoid taxes.

I think this committee needs to take this charge very seriously that the public increasingly is losing confidence in this tax system, causing others perhaps to cheat, and increasingly is losing confidence in this whole legislative body's ability to do anything. And, if we cannot narrowly follow Mr. Stack's advice and Senator Wyden's ideas and do something narrowly now about inversions, we clearly have not lived up to our public charge.

Let me ask a question of Mr. Sloan.

We are seeing increasingly more and more stories, partly from Senator Levin's work on his subcommittee, that hedge funds and investment banks are big drivers of these deals, which indicates a potentially short-term focus on stock prices and fees. The rewards to Wall Street are plentiful, as Mr. Sloan said. Premiums are offered to shareholders of foreign companies so the inverting companies may avoid U.S. taxes.

If you would, answer these couple of questions, if you would, Mr. Sloan. What role, in your mind, do equity funds, private equity funds, investment banks, hedge funds, play in encouraging companies to avoid taxes by completing an inversion? Is there any counterweight to this pressure that companies receive from short-term-focused investors?

Mr. SLOAN. All of these players are in business to make money. They are in a competitive business. They want to show a higher rate of return than other people so they can continue to attract more money and get more fees. And, as long as something is not illegal, they will do it.

If you talk with them socially, they are not bad people. They are human beings, even like Senators or journalists. They are regular people, but they have these forces that drive them. And I think there are perfectly fine corporate CEOs who, if you people will just protect them and get rid of the inversion temptation, will be very happy not to invert.

But everyone now feels pressure, and everyone is scared, and it is becoming a mania such that, by the time it fades away, it will be too late.

Senator BROWN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Brown.

Senator Schumer is next. And I am going to try, even after the first vote, to run over and vote, because we have colleagues who feel very strongly about this.

Senator Schumer?

Senator SCHUMER. Thank you, Mr. Chairman. I want to thank you and Ranking Member Hatch for holding this hearing today.

It is absolutely critical we quickly develop and process a proposal to combat this growing trend by some U.S. corporations to leave our borders for tax-avoidance purposes. There has been a significant uptick in the number of inversions over the past 10 years. Forty-seven U.S. corporations have reincorporated overseas through these inversions during that period. Now there are more than a dozen prospective deals.

Many of my colleagues, particularly on the other side of the aisle, argue we should not be looking at this issue in a vacuum right now. They say we should instead be focused on corporate tax reform. I would ask those arguing that we wait for tax reform, just how soon do you think that is going to be possible? Chairman Camp tried tax reform on the Republican side. Even Speaker Boehner did not give it much credence.

So, if we wait for tax reform, we are going to have lots more inversions, and it is going to take far too long, if we ever get to tax reform at all. Saying that we should wait for tax reform to deal with inversions is a green light to allow many more inversions to

occur. For some who make that argument, frankly, it is an excuse to keep this loophole in place for the foreseeable future.

The tax reductions achieved through inversions, as you know, happen in a couple of different ways, Mr. Chairman. First, by moving their domicile offshore, these companies are no longer subject to U.S. taxes on any of their international operations, and this has been appealing to types of businesses that operate in a global supply chain, like pharmaceutical companies.

But today we are seeing an uptick in more traditional brick-and-mortar companies—Walgreen's, for instance—doing the same thing. Why is that? Well, it is the second piece of the inverter's tax-avoidance equation. Not only can these companies avoid paying taxes on their international operations when they invert and re-incorporate abroad, they can also avoid paying U.S. taxes on their businesses that remain in the United States. One way they do this is through a mechanism in the tax code called the interest expense deduction.

It is a 5-step process. They set up a U.S. subsidiary to operate their U.S. business. When that subsidiary owes U.S. taxes, they transfer the corporate funds between the foreign parent and the subsidiary and call it a loan to the subsidiary. That loan triggers a U.S. tax deduction, the interest expense deduction for the subsidiary, which then largely offsets their U.S. tax liability. The loan is repaid through the profits of the U.S.-taxed subsidiary to the foreign parent, and U.S. taxes have been avoided. As a result, they pay little or no tax on their U.S. profits as well.

Now, we have attempted to limit this type of behavior in the past. We put a cap on the debt-to-equity ratio of the U.S. subsidiary, but the current law still provides a very lucrative tax benefit for inter-company benefit. In fact, Mr. Sloan, your magazine or your website did an op-ed on this, talking about the risks and rewards of inversions, which mentions the interest expense deduction.

So, as we work together to put forward a proposal to combat this growing challenge, we have to look at it from every angle. Now, I support the proposal that Senator Levin and the administration have been working on, which calls for an immediate 2-year moratorium and increasing the number of foreign shareholders to implement inversion from 20 to 50, making it more difficult for it to happen. I do have concerns with the management and control part of the Levin proposal, because we want to keep jobs here at home, and the management and control proposal may encourage jobs to grow abroad.

But Levin's proposal is not enough. We have to go further. We should also include a proposal that further limits or disallows the interest expense deduction to deal with the U.S. profits that they are also trying to avoid. Doing so will be a deterrent for those considering an inversion, as they will no longer see that opportunity to avoid U.S. taxation, and it will deal with the retroactive problem because you eliminate it prospectively, but any company that did an inversion 6 months ago, 1 year ago, 5 years ago, will still lose this deduction.

So it is a prospective policy action to counter past and future inversion activity. It would ensure we do not leave those inverters

who are at the front of the line, the ones who started the trend, with a competitive advantage.

So, Mr. Stack, my only question is—because my time is running out, and I know my dear colleague is waiting—does the administration agree that we should consider measures to further limit or disallow the current interest expense deduction for inverters in any legislative package we pursue to combat inversions this year?

Mr. STACK. Yes, Senator. We fully agree, and we think you have shone a light on a very dangerous part of the inversion craze, which is the ability, the day after the inversion transaction, to continue to strip the U.S. tax base. We have a budget proposal to that effect, but we think you are pointing to a very critical aspect of the inversion problem.

Senator SCHUMER. Thank you. I just want to say to companies doing inversions, if you want to operate here, you want access to this market, you want access to the workforce, access to the economy, understand this here today. To continue to have that access, you are going to have to pay your fair share of U.S. taxes. Things are changing.

The CHAIRMAN. Thank you, Senator Schumer.

The time for the vote has expired. We are going to go with Senator Stabenow. Senator Toomey is next. I am going to try to come back just as quickly as I can. Thanks.

Senator Stabenow?

Senator STABENOW [presiding]. Thank you. I wanted very much to be here, even though we are going to have to go running out. Thank you to each of you.

First, I want to say to my colleagues, we have a place to start tomorrow, which is the Bring Jobs Home Act. I am very pleased to be working with Senator Walsh on that. It takes a simple first step on what needs to be a series of steps and will simply say, if you want to move your plant, if you want to move the company overseas, we are not paying for the move; we are not going to allow you to write off your costs of moving out of this country. And, if you want to come back, we will be happy to let you write that off and give you an additional 20-percent tax credit. But if you leave, you are on your own.

Now, we know that is not enough, because we have a lot of folks who only leave on paper. And so they are not really picking up the plant and leaving. But I will say, Mr. Sloan, I could not agree with you more. This is not a partisan issue. This is an American issue. I think the American public is going to be watching very closely to see which companies that need consumers are doing this, and I think these companies underestimate the reaction of consumers and other businesses in going forward.

I do think if we can move forward and overcome a filibuster, get on the Bring Jobs Home Act, we could add Carl Levin's bill. And I am with you, even though I serve with both my dear colleagues, Sandy and Carl in Michigan, I think Carl's approach of a 2-year effort to get us to tax reform is the right way to go, and we could add that certainly to the Bring Jobs Home Act, and I believe that we need to do that and we need to get started on this.

I also think it is important—Dr. Merrill, you are right, I mean, certainly, all of you, saying we need tax reform, we need to do that,

we know we need to do that. We know we are in a global economy. We have to address this. But we also do know that I do not know of any sector paying 35 percent, our corporate rate.

The reality is, we have a lot of incentives for companies to invert. We want incentives that relate to manufacturing or R&D or other things. But when I look at the list, from medical devices at 18.8 percent or financial services at 16.5 percent or petroleum production at 11.3 percent or down to public-private equity which is paying a 0.8-percent rate, there is a large disparity and a number of issues that we need to address.

Here is what I want a comment on, and we have two issues: corporate tax reform and the global economy. How do we address these and incentivize making things and growing things in America and innovating in America?

And then we have folks who just plain do not want to pay their fair share yet benefit from America. So you have folks doing inversions who do not want to breathe Beijing's air. They want to breathe American air. They do not want the water of third world countries. They want to be able to drink the water. They do not want the rule of law of a lot of countries. I know in Haiti, talking to our businesses, you pull up a cargo ship, you cannot get the product off the ship without paying a whole bunch of bribes.

So they want our rule of law; they want our innovation, education, and infrastructure; they want to breathe the air and drink the water; they just do not want to contribute. That does not sound like the normal American values to me. What it does is create a race to the bottom where we are not going to have customers, and then we are really not going to have businesses as we go forward from here.

So this is of deep concern to all of us.

I guess, Mr. Stack, I would just simply ask you, when we look at competitiveness internationally, from your perspective, certainly the rate is important, but we know even going to 28 percent, that means eliminating R&D tax credit section 199 for small businesses, it means eliminating accelerated depreciation, which is so critical in a State like mine with manufacturing.

There has to be more to it than just tax grade in terms of investing in America, and I would ask you, if we are going to stay competitive internationally, make things and grow things here, what are some of the other priorities of tax reform besides just lowering the rate?

Mr. STACK. Thank you, Senator. First, on the rates, I would also add the point that a lot of the discussion about rates kind of ignores the fact that there will always be countries with lower rates than ours where people may want to seek to go and there is this tax competition going on.

In terms of other things we could be doing, the first thing I would want to point out—and this also relates back to rates—is our effective rates, as you were pointing out, vary widely. So we do not really have a level playing field across our industries. Number two, we do not really have a level playing field with countries that can take IP and put it offshore or have a broad enough market offshore to take advantage of some of these international provisions.

So, in addition to lowering the rates, we think it is very important to broaden the base for these taxes so that we can create some equality, eliminate the winners and losers, so that everybody has the advantage of this lower effective rate as we go forward. And, as you also point out, maintaining incentives for research and development so that we remain the premier country in terms of this type of activity is also a critical concern.

Senator STABENOW. Thank you.

I believe, at this moment, I have to get over to vote or I am going to miss the vote.

Thank you very much. Are we in recess?

We are in recess subject to the call of the chair. Thank you very much.

[Whereupon, at 11:11 a.m., the hearing was recessed, reconvening at 11:46 a.m.]

The CHAIRMAN. I very much appreciate Senator Portman's patience. He and I have talked often about tax reform, and I look forward to working closely with him on these issues.

Senator Portman?

Senator PORTMAN. Thank you, Mr. Chairman. I have had some long conversations with you, and I appreciate your championing tax reform, and I liked your first response to the inversion proposals.

We have a little difference of opinion on tactics here, because I do think this is an opportunity for us to encourage solving the problem rather than dealing with the symptom, and we have heard a lot of testimony today about what will happen if we just go after this particular issue, and I know there is some difference of opinion among the panelists about that.

I do not think there is any difference of opinion, I hope, among the panelists about the fundamental problem. Mr. Stack and I just spoke. I have spent a lot of time talking to administration officials about this issue too.

The bottom line is that it is not advantageous to be an American company. It makes more sense to be a foreign entity, to be able to take advantage of a tax system where the great majority of our competitors—93 percent of our foreign competitors, as Peter Merrill told us today—have a territorial system, have a lower rate. And it is a deadly combination to have this high rate and to have a worldwide system.

I just do not think what we are talking about in terms of a short-term fix is going to help. In fact, there is some good testimony about how it could even hurt because, if you just deal with inversions, you have some unintended, perhaps, but negative consequences—demanding the location of even more jobs overseas is what Dr. Desai talked about.

My big concern is foreign acquisitions. Recently we sat down with a lot of U.S. companies to talk about this issue. In fact, I have been doing this for the last few years, as some of you know, and have worked on this in the Super Committee, and we are just hearing over and over again the fact that already foreign acquisitions are on the rise, even without this rule.

So, yes, we can put this rule in place, and then we could limit the deductibility of interest, as one of my colleagues said, and we

can make it even harder to be an American company. What will happen is, we will have more and more foreign companies owning U.S. assets. Some of those will be takeovers.

Recently, a biopharmaceutical company came to see me, this was last week. They were from the Boston area. And I asked them about the acquisitions in the Boston area of bio-pharma companies. Twenty-eight companies have been acquired in the last several years, 17 of those 28 were acquired by foreign entities. So you sort of put the hole in the dam here, and then you are going to have a flood over here, and you are going to have an even worse result—even more pressure on jobs leaving this country.

So we talk a lot about revenue and income stripping and earnings stripping, and I agree we need to have a tax code that captures income in the most efficient way, but this is about jobs. So my question, I guess, to Mr. Stack is, what is going to happen if we continue to make it harder to be an American company? Are we not going to see more, not just acquisitions, but acquisitions of American assets?

These companies also tell me that, because foreign companies have higher after-tax profits, it is more profitable for them. They can pay a premium for our assets, in other words for subsidiaries being sold, and you will see more of that. You will see American companies shrinking and not being taken over by foreign entities.

What is your answer to that?

Mr. STACK. Senator, I think with the tax code, as we look out in terms of leveling this playing field, it is important for us to take, as an opening step, that we will never be able to offer, let us say, rates as low as countries that are trying very hard through tax competition to lure companies overseas. So there will often be some kind of a tax differential between the United States and other countries that might, on the margins, fuel some of that acquisition activity.

We have a lot of great things in this country, though, that keep companies here and keep them competitive and keep them doing very well. So I do agree then—and all the plans on tax reform seek to lower the rate, and there is universal consensus that our rate is too high and we should be bringing it down. And when we bring it down, we will come closer to leveling the playing field with those foreign acquirers.

Senator PORTMAN. So I think this is not just an important problem, I think it is an urgent problem, and I think you all have sounded the alarm here. Again, we have differences on the witness panel and on our panel as to how to address it, but it seems to me, when you look at the history of our country, the only time you see major tax reform is when the administration takes the lead. Treasury has to be engaged and involved. I am a former OMB director. OMB has to be involved in the numbers.

What is Treasury doing? Tell me what concrete steps are being taken to address this, as was said today, emergency situation? Is it just to plug the hole in the dam here, or are you actually looking at, as the President has talked about over the last couple of years, actually solving the underlying problem, making American companies more competitive?

Mr. STACK. Senator, the President's framework in 2012 really was kind of a far-reaching move forward to think differently about our international tax rules, and that is to say that it was going to be able to bring down the rates, broaden the base to deal with some of the differential effective rates I mentioned earlier, but also, through the foreign minimum tax, try to cut out some of the game-playing that goes on by stripping into very low tax jurisdictions. We think that that kind of set the tone for some of the work that was done both in the Finance Committee and by Chairman Camp, and we think that there is a very robust set of proposals on the table right now.

In addition, for many of the things we are talking about today in terms of base stripping, we put several detailed proposals in our budget to get at this opportunity, once a company inverts, to strip out of the U.S. tax base, which, as everyone knows, provides a lot of juice for these transactions since they can do better at reducing U.S. taxes once they are offshore than they could before.

So we think we have shown leadership in our framework. We think we have shown leadership in putting concrete proposals in our budget, and I know the President and Secretary stand ready to work with Congress on both sides of the aisle to push through international tax reform.

Senator PORTMAN. I would love to see a proposal, and I would love to see that push. I do not know, maybe my colleagues see more of it than I do. Again, I have had some great conversations with individuals at the Treasury and in the administration, including at the White House, but I just do not see the push.

I hope we will use this unfortunate situation where we have examples every week of another major inversion, another one this past week—and it happened to be a pharmaceutical company—to actually get us to the point where we are solving the underlying problem.

If we make it worse by making it even less advantageous to be a U.S. company, I really worry we will look back 5 years from now and see a hollowed-out American corporate base and wonder what happened. What happened is, we abdicated our responsibility here in doing the thing that everybody on this panel, I think, agrees we have to do, which is reform our code to make it competitive.

I know my time is up, Mr. Chairman. I appreciate the testimony today. I hope it results in some very specific action by the administration and by the Congress.

The CHAIRMAN. Thank you, Senator Portman. I look forward to working with you on these matters in a bipartisan way.

I would say to our guests, I have some additional questions. Senator Hatch is on a very tight timeline, and so I would like Senator Hatch to go first.

Senator HATCH. That is very gracious of you, Mr. Chairman, and I appreciate it. It is a pleasure to work with you.

This question is for Dr. Merrill. As you know, both Japan and the United Kingdom adopted territorial types of tax systems in 2009, switching from a worldwide tax system with deferral. These are two countries with large economies. Japan is the third-largest economy in the world and the United Kingdom is the sixth-largest economy in the world.

Can you tell me why Japan and the United Kingdom switched from a worldwide with deferral system like the current United States tax system to a territorial system, and, after 5 years of experience with a territorial tax system, what have been the results for both Japan and the United Kingdom?

Dr. MERRILL. Yes. Thank you for the question. The United Kingdom was experiencing a phenomenon not unlike what we are experiencing now. They saw a number of large multinational companies, some quite significant, that had actually moved their legal headquarters out of the U.K., primarily to Ireland. And that was of great concern to the government, so they decided that it would be appropriate to adopt a more competitive tax system along the lines of the quote in my oral statement so that their tax system would be more welcoming to multinational business.

One of the factors for the U.K. is they have many companies there that earn only a small part of their total income, worldwide income, in the U.K., and yet the U.K. had a tax system like ours that was taxing the worldwide income of companies that only earned a small amount of income in the U.K. So, in order to become a more attractive location for multinational companies, they went to the territorial-type tax system, 100-percent exemption of foreign dividends, and they made a number of other changes, as I indicated, lowering their tax rate. They have also adopted a 10-percent refundable research credit. They also adopted a 10-percent, phased-in 10-percent tax rate on income from patents, and they also modified their C rule.

So they have done a whole package of things mainly to make it more attractive for multinational companies to be headquartered in the U.K., and they have been successful. As Dr. Robinson mentioned, some of the companies that left the U.K. actually have moved their headquarters back to the U.K. in response.

Japan is a different situation. Obviously, the Japanese economy has not been attracting the kind of growth that they have been looking for, and they saw Japanese multinationals, like the U.S., facing a very high corporate tax rate, a worldwide system, and money was not being repatriated to Japan. The Ministry of Economy, Trade, and Industry wanted to see that money come back for additional investment in Japan, and that is why they made the change.

Senator HATCH. Thank you.

Mr. Saint-Amans, glad to have you here. This is a question for you. I appreciated what you wrote in your testimony, that, quote, "The work of the OECD is done by consensus. That is, measures cannot be adopted without the consensus of all member countries."

Now, presumably, consensus of all member countries means that all member countries will consent to the work the OECD is doing or else the OECD will not do that work or will not issue such a report. Am I right on that?

Mr. SAINT-AMANS. Yes, Senator. A consensus means that a report or soft rule, which is what we develop, is agreed when no country around the table objects to it.

Senator HATCH. And in making sure you have the consensus of the United States, please keep in mind our system of separation of powers. Lawmaking capabilities primarily are vested with the Con-

gress. In obtaining the consent of the United States, it is necessary to get the consent of the U.S. Congress. So we do appreciate you being here for this Senate hearing.

Will you please assure me that you understand that to obtain the consent of the United States for the OECD's work, including for the BEPS project, that Congress must be kept informed of the work, and, of course, that has to be working in conjunction with the U.S. Treasury as well?

Mr. SAINT-AMANS. Senator, I do think that not only the Secretary, of course, but all the OECD member countries are fully aware of this. We are more than happy to engage with the staff on the Hill for the Senate, but without impeding on what Treasury is doing.

And I would like to add that most of the measures which are completed in the project, fighting base erosion and profit-shifting, are soft rules. These are a common interpretation of standards, and so they do not require translation by parliament, but information from all stakeholders and, in particular, the Congress, is taken seriously by the OECD secretariat—and I will not speak on behalf of it, but I think also by Treasury.

Senator HATCH. Mr. Stack, let me just ask you the same question. Please reassure me that the U.S. Treasury Department will keep Congress informed, but not get ahead of the Congress in the decision-making process and in negotiations with the OECD regarding BEPS.

Mr. STACK. Yes, Senator. We fully intend to do that. I have already been up to the Hill twice to meet with bipartisan staffs, both houses, and I look forward to continuing that throughout the process.

Senator HATCH. We appreciate your work in that regard. Thank you for doing that.

I want to thank all of you for being here. I have to leave because of other commitments, but this has been extremely interesting, and I am going to read the transcript so I will know exactly what you all say. I am going to hold you to it too.

Thank you, Mr. Chairman.

The CHAIRMAN. He will, be on notice.

We are moving toward the end of the hearing. Senator Portman may have additional questions. But let me give you my sense of where we are.

I certainly am not interested in building any walls. I want to close a loophole, and then I want to drain the swamp. I want to fix this dysfunctional mess of a tax code so we have incentives for creating red, white, and blue jobs, creating jobs here in our country.

I know we are going to be calling on you all often in the days ahead. I just have a couple of other questions about issues that are pending.

Senator Thune, you are next. If I could just finish these two questions, then we will go right to you.

The first deals with the implications of inversions on health care costs in America and the implications for the American consumer.

I was struck by comments made in the *Wall Street Journal* recently by the CEO of Abbott, who said that he was concerned about

the higher prices that American consumers would have to pay if proposed inversions like his company's did not go through. And I am still trying to figure out how these savings are going to be passed on to consumers and, of course, to taxpayers who put up so much of the money that funds the Medicare program.

I will ask all three of our professors: Dr. Desai, Dr. Merrill, and Dr. Robinson. Explain to me how somehow these costs, particularly medical costs, because so many of the inversions thus far are medical, explain to me how or even if—because you have done some scholarship on this, Dr. Desai—this is going to benefit the American consumer and the Medicare program in particular.

Let us start with you, Dr. Desai.

Dr. DESAI. I think the broad way to think about this problem is to understand that this question relates to the broader question of the incidence of the corporate tax, who pays the corporate tax, and there are really three sets of folks who can pay.

So the first is customers, which is what you are referring to via the health care system; the second is workers; and then, the third is capital or shareholders. So whenever there is a tax-saving move like an inversion, we can expect those benefits to accrue to one of those three sets of people. Either workers are going to get high wages, shareholders are going to get high returns, or customers will get lower prices.

I think most of the consensus in the scholarship is that when taxes change, they do not typically get transmitted to product prices, because——

The CHAIRMAN. They do not typically get translated to product prices, which would be the prices that Americans pay for health care.

Dr. DESAI. In this example, exactly right.

The CHAIRMAN. Very good. Thank you.

Dr. DESAI. They typically get transmitted more likely to wages and, to some degree, to shareholders.

The CHAIRMAN. Very good. Let me then—because Senator Thune has just come back—bring you into this question, Dr. Merrill and Dr. Robinson, and that is the impact of reform on the deferral issue. Of course, one of the goals around which there is bipartisan support for corporate tax reform is to simplify the system. I think we all understand that the international tax is inherently complicated.

My question is, wouldn't repealing deferral go a long way toward corporate tax simplification by eliminating the complicated system that exists today of tracking unused foreign tax credits and the related earnings and profits? In effect, income would be subject either to immediate taxation or exempt, and the current foreign tax credits would be utilized against current taxable income.

So answer the question, if you might. Would deferral eliminate a very complicated feature of the tax system, and would doing that as part of bipartisan comprehensive tax reform make the system more simple and understandable?

Dr. Robinson?

Dr. ROBINSON. I do think, as I put in my written testimony, that the implicit cost of the U.S. tax system is higher than the explicit cost, and what I mean by that is that the cost associated with actu-

ally avoiding repatriation or maintaining deferral for long periods of time is what I believe makes our tax system uncompetitive.

I do think that eliminating deferral so long as the rate, of course, was lowered sufficiently would be what I would be in favor of, and the reason that I say that is because the alternative approach, of course, is to implement some sort of territorial system. But I think those types of systems, if you design them appropriately, would have to recognize instances where earnings were not subject to robust tax systems abroad, and then you have to introduce all sorts of exceptions and exclusions and base-broadening provisions. And, by the time you introduce those, you are sort of right back where you started.

So I am largely in favor of ending deferral and lowering the rate if it means a simplification.

The CHAIRMAN. Dr. Merrill, unless you want to add anything, I will recognize Senator Thune. Is there anything you wanted to add?

Dr. MERRILL. Why don't we take Senator Thune's question?

The CHAIRMAN. Very good. Senator Thune?

Senator THUNE. Thank you, Mr. Chairman. I want to thank you and Senator Hatch for holding this important hearing, and thank you all for making time to share your expertise with us.

I suspect there are significant differences of opinion about how to improve the U.S. tax code, differences of opinion among members here in the Finance Committee and probably in the Senate and the Congress, but I think that all of us agree that we want American companies to be competitive. We want for them to be able to compete and win in the global marketplace, and I think, unfortunately, we ask them to do it with one hand tied behind their back, because we actually make the rules that they play by. And, when you make bad rules, you get bad outcomes. And there are economic signals right now that are driving a lot of the decision-making that our businesses are following.

So I think some of this inflammatory rhetoric and accusing them of not being economic patriots is really not helpful, and I would hope that we could focus on not just the symptoms, but actually the cause for these problems, and that is, we have an outdated, dysfunctional tax code, with the highest rate in the developed world. And we are also one of only a few countries in the world that continues to use a worldwide system, that has not moved to a territorial system. I should not say in the world, but certainly one of the few countries in the OECD.

So I just think that we need to focus on the problem here, and the problem is the high rate. There was a time back in 1986 when the tax code was last reformed where our corporate tax rate was 5 points lower than the average. Now, it is about 14 points higher than the OECD average. This is what you are going to get when you have these kinds of rules. So we need to change the rules. We need to reform the tax code.

So I guess it seems, to me at least, that the system is basically the worst of all worlds, because we are asking our businesses to compete in the foreign marketplace, and not only do we have the highest corporate income tax rate among OECD nations, we are

also, as I said, one of the few nations that has a worldwide system of taxing income.

So, Dr. Merrill, I guess I would ask you, could you elaborate a little bit on your testimony in terms of what this means for a U.S.-based company competing in foreign markets against companies that are based in nations with more modern and favorable tax systems?

Dr. MERRILL. Yes. Thank you. What we are seeing is a world where a U.S. company that operates abroad is now generally competing with foreign competitors in the same market, but facing a very different home country tax system. They all face the same rules in the country where they are operating.

The difference is, they face different home country taxation. So, if the U.S. company earns income abroad and wishes to invest it back home in the United States, bricks and mortar, it wants to use the money to give back to its shareholders, it wants to use the money to pay higher wages to its workers, it faces a U.S. tax on that repatriated earnings that would not be the case if it was a foreign-headquartered company under a territorial-type system.

So we see this manifesting itself in U.S. companies stuck in a way, building up cash abroad that they would like, in many cases, to return to the U.S. to invest here, to use for a variety of purposes. But, if they do, they would face the highest tax rate in the world in bringing it back.

So that is a very important driver of why a U.S. company is not a particularly attractive candidate when they go out to buy a foreign company. If you are a shareholder in a foreign company and a U.S. company says, "Gee, I would like to buy you," you realize that that means that if you are acquired, any foreign profits that will be distributed to you have to go through the U.S. corporate income tax system. If you are purchased by a foreign acquirer, that is not the case. So it makes it harder for U.S. companies to make foreign acquisitions. It makes it harder for them to even invest back at home.

Senator THUNE. And there seems to be a misperception about this—the way that some of this has been covered at least in the press articles. It is implied that U.S. companies are somehow changing the taxation of their U.S. income through these deals.

Is it not the case that income earned in the United States remains subject to U.S. tax regardless of the corporate structure?

Dr. MERRILL. A U.S. company that moves its legal headquarters abroad is still subject to U.S. income tax on its U.S. operations and is still subject to tax if it brings back the foreign earnings that it has previously earned in its foreign affiliates.

Senator THUNE. This is a question—one more, Mr. Chairman?

The CHAIRMAN. Of course.

Senator THUNE. There is the suggestion in the administration's proposal that we attempt to stop corporate inversions. But there is a concern that some of the steps that are being taken, that are designed to stop them, actually could cause more harm than the inversions themselves.

In particular, there is a concern that this management control test that is being advanced by the White House and some here in

the Senate could have the effect of encouraging mergers, whereby management control would be outside of the United States.

What is your view on that issue?

Dr. MERRILL. Congress has a long history of trying to address inversion transactions, and each time it has produced unintended effects. Congress tried in 1984, the IRS tried about 10 years later in 1994, and, of course, Congress in 2004 adopted legislation, each time trying to deal with the transaction of the day. What happened is companies found different ways to achieve what the economic incentives are driving them to do, which is to have the assets owned in a tax jurisdiction that is more favorable.

So the concern would be that another stopgap measure could lead to the kinds of transactions that are not desirable from a U.S. standpoint, a true foreign acquisition of a U.S. company where the headquarters jobs are abroad and the U.S. headquarters shrinks.

Senator THUNE. Mr. Chairman, I thank you. I appreciate the answers to these questions, and I would ask if I could get my statement, my entire statement, which I did not use all of, included in the record and, again, point out that we have a problem here. The problem is our tax code.

The CHAIRMAN. Without objection, it is so ordered.

[The prepared statement of Senator Thune appears in the appendix on p. 101.]

The CHAIRMAN. Senator Thune, you may not have been here when I made this point. I am fully committed to working with you and colleagues on the other side of the aisle for the ultimate cure, which is fixing this dysfunctional mess of a tax system.

The question is, what are we going to do about the damage that is being done right now?

Senator Portman, do you have any other questions you would like to ask?

Senator PORTMAN. Thank you, Mr. Chairman. Why don't you go ahead, and then I will?

The CHAIRMAN. I have no other questions.

Senator PORTMAN. Can I just do a quick, quick round with the team here?

The CHAIRMAN. Of course.

Senator PORTMAN. First of all, I quote you all the time, because Chairman Wyden makes the point that the tax code is 100 years old and it looks like it. So I appreciate your attitude about wanting to pursue reform. I am concerned that by taking this detour, it is going to make it harder, not easier, and, again, there may be the unintended consequences we talked about, including accelerating this acquisition of U.S. companies by foreign entities.

By the way, the Joint Committee on Taxation, which is our official nonpartisan scorekeeper, has said, with regard to the President's proposals that were in his budget last year—Mr. Stack went through those in his testimony, and they are mostly international tax revenue raisers to deal with some of these issues—they said, and I quote, "Many of these proposals may make corporate structures with a domestic parent relatively less attractive than corporate structures with a foreign parent, and these proposals are likely to raise U.S. tax liabilities for the domestic parent structure more than the foreign parent structure."

That seems pretty clear—and that is not Republicans or Democrats; these are our nonpartisan arbiters as to what we ought to be doing in terms of good tax policy.

I guess one question that I would love to hear about from this distinguished panel is—Dr. Robinson talked a little about access to capital, and the most efficient flow of capital, obviously, is a big disadvantage to U.S. companies now. So forget the rate, even forget kind of the general notion of territorial versus worldwide. The fact is these U.S. companies are not as nimble. They cannot move assets around where they need them, and I think that has to be addressed.

Here is my question. Sometimes when I debate my colleagues on this issue, they say, well, just because a company is foreign does not mean they do not have U.S. jobs, which is true. Anheuser-Busch still has U.S. jobs. They sell a lot of beer in America. Their market share is in good shape.

Maybe, Peter, if you could address this or Dr. Desai or Dr. Robinson, whoever has looked into this. But can you tell us a little about what happens when one of our—Peter talked about Fortune 500 companies over the last 15 years, where you have seen a one-third reduction in U.S. companies.

What happens? What is the impact on jobs when you see U.S. companies being acquired by a foreign company?

Dr. MERRILL. I have not actually studied that issue. It could go either way. If the foreign company is a better-managed company, has better management and brings in new technology, it could increase jobs. On the other hand, it could go the other way, but I do not know what the actual experience has been.

Senator PORTMAN. Dr. Desai?

Dr. DESAI. I think you are right to put this in the context of the broader market for corporate control, which is I think really the issue with foreign acquisitions. And I think the issue of foreign acquisitions is, particularly with respect to high value-added headquarter jobs, those may well get relocated when it becomes foreign-owned.

That is something that we have seen at least anecdotally, and we also know that headquarter jobs are really important. They give rise to lots of economic spillovers more generally. So for that reason, I think you are right to be suspect of the potential harm of these foreign acquisitions, which is they can lead to high value-added jobs going abroad and, in particular, headquarter jobs.

Senator PORTMAN. Dr. Robinson, have you done any research on this?

Dr. ROBINSON. I was going to say I do not have anything concrete to add. I have not done any research in this area.

Senator PORTMAN. Let me just insert something that I find pretty obvious. When a company chooses to domicile somewhere else, and particularly when the headquarters moves, which often happens, as Dr. Desai says, there is an intangible impact.

So the companies in our great cities in America are major benefactors. Companies in my home State of Ohio are involved in every single nonprofit in one way or another and often provide a lot of executives to help to lead these nonprofits and charities and, obviously, make huge contributions, and I would love to see some re-

search on that, because I do think this is sort of the intangible impact of companies pulling out of the U.S. that has not been given adequate focus and research.

So, if any of you all have any thoughts on that, I would love to see if we could look into that. So certainly, on the jobs front, we would like more information, but also on this sort of intangible benefit.

What happens? Why does it matter? I think it matters. I think my colleagues do. That is why Senator Wyden and others are working hard on this. But I think we need better information to be able to explain this more in terms of the impacts, the negative impacts, to our constituents.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Portman.

At this point, I would ask unanimous consent that a statement by Senator Levin be included in the hearing record.

Without objection, the statement will be included.

[The prepared statement of Senator Levin appears in the appendix on p. 43.]

The CHAIRMAN. Let me leave you all with one thought that we really have not, I think, gotten into much this morning.

It seems to me that it would be one thing if there were just a few of these inversions. In other words, if there were a few of them, we would work, as we have talked about this morning, on comprehensive, bipartisan tax reform, we would fix it, and then we would not be back here again in another decade.

Part of what has influenced my judgments is that that is not going to happen. And I spoke a couple of hours ago about reports from the financial press about this feeding frenzy. That is what is actually going on out there. It is not a few of these inversions that you could put to bed with comprehensive tax reform. But according to the financial press, it is a feeding frenzy, where you have the investment bankers going out to all the possible companies with their slide decks and saying, "You had better do this quickly." And the reality is that tax reform is moving slowly and the inversions are moving very rapidly, and, as I indicated before, I think that is a prescription for real chaos.

So, as you could hear from the Senators here today—there was not a lot of shouting and a lot of screaming and finger-pointing—there is a lot of good will here. And my hope is that, with your good counsel—it has been a very good hearing, with very thoughtful testimony—you can help us address both of these tasks: to close the inversion loophole and then move on to the great challenge in front of this committee, and that is the real cure, which is comprehensive, bipartisan tax reform.

With that, the Finance Committee is adjourned.

[Whereupon, at 12:21 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Testimony
of
Mihir A. Desai
Mizuho Financial Group Professor of Finance
Professor of Law
Harvard University

before the

U.S. Senate Committee on Finance
July 22, 2014 10:00 a.m.

Chairman Wyden, Ranking Member Hatch, and Members of the Committee, it is a pleasure to appear before you today to discuss international tax reform. I am a Professor of Finance at Harvard Business School, a Professor of Law at Harvard Law School and a Research Associate of the National Bureau of Economic Research.

Recent merger transactions highlight long-simmering problems in the U.S. corporate tax, particularly with respect to its international provisions. My comments attempt to outline briefly the origins of these transactions, the range of alternative solutions, guidelines for evaluating alternative reforms and some reforms that should be avoided.

1. The last twelve months have witnessed a remarkable wave of merger transactions that facilitate the expatriation of U.S. corporations. Such transactions reflect the effects of policies and of the changing structure of multinational firms. From a policy perspective, the transactions highlight the increasing costs of employing a) a worldwide tax regime when most other large capital exporting countries no longer maintain such regimes and b) a corporate tax rate that stands well above rates employed by other OECD countries. From a firm point of view, the transactions highlight a) the increased mobility of activity in today's economy, b) the growing "decentering" of firms whereby headquarter locations have been split up and reallocated across the world, and c) the growing importance of non-U.S. markets for U.S. firms. Rather than questioning the loyalties of executives, it is critical to understand these underlying structural and secular forces. [See references 1, 2, 3, and 4]

2. While these transactions naturally attract growing attention, inversions are merely the most visible manifestation of these developments. In addition to inversions, these forces are giving rise to a) incorporation decisions by entrepreneurs that anticipate the burdens of being a U.S. corporation, b) merger patterns that reflect the penalties of being domiciled in the U.S and the importance of offshore cash for U.S. corporations, c) investment patterns by U.S. and foreign companies, d) profit-shifting activities that are not value-creating and e) the consequent, negative impact of all of these distortions on the U.S. labor force. While it is tempting to limit attention to the more sensational effects and characterize them as tax-avoiding paper-shuffling, this would effectively be missing the forest for the trees. [See references 1, 2, 4 and 7]

3. Reforms should be focused exclusively on advancing U.S. welfare with particular attention on reforms that will improve American wages. These goals are mistakenly thought to be achieved by limiting the foreign activities of U.S. firms as foreign activities can be viewed as diverting economic activity away from the U.S. In fact, the evidence suggests the opposite as firms expand globally, they also expand domestically. Indeed, American welfare can be advanced by ensuring that investments in the U.S and abroad are owned by the most productive owner and that American firms flourish abroad, a goal advanced by the territorial regime that has now been adopted by most comparable countries. While the developments described above have crystallized the case for international tax reform with an increasing attention on switching to a territorial regime, there is still tremendous variation in proposals for territorial regimes. Some proposals, including those with an alternative minimum tax on foreign profits, are tantamount to a backdoor worldwide regime with even more complexity than today's system. Revenue considerations should figure largely in tax reform today but should be accorded secondary status in this setting given the very limited revenue provided by current international tax rules and the remarkable complexity and distortions required to secure any such revenue. Additionally, it is not clear that policies should prioritize revenue considerations in other countries. [See references 2, 5, and 6]

4. More broadly, the corporate tax is ripe for reform. In addition to international reforms and a rate reduction, reform should address the two other major developments in the corporate tax arena: a) the growing prominence of non-C corporate business income, and b) the disjunction between profits reported to capital markets and to tax authorities. A useful blueprint for reform would include a) moving to a territorial regime unencumbered by excessive complexity, b) a considerably lower tax rate in the range of 18-20%, c) better alignment of book and tax reporting of corporate profits and d) by some taxation of non-C corporation business income. This combination of reforms has the potential of addressing significant changes in the global economy in a revenue-neutral way that will advance U.S. welfare. More fundamental reforms, including those that replace a corporate tax with a consumption tax, are preferred if feasible. [See Reference 1]

5. Legislation that is narrowly focused on preventing inversions or specific transactions runs the risk of being counterproductive. These transactions are nested in a broader set of corporate decisions, leading to several unintended consequences. For example, rules that increase the required size of a foreign target to ensure the tax benefits of an inversion can deter these transactions but can also lead to more substantive transactions. More substantive transactions are likely to involve the loss of U.S. activity as American firms will be paired with larger foreign acquirers that demand the relocation of more activity abroad, including headquarters functions. Similarly, specific regulations targeted at inverted firms may also lead to foreign firms leading such transactions to avoid those regulations. While it is tempting to address specific transactions in advance, or in lieu, of broader reform, it is useful to recall that the last wave of anti-inversion legislation likely spurred these more significant, recent transactions and reduced the prospect of reform in these intervening years. [See References 4 and 7]

Members of the Committee, I admire your foresight in addressing these issues. These highly visible manifestations of the structural problems in the corporate tax provide a significant opportunity for genuine reform. I'd be delighted to answer any questions.

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STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER U.S. SENATE COMMITTEE ON FINANCE HEARING OF JULY 22, 2014 THE U.S. TAX CODE: LOVE IT, LEAVE IT, OR REFORM IT

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following opening statement at a committee hearing on international taxation:

I would like to thank Chairman Wyden for holding today's hearing.

I think we can all agree that addressing the shortcomings of our international tax system is a critical step on the road toward comprehensive tax reform.

As we consider reforms to our tax code, our primary goals should be to make the U.S. a better place to do business and to allow American companies to more effectively compete with their foreign counterparts in the world marketplace.

Sadly, when it comes to our international tax system, much of the attention gets placed elsewhere.

For example, in 2013, the OECD launched its Base Erosion & Profit Shifting, or BEPS, project. While we appreciate the OECD's efforts in bringing tax authorities together to discuss and work through issues, many of us have expressed concern that the BEPS project could be used by other countries as a way to increase taxes on American taxpayers.

The issues under negotiation with the BEPS project are complex and can have far-reaching and negative consequences. While I think we should be willing to work through these issues until an international consensus is reached, we should not be rushed into accepting a bad deal just for sake of reaching an agreement.

I think we're right to expect that the Treasury Department will aggressively represent American employers and their workers in the BEPS negotiations, while responsibly consulting with Congress as the discussions proceed. Hopefully, in the end, the focus of these discussions will return to base erosion principles, instead of ways foreign countries can raid the American Treasury or American businesses.

Of course, while the BEPS negotiations are important, the most high-profile international tax issue today is corporate inversions. It seems that almost every day, we are hearing about a U.S. multinational opting to invert to a foreign jurisdiction.

As I have said publicly on multiple occasions, I am greatly concerned about corporate inversions.

Ultimately, the best way to solve this problem will be to reform our corporate and international tax system in a manner that will make our multinationals competitive against their foreign counterparts.

That will mean, among other things, a significant reduction in the corporate tax rate and major changes to make our international tax system more competitive.

Over the past few months, we've seen a handful of legislative proposals to address the issue of inversions. Most of them are punitive and retroactive. Rather than incentivizing American companies to remain in the U.S., these bills would build walls around U.S. corporations in order to keep them from inverting.

This approach, in my view, completely misses the mark.

While it may put a stop to traditional inversions it could actually lead to more reverse acquisition inversions as our U.S. multinationals would, under this approach, become more attractive acquisition targets for foreign corporations.

Whether it is traditional corporate acquisition inversion or a reverse acquisition inversion, the result is the same: continued stripping of the U.S. tax base.

In fact, the approach in the proposed anti-inversion legislation is so misguided it reminds me of an old joke:

A drunk is looking for something under a street light.

A police officer walks up to him and asks what he is looking for.

The drunk says, "My keys."

The police officer helps the drunk look for a few minutes without success and finally asks, "Did you lose your keys here?"

The drunk says, "No. I lost them across the street."

The officer responds, "Then why are you looking for them on this side of the street?"

The drunk replies, "Because the light is better over here."

Once again, the ultimate answer to this problem -- and the only way to completely address the issue of inversions – is to reform our tax code.

However, as I've also said publicly, there may be steps that Congress can take to at least partially address this issue in the interim. While I don't support the anti-inversion bills we've seen thus far, I, personally, am open to considering alternative approaches, though I do have a few stipulations as to what proposals I'll consider.

For example, whatever approach we take, it should not be retroactive or punitive. And, it should be revenue neutral.

Our approach should move us towards, or at least not away from, a territorial tax system and should not enhance the bias to foreign acquisitions.

Most importantly, it should not impede our overall progress toward comprehensive tax reform. Toward that end, it should not be inconsistent with our House colleagues' approach. I think there's a growing chorus out there among some of my friends on the other side of the aisle to use corporate inversions as a political wedge issue in an election year. In fact, I was recently the recipient of a very politically-toned letter from Treasury Secretary Lew on this issue. I hope that's not the direction we take. If we actually want to accomplish something on this issue, we're going to have to work together.

As you can see, Mr. Chairman, we have a lot to discuss today. Thank you for holding this important hearing. I look forward to hearing from our panel.

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STATEMENT OF SENATOR CARL LEVIN
BEFORE THE SENATE FINANCE COMMITTEE
ON
"The U.S. Tax Code: Love It, Leave It or Reform It!"

July 22, 2014

Chairman Wyden, Ranking Member Hatch, and colleagues, thank you for allowing me to submit this statement for the record of today's hearing on international taxation.

As you know, the Permanent Subcommittee on Investigations, which I chair, has conducted a series of investigations, spanning more than a decade, into offshore tax avoidance and tax evasion. In recent years, the IRS has cracked down on some individual offshore tax cheats who use tax shelters and secret foreign bank accounts to evade paying their U.S. taxes in violation of U.S. law. And, this month, the Foreign Account Tax Compliance Act took effect, which will further strengthen U.S. tax enforcement.

But, today, many of the biggest tax giveaways aren't to taxpayers who are breaking the law. Instead, many taxpayers – especially large, often highly profitable multinational corporations, are using a number of tax loopholes that may or may not be legal, but are unjustified because of lack of economic purpose and whose purpose is pure and simple tax avoidance. The Cut Unjustified Tax (CUT) Loopholes Act (S.268), which I and Senator Whitehouse introduced last year, would shut down a number of the most longstanding and egregious loopholes, and I urge you to consider including its provisions in any tax reform legislation you advance.

While the CUT Loopholes Act targets a number of loopholes, I'd like to discuss one particular tax loophole that has recently gained traction among large multinational corporations seeking to avoid U.S. taxes. Tax inversions, where a U.S. company moves its tax address to a low-tax jurisdiction through a merger with a smaller foreign competitor, have become the latest tool for CEOs seeking to dodge Uncle Sam. These transactions have allowed U.S. corporations to reduce their tax rates by up to 12 percentage points by claiming, for tax purposes, that they have moved away from the United States. Yet, a company's executives, officers, and management all remain in the United States, benefiting from our country's marketplace, laws, resources, infrastructure, and workforce, while declining to provide their share of financial support for the very qualities that help them succeed.

Unlike many tax loopholes our Subcommittee has investigated, the tax inversion loophole is being exploited in plain sight. Daily, there are front page media reports describing one new inversion transaction after another. Sadly, iconic American companies like Walgreens, Medtronic, and Pfizer have already taken steps to give up their American corporate citizenship in order to lower their tax bills. And the problem is growing. Just last week, two more American companies, both closely tied to Abbott Laboratories -- an American company since 1888 -- sought to move their tax addresses overseas in two separate transactions.

These companies aren't moving because there are better business opportunities in foreign countries. Their move is a pure and simple tax dodge. Executives don't move, and the company

headquarters isn't moved. What's more, inverted corporations continue to claim U.S. research and development tax credits, receive intellectual property protections in U.S. courts, and benefit from the safety and security provided by our nation's military.

Tax inversions aren't a driver of job creation in the United States. In fact, one need only look to California, where an American drug maker has been forced to lay off 1,500 employees in a bid to fight off a hostile takeover from an inverted corporation that has been swallowing up U.S. companies due to the advantages of the inverted corporation's tax structure.

In other cases, inverted companies may claim to be creating jobs because they gain access to more capital. Although many small businesses have struggled to access capital as our economy recovers, for most profitable multinationals, capital is available from other sources that don't use a tax inversion. Interest rates are at all-time lows, and banks are more ready to lend than any time in recent years. The equity markets are booming, with a growing market for public offerings. And multinationals have $2 trillion offshore that they could tap into if they wanted to invest and create new jobs.

Both Democrats and Republicans recognize that tax inversions are a major problem that must be addressed. I urge you to take action to put a stop to tax inversions, and I urge you to do so now. While most recognize that tax reform should take place, we can't afford to wait for a comprehensive tax reform effort to fix the problem of tax inversions. If we wait, billions of dollars in badly needed revenue will disappear, growing the deficit, hurting our security, leaving our roads in disrepair, shortchanging education, and other priorities. Worse yet, while those billions of dollars in tax revenue disappear, the corporate freeloaders multiply – taking advantage of America's greatness while refusing to pay their fair share.

Two months ago, I, along with 22 of my colleagues, introduced the Stop Corporate Inversions Act (S.2360). This bill would establish a two year moratorium on tax inversions. That two year moratorium would stop what nearly all agree is an abuse of our tax system, and provide Senators with two years to debate a permanent solution as part of a comprehensive tax reform effort. All ideas to bring the archaic U.S. tax system into the 21st Century can be debated during that two year period. The issue is whether in the meantime we should let the inversions flow. I believe we shouldn't.

If we don't act, we are forcing the corporations that don't use the inversion tax gimmick to compete against the corporations that do. We will create economic pressures on our patriotic corporations to change their tax addresses. As one after another U.S. corporation moves overseas through a tax inversion, more U.S. competitors will face financial pressure to do the same, in order to stay on a level playing field. It isn't fair to the U.S. taxpayers who foot the bill, and it isn't fair to the U.S. corporations who want to do the right thing.

In 2002, the Finance Committee showed that it could work on a bipartisan basis to stop a similar tax inversion loophole. At that time, the then-Chairman and Ranking Member, Senators Baucus and Grassley, told companies that they would put a stop to corporate inversions, and drew a line in the sand, warning that tax inversions taking place after a specific date would be retroactively subjected to tax as a domestic U.S. corporation.

It took time, but Senators Baucus and Grassley achieved their goal. And, more importantly, they stopped a wave of corporate inversions that threatened to decimate our country's tax base.

Now a loophole has emerged which jeopardizes the effectiveness of our anti-inversion law. We must act speedily to close that loophole. Chairman Wyden has made clear that he intends to make any closure of the loophole in the tax inversion law retroactive to May 8, 2014. I support making any legislation retroactive to that date, and 22 other Senators supporting my bill, S.2360, do also. U.S. corporations should understand that if they pursue a tax inversion after May 8, 2014, they do so at their own risk.

We cannot afford to wait for tax reform to address the issue of tax inversions. Urgent action is needed now, and I urge you to take action as soon as possible to end this abusive tax loophole.

I look forward to working with you to both stop tax inversions and to improve our international tax system.

Statement of Peter R. Merrill
Principal, PricewaterhouseCoopers LLP
Hearing Before the United States Senate Committee on Finance

July 22, 2014

I. Introduction

Chairman Wyden, Ranking Member Hatch, Members of the Senate Finance Committee, thank you for the opportunity to testify today. My name is Peter Merrill. I am a Principal in the National Economics and Statistics group of PricewaterhouseCoopers LLP (PwC). As a Ph.D. economist, the focus of my practice is primarily on the economic effects of tax policy. I am appearing here today on my own behalf, expressing solely my own views, not those of PwC, its clients, or any other entity.

Taxation is one factor that affects the ability of U.S. multinational corporations ("multinationals") to compete in foreign markets. The U.S. tax system currently diverges in a number of important respects from the policies and practices of other major industrial countries—often to the competitive detriment of U.S. businesses with international operations. With the one-third decline in the share of U.S. companies in the Forbes Global Top 500 list, dropping from 200 in 1998 to 135 in 2013, it is clear that U.S. companies face a far more competitive global environment and thus the effects of U.S. international tax rules on the competitive position of U.S. companies has become even more important (see Figure 1).

I have been asked to provide an overview of how the U.S. rules for taxing international income compare with other advanced economies. This statement provides a brief summary of the key U.S. rules governing the taxation of foreign source income, compares these rules with the tax rules of other OECD member countries, describes recent international tax reforms in Japan, the United Kingdom (UK) and New Zealand, and discusses some of the economic effects of these U.S. tax policies.

II. Overview of U.S. Taxation of Corporate Foreign Source Income

A. Worldwide System of Taxation

The United States has a worldwide tax system under which U.S. domestic corporations are subject to U.S. income tax on both their domestic income and their foreign source income. Thus, a U.S. corporation is subject to taxation by the United States on all of its income regardless of where the income is earned. The top U.S. corporate income tax rate, including state income tax, is 39.1 percent, the highest rate among Organisation for Economic Co-operation and Development (OECD) countries.

B. Deferral

While the United States has a worldwide tax system, the tax law recognizes the separate legal status of foreign corporations and generally allows U.S. shareholders to defer paying U.S. tax on foreign income until such income is distributed. However, U.S. shareholders may be taxed on certain types of undistributed profits of a foreign corporation, in particular, under the so-called U.S. subpart F rules that apply to controlled foreign corporations (CFCs) and the passive foreign investment company (PFIC) rules.

The subpart F regime, enacted in 1962, applies to U.S. shareholders that own 10-percent or more of the voting stock of a CFC. Under this regime, 10-percent U.S. shareholders must include in their taxable income their respective shares of certain types of CFC income (collectively referred to as "subpart F income"), regardless of whether that income has been distributed. Assuming the ownership requirements are met, U.S. corporate shareholders of CFCs may claim a foreign tax credit for the underlying foreign income taxes incurred by the CFC on its subpart F income. When a CFC distributes income that has been taxed under subpart F, it is not taxed again by the United States.

Subpart F income has numerous components, the most important of which is foreign base company income. Foreign base company income includes foreign personal holding company income (which consists mainly of passive investment income) and foreign base company sales, services, and oil-related income (generally active business income).

Subpart F also requires a 10-percent U.S. shareholder to include in income its pro rata share of any investments in U.S. property by a CFC. For this purpose, a loan to a related U.S. corporation is considered an investment in U.S. property.

Unlike domestic subsidiaries, foreign subsidiaries, other than certain Mexican and Canadian subsidiaries, cannot be included in a U.S. consolidated return. Thus, any losses of foreign subsidiaries cannot be used to offset other profits of the U.S. group. Also, the dividends received deduction, which partially or completely relieves corporations from taxation on dividends from domestic subsidiaries, generally does not apply to dividends from foreign subsidiaries.

C. Mitigation of Double Taxation

If a U.S. corporation conducts business outside the United States, it generally will be subject to taxation by the country or countries in which it conducts business. Because the United States taxes worldwide income, a U.S. corporation's foreign income also is subject to U.S. income tax. To mitigate double taxation of income earned abroad, foreign income taxes generally may be credited against U.S. income tax, with allowable foreign tax credits limited to the U.S. tax on foreign source income.

Specific rules are prescribed for identifying the source (domestic or foreign) of various types of income, such as interest, dividends, rents and royalties, services, and sales of purchased and manufactured goods. Other rules allocate and apportion expenses between domestic and foreign source income for foreign tax credit purposes. Expenses that are not directly allocable to a particular item of income, in particular, interest, research and development (R&D), and stewardship expenditures are subject to special allocation rules.

III. Comparison of How Other Countries Tax Corporate Foreign Source Income

A. Statutory Corporate Tax Rate

The top U.S. statutory corporate tax rate, including state corporate income tax, is 39.1 percent. This is the highest rate among the 34 OECD member countries, more than 14 percentage points higher than the average for the other OECD countries (24.8 percent), and almost 10 percentage points higher than the average for the other G7 countries (29.4 percent) (see Table 1).

The United States has not always had the highest corporate tax income rate among OECD economies. In 1988, as a result of the rate reduction made by the Tax Reform Act of 1986, the U.S. corporate rate was more than five percentage points below the OECD average. Since then, the other OECD countries have reduced their corporate tax rates by an average of 19 percentage points, while the U.S. federal corporate tax rate has remained at 35 percent since 1993 (see Figure 2).

The high U.S. statutory corporate income tax rate has a number of adverse economic consequences in an increasingly global economy. First, it discourages both U.S. and foreign companies from locating their most profitable assets and operations inside the United States. Second, it encourages both U.S. and foreign companies to locate their borrowing in the United States, as the value of interest deductions is greater against a higher corporate tax rate. Third, it discourages U.S. multinationals from remitting foreign profits to the United States and being subjected to the higher U.S. corporate tax. As a result, a growing share of the foreign earnings of U.S. subsidiaries may be more effectively invested outside the United States.

Effective tax rates take into account both the statutory tax rate as well as the breadth of the tax base. There are a number of ways to calculate effective tax rates including economic measures, such as marginal and average effective tax rates, and financial accounting measures, such as cash and book tax rates. Using a variety of different measures, international comparisons of corporate effective tax rates generally find that the U.S. corporate tax rate is higher than average (see Figure 3).

B. Relief of Double International Taxation

Unlike the United States, 28 of the other 33 OECD member countries and all other G-7 countries, have adopted dividend exemption (so-called "territorial") tax systems (see Table 2).

Under these territorial tax systems, the active foreign income of foreign subsidiaries generally is taxed only by the country where it is earned, and it can be distributed to the parent company with little or no residual taxation. By contrast, under the U.S. worldwide system, foreign income is taxed by the country where it is earned and then by the United States (with a foreign tax credit) when the income is remitted to the United States.

There has been a pronounced shift over the last 25 years toward the use of territorial tax systems. In 1989, only 10 OECD member countries had territorial tax systems and just two of the G-7 countries (Canada and France) had such a system (see Figure 4). Today, 28 OECD countries and all other G-7 countries have adopted some form of territorial tax system. Notably, over this period, only two OECD countries switched from territorial to worldwide tax systems (Finland and New Zealand) and both countries subsequently switched back to territorial tax systems.[1]

As a result of these trends, U.S. multinationals now compete against foreign competitors that overwhelmingly are taxed under territorial systems. Within the OECD, 93 percent of the non-U.S. parented companies on the Global Fortune 500 list in 2012 were located in countries that use territorial tax systems (Figure 5).

C. Allocation of Indirect Expenses

The U.S. rules for determining the source of income are unusual among OECD member countries in allocating and apportioning indirect domestic expenses, most importantly interest and R&D expenses, against foreign source income. As a result, when a U.S. company borrows money or conducts R&D in the United States, its foreign tax credit may be reduced.

In lieu of apportioning indirect expenses, eight of the 28 OECD countries with territorial tax systems exempt slightly less than 100 percent of foreign dividends, typically 95 percent (97 percent in Norway).

D. Controlled Foreign Corporation Regimes

The U.S. subpart F regime was enacted in 1962, and as described above, treats certain unrepatriated income earned by a CFC as if distributed to its U.S. shareholders and subject to current U.S. taxation. While the Kennedy Administration had proposed including all foreign subsidiary income within the scope of subpart F (other than income earned in less developed countries), Congress retained the general principle of deferral and limited the scope of subpart F to certain passive and mobile income, with the goal to avoid unduly harming the competitive position of U.S. multinationals.[2]

Currently, 23 of the 34 OECD member countries have some form of CFC regime (see Table 3). In general, the scope of these CFC regimes is more limited than the U.S. CFC regime. Most countries restrict their CFC regimes to passive income and do not have provisions comparable to either the U.S. foreign base company sales, services, and oil-related income rules or the U.S. rules imposing current tax

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[1] Source: PricewaterhouseCoopers, *Evolution of Territorial Tax Systems in the OECD,* The Technology CEO Council, April 2, 2013.

[2] National Foreign Trade Council, *International Tax Policy for the 21st Century*, December 15, 2001, pp. 37-57.

on foreign income invested in domestic property. Moreover, 12 of the 23 OECD member countries with CFC regimes are EU member states whose CFC rules (as they apply to EU corporations) are restricted by EU law to "wholly artificial arrangements."[3]

The potentially adverse competitive impacts of the relatively stringent U.S. CFC rules, however, have been mitigated by (1) the temporary enactment in 2006, and subsequent extensions, of the CFC look-through rules (which generally exclude from subpart F interest, dividends, rents, and royalties received from a related CFC and paid out of its active, non-subpart F income); (2) the temporary enactment in 1997 and subsequent extensions of the active financial services income exception from subpart F; and (3) the issuance by the IRS in 1996 of entity classification ("check the box") regulations that allow eligible entities (including foreign entities) to elect to be treated as corporations or as fiscally transparent.

IV. Recent Corporate Tax Reforms by Other Countries

A. United Kingdom

In 2009, the UK government replaced its worldwide tax system with a 100-percent dividend exemption (territorial) system.[4] Subsequently, HM Revenue and Customs and HM Treasury released the *Corporate Tax Road Map*, which set out a bold vision for a multi-year corporate tax reform package:

> "The Government wants to send out the signal loud and clear that Britain is open for business … . In recent years too many businesses have left the UK amid concerns over tax competitiveness. It's time to reverse this trend. Our tax system was once viewed as an asset. And it needs to be an asset again. That is why the Government is prioritising corporate tax reform. Responding to the concerns of business, the UK is headed for a more competitive, simpler, and more stable tax system in the future, creating the right conditions for business investment."[5]

Chancellor George Osborne's 2011 budget accelerated the reforms with the goal to "create the most competitive tax system in the G20."

Since 2009, the UK government has enhanced the competitiveness of its corporate tax system by:

- Lowering the corporate income tax rate seven percentage points, from 28 percent in 2010 to 21 percent in 2014, with a further reduction to 20 percent scheduled in 2015.
- Extending the territorial system to foreign branches in 2011.
- Revising the UK CFC rules, effective in 2013, to be consistent with the territorial tax regime and focus more narrowly on foreign profits artificially diverted from the UK.
- Enacting a "patent box" system, effective in 2013, that phases in a 10-percent rate on patent-related income.
- Adopting a new 10-percent, non-incremental, refundable R&D credit.

In response to these corporate tax reforms, some multinationals returned to the UK and a number of other multinationals relocated their legal headquarters to the UK.

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[3] See Judgment of the European Court of Justice, Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Case C-196/04, September 12, 2006.

[4] EU law restrictions on dividend taxation, CFC regimes, and on tax barriers to corporate expatriation were influential in shaping UK corporate tax reform.

[5] HM Revenue & Customs and HM Treasury, *Corporate Tax Reform: delivering a more competitive system*, November 2010, p. 7.

HM Revenue & Customs and HM Treasury (2013) used a computable general equilibrium model of the UK economy to simulate the long-term impacts of a reduction in the corporate tax rate from 28 percent in 2010 to a scheduled 20 percent in 2015. Relative to the baseline forecast, the study estimated that the rate reduction would increase GDP by between 0.65 percent and 0.82 percent after 20 years, and that these growth effects would offset between 45 percent and 60 percent of the static revenue cost of the tax rate reduction.[6]

Other researchers used data on 61,738 UK-owned foreign affiliates in 2008 and 2009 to estimate the impact of the UK territorial tax system, which took effect in 2009.[7] The authors found that UK parents of foreign affiliates responded to the adoption of the territorial tax system by increasing repatriations (by an average of over $2 million per affiliate) and reducing foreign affiliate investment.

B. Japan

Effective in 2009, Japan replaced its worldwide tax system with a 95-percent exemption for dividends received by Japanese corporations from foreign subsidiaries. The Japanese Ministry of Economy, Trade and Industry had advocated adoption of a territorial system to encourage repatriation of foreign earnings to Japan with a key goal of increasing domestic investment.[8]

In 2010, Japan liberalized and clarified its CFC rules, notably including within the scope of these rules only CFCs with an effective tax rate of less than 20 percent, as compared to 25 percent under prior law.

In 2011, Japan enacted a corporate rate reduction of five percentage points, but simultaneously enacted a temporary 2.5 percentage point surtax to aid in reconstruction work from the March 2011 earthquake. Both changes took effect in April 2012, resulting in the combined national and local corporate rate declining from 40.69 percent to 38.01 percent. The temporary surtax was to be in place for three years, but in 2014 was repealed one year early. As a result, beginning in April 2014, Japan's corporate tax rate declined to 35.64 percent. In June, Prime Minister Shinzo Abe's cabinet approved further reductions in the corporate tax rate to below 30 percent phased in over several years.

One report studied the effect of the adoption of territorial tax systems in Japan and the UK on cross-border mergers and acquisitions. The report estimates that elimination of the worldwide tax system in Japan increased the number of international mergers and acquisitions with a Japanese acquirer by 31.9 percent.[9]

Another report analyzed the effects of the UK and Japanese adoption of territorial tax systems in 2009.[10] The authors found that as a result of the adoption of territorial taxation, both UK and Japanese firms accumulated less cash, increased distributions to shareholders, and reduced foreign investment; however, they did not find a significant impact on domestic investment.[11]

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[6] HM Revenues & Customs and HM Treasury, *Analysis of the dynamic effects of corporation tax reductions,* December 5, 2013.

[7] Peter Egger, Valeria Merlo, Martin Ruf, and Georg Wamser, "Consequences of the New UK Tax Exemption System: Evidence from Micro-level Data," CESifo, Working Paper no. 3942, September 2012.

[8] Todd Landau, Takaaki Tokuhiro, Kinjun Muraoka, and Shuta Kobayashi, "Japan issues proposed 2009 tax reforms," *Journal of International Taxation,* March 2009, pp. 15-19.

[9] Lars P. Feld, Martin Ruf, Uwe Scheuering, Ulrich Schreiber, and Johannes Voget, "Effects of Territorial and Worldwide Corporation Tax Systems on Outbound M&As," Center for European Economic Research, Discussion paper no. 13-088, 2013.

[10] Matteo Arena and George Kutner, "Territorial Tax System Reform and Corporate Financial Policies," December 2013, available at: http://ssrn.com/abstract=2160954

[11] The global financial crisis, which occurred concurrently with the adoption of territorial tax systems in Japan and the UK, may have dampened domestic investment. Also, under the prior worldwide tax systems used in Japan and the UK, foreign subsidiary earnings could be lent to the parent company without triggering tax.

C. New Zealand

Prior to 1988, dividends received by a New Zealand company from a foreign company were exempt from New Zealand income tax. Beginning in 1988, New Zealand resident companies were taxed on all income earned by their CFCs on a current basis with credits for foreign taxes (i.e., a worldwide system without deferral). No other OECD country has adopted a similar tax system. Instead, other OECD countries generally limit their anti-deferral regimes to passive income.

The New Zealand government ultimately determined that taxing all foreign subsidiary earnings on a current basis had adverse effects on their domestic economy. A 2006 New Zealand government report noted the following concerns with such an international tax system:[12]

1. "Since New Zealand taxes the income of its CFCs more heavily than other countries, it can be attractive for innovative and dynamic firms to migrate from New Zealand, establish themselves in other countries or simply stay small and local." [p. 7]

2. "Migration of even one or two of New Zealand's large dynamic firms could have a substantial negative effect on the economy ... Not only would migration lead to jobs within head offices being shifted offshore, so too would be the demand for associated professional services ... Firm migration also reduces the extent to which New Zealand could benefit from cluster effects." [p. 11]

3. "A foreign tax credit system can provide incentives for domestic firms to channel offshore investment into higher-tax foreign countries in ways which are not in New Zealand's best interest." [p. 9]

4. "Finally, higher taxes on offshore income may also make it difficult for New Zealand-based firms to expand out of local markets ..." [p. 12]

The 2006 report also noted that while the stock of outbound direct investment by New Zealand had remained relatively constant since the early 1990s, fluctuating between 10 and 15 percent of GDP, for the OECD as a whole, and Australia in particular, outbound direct investment increased from 10 percent of GDP to around 30 percent by 2004 (see Figure 6).

In response to the adverse economic effects of the change to a worldwide system without deferral, New Zealand switched back to a territorial system in 2009 (effective for tax years beginning after June 30, 2009). The New Zealand reform (1) restricted the scope of the CFC regime to passive income, and (2) exempted 100 percent of foreign subsidiary dividends.

V. Economic Effects of U.S. International Tax System

With the highest corporate tax rate among OECD countries and a worldwide tax regime, the U.S. corporate tax system falls far outside international norms for advanced economies, with possible adverse consequences for the U.S. economy. This section discusses the effects of U.S. tax policy on (A) foreign investment, (B) headquarters location, and (C) economic growth.

A. Foreign Investment

With the rapid growth in emerging market economies, the foreign share of U.S. multinational company earnings has increased. For all U.S. public companies, domestic and multinational, 48 percent of 2012

[12] Hon. Dr. Michael Cullen (Minister of Finance) and Hon. Peter Dunne (Minister of Revenue), *New Zealand's International Tax Review: a direction for change*, 2006.

pre-tax book earnings was reported as coming from foreign sources.[13] The effect of U.S. tax law is to discourage companies from remitting these foreign earnings to, or investing it in, the United States, because doing so would result in imposition of U.S. tax at a federal rate of 35 percent, with an offset for associated foreign income taxes. As foreign income tax rates have fallen, the U.S. tax that would be incurred by repatriating foreign earnings has increased, in effect discouraging the repatriation of foreign income that is not currently needed for business purposes abroad.

One measure of the amount of earnings accumulated abroad that companies do not intend to repatriate or invest in the United States is the amount of income recorded on their financial statements as permanently or indefinitely reinvested abroad. Some of these earnings are reinvested abroad in active business assets, such as plant, property, and equipment, and some is invested in cash and equivalents.[14] Audit Analytics estimates that for the companies in the Russell 1000, permanently reinvested earnings reached $2.1 trillion in 2013, an increase of $1 trillion over the prior five years.[15]

One consequence of the U.S. tax rules with respect to repatriated foreign earnings is that it is more attractive for U.S. multinationals to invest abroad than at home. For example, if a foreign subsidiary earns $100 million and distributes $80 million of earnings, after paying $20 million of foreign tax, to its U.S. parent, there would be just $65 million available to invest after paying $15 million of U.S. corporate tax (35 percent of $100 million less a credit for the $20 million of foreign tax). By contrast, the entire $80 million would be available to invest if used to expand abroad or acquire a foreign company. In this example, the U.S. tax system effectively provides a $15 million tax incentive for investing *outside* the United States.

Walter Galvin, the retired Vice Chairman of Emerson, testified about a real-life example of how the U.S. tax system encouraged foreign investment:

> "Last year, Emerson bought a company in the U.K. called Chloride for about $1.5 billion with cash we had earned abroad and kept abroad. We considered other options for that cash, such as bringing it to the U.S., but the U.S. tax code would charge us an extra 10 to 15 cents in taxes on every dollar. Where is our return higher? A dollar invested in the U.K. or 85 cents in the United States?"[16]

Academic research confirms that U.S companies with foreign profits that would be subject to U.S. tax if repatriated are more like to invest abroad. Across a large sample of U.S. multinationals, one report found that both the probability and the number of foreign (but not domestic) acquisitions increases with the amount of foreign cash.[17] The authors also found that the stock market reaction to announced foreign acquisitions is more negative for firms with more locked out cash, suggesting that, "firms are both stockpiling cash and (poorly) investing overseas because U.S. policy hinders repatriation."

B. Headquarters Location

The combination of a high U.S. corporate tax rate and a worldwide regime which taxes foreign income when remitted to the United States is an important disadvantage to the selection of the United States as headquarters. If the United States is chosen as the tax home of the merged entity, distributions to the ultimate parent company of foreign income would be subject to the U.S. repatriation tax – a tax that does

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[13] PwC calculations based on Compustat data.

[14] Ben Casselman and Justin Lahart, "Companies shun investment, hoard cash," Wall Street Journal, Sept. 17, 2011.

[15] Audit Analytics, available at: http://www.auditanalytics.com/blog/wp-content/uploads/2014/04/IRE-April-2014-Picture-1.png

[16] Testimony of Mr. Walter J. Galvin before the Committee on Ways & Means, U.S. House of Representatives, Hearing on "How Business Tax Reform Can Encourage Job Creation," June 2, 2011.

[17] Hanlon, Michelle and Lester, Rebecca and Verdi, Rodrigo S., "The Effect of Repatriation Tax Costs on U.S. Multinational Investment," May 23, 2014 (Journal of Financial Economics, forthcoming). Available at SSRN: http://ssrn.com/abstract=2441529 or http://dx.doi.org/10.2139/ssrn.2441529

not apply if the parent company is headquartered in a country with a territorial tax system. Moreover, by establishing legal headquarters in a country with a territorial tax system, the company will be better positioned as an acquirer of businesses. This can be observed in a number of cross border merger and acquisition transactions in which the combined company has chosen to be legally headquartered outside of the United States.

Based on the experience of the UK and Japan, one study estimated that if the United States were to switch from a worldwide to a territorial tax system, the number of cross-border mergers and acquisitions in which the U.S. company was acquirer would increase by 17.1 percent.[18]

C. Economic Growth

A recent report by Laura D'Andrea Tyson and colleagues at the Berkeley Research Group analyzed the macroeconomic effects of eliminating most of the U.S. repatriation tax by adopting a 95-percent exemption for active foreign subsidiary earnings. The report estimated that such a territorial tax system (at the current U.S. corporate tax rate) would, on an ongoing basis, increase repatriations by $114 billion per year, increase U.S. GDP by $22 billion annually, and create an estimated 154,000 new jobs per year, with even larger effects during an initial transition from the current U.S. worldwide tax system.[19]

VI. Conclusion

U.S. companies are increasingly competing in foreign markets, which account for over 95 percent of the world's population and over 75 percent of global purchasing power. In many cases, a U.S. company's sales of goods and services overseas creates jobs and growth in the United States. For U.S. companies to succeed in the global marketplace, they must be able to provide goods and services that are competitive in terms of quality, innovation, and price.

Since the last major reform of the U.S. corporate income tax in 1986, the importance of foreign markets to the success of U.S. business has grown and international competition from foreign-based companies has increased. Over this same period, other advanced economies have reduced their corporate tax rates and moved from worldwide to territorial tax systems. As a result, the U.S. corporate tax system has become an outlier among OECD countries. Reform of the U.S. tax system to bring it more in line with international norms would enhance the ability of U.S. multinationals to continue to compete and succeed in global markets.

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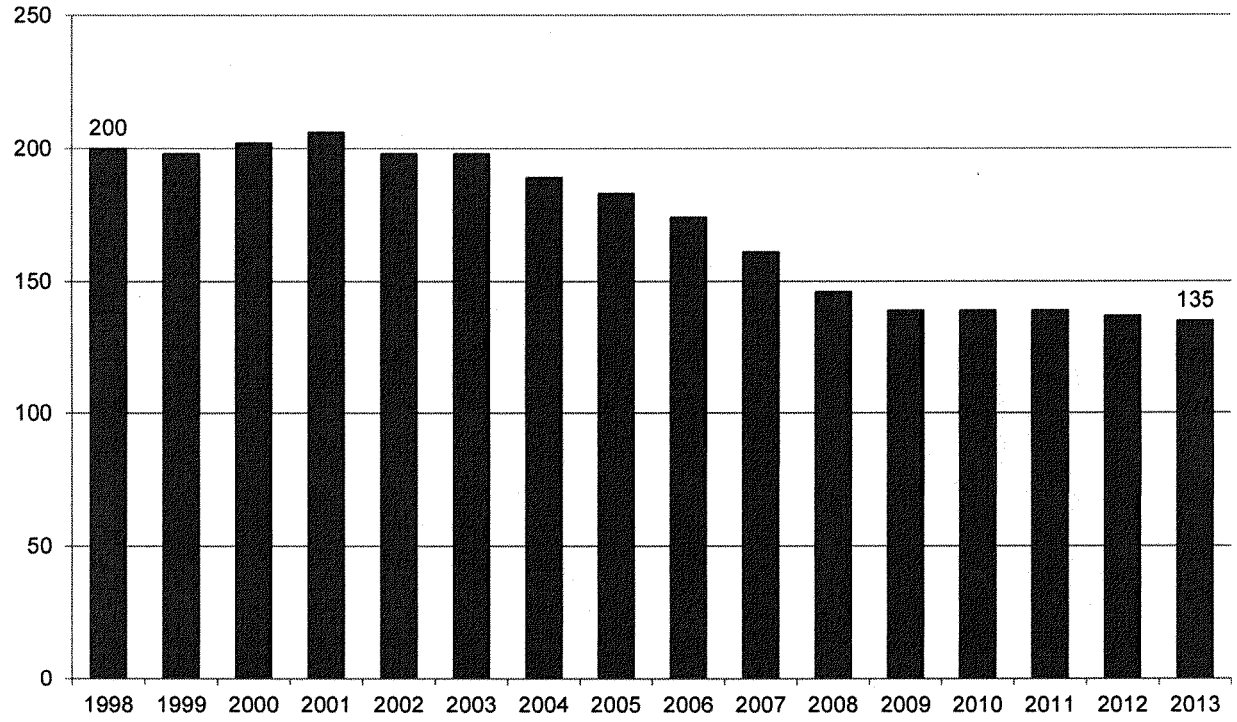
[18] Feld et al. (2013), *op cit*.

[19] Eric Drabkin, Kenneth Serwin, Laura D'Andrea Tyson, "Implications of a Switch to a Territorial Tax System in the United States: A Critical Comparison to the Current System," Berkeley Research Group, October 2013.

Figure 1

U.S. Companies in Global Top 500 Companies, 1998-2013



Source: Forbes 500s List, 1999-2003; International 800 List, 1999-2000; International 500 List, 2001-2003; Global 2000 List, 2004-2014.

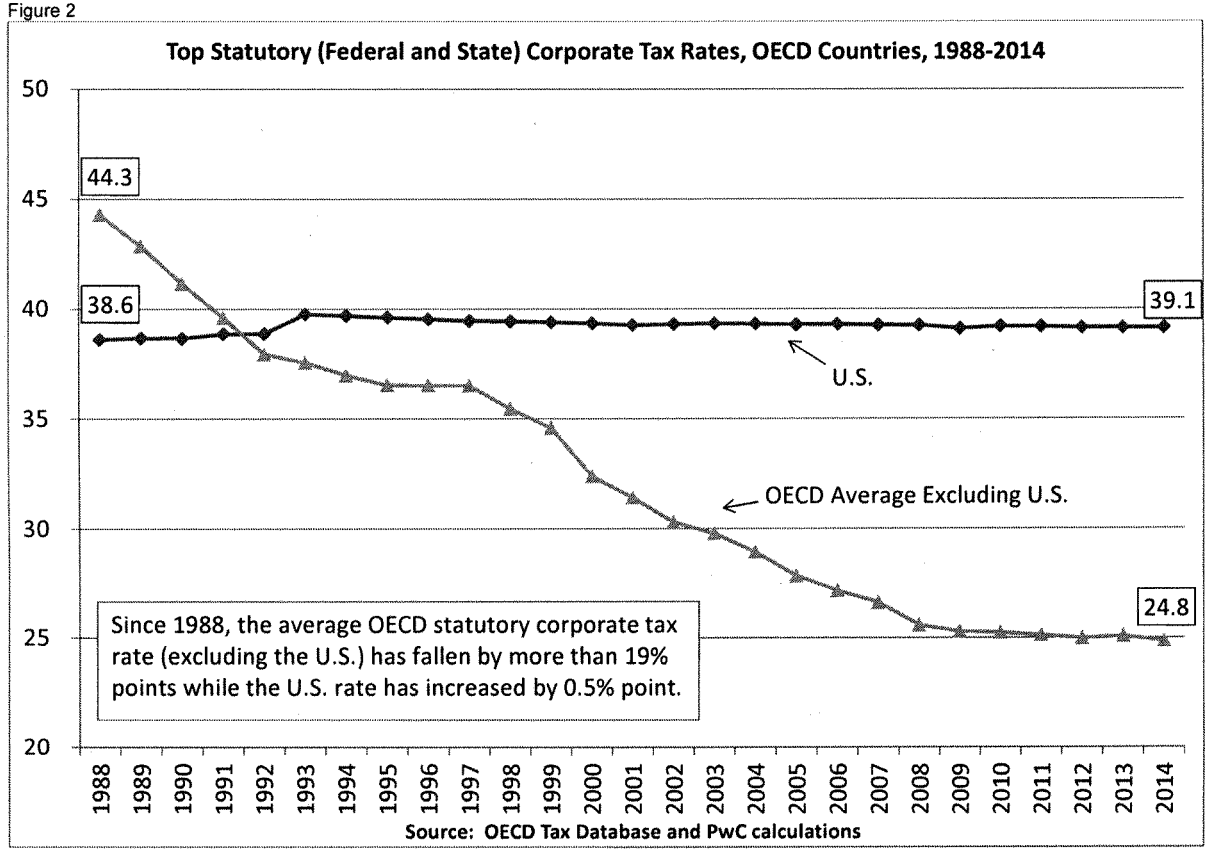
Table 1

Top Corporate Tax Rate (Federal plus State), OECD Countries, 2014

Rank	Country	Rate
1.	**United States**	**39.1**
2.	Japan	37.0
3.	France	34.4
4.	Belgium	34.0
5.	Portugal	31.5
6.	Germany	30.2
7.	Australia	30.0
8.	Mexico	30.0
9.	Spain	30.0
10.	Luxembourg	29.2
11.	New Zealand	28.0
12.	Italy	27.5
13.	Norway	27.0
14.	Israel	26.5
15.	Canada	26.3
16.	Greece	26.0
17.	Austria	25.0
18.	Netherlands	25.0
19.	Denmark	24.5
20.	Korea	24.2
21.	Slovak Republic	22.0
22.	Sweden	22.0
23.	Switzerland	21.1
24.	Estonia*	21.0
25.	United Kingdom	21.0
26.	Chile	20.0
27.	Finland	20.0
28.	Iceland	20.0
29.	Turkey	20.0
30.	Czech Republic	19.0
31.	Hungary	19.0
32.	Poland	19.0
33.	Slovenia	17.0
34.	Ireland	12.5
G-7 average excluding U.S.		**29.4**
OECD average excluding U.S.		**24.8**

Source: OECD Tax Database

Figure 2


Top Statutory (Federal and State) Corporate Tax Rates, OECD Countries, 1988-2014
50
45
40
35
30
25
20
44.3
38.6
39.1
24.8
U.S.
OECD Average Excluding U.S.
Since 1988, the average OECD statutory corporate tax rate (excluding the U.S.) has fallen by more than 19% points while the U.S. rate has increased by 0.5% point.
1988
1989
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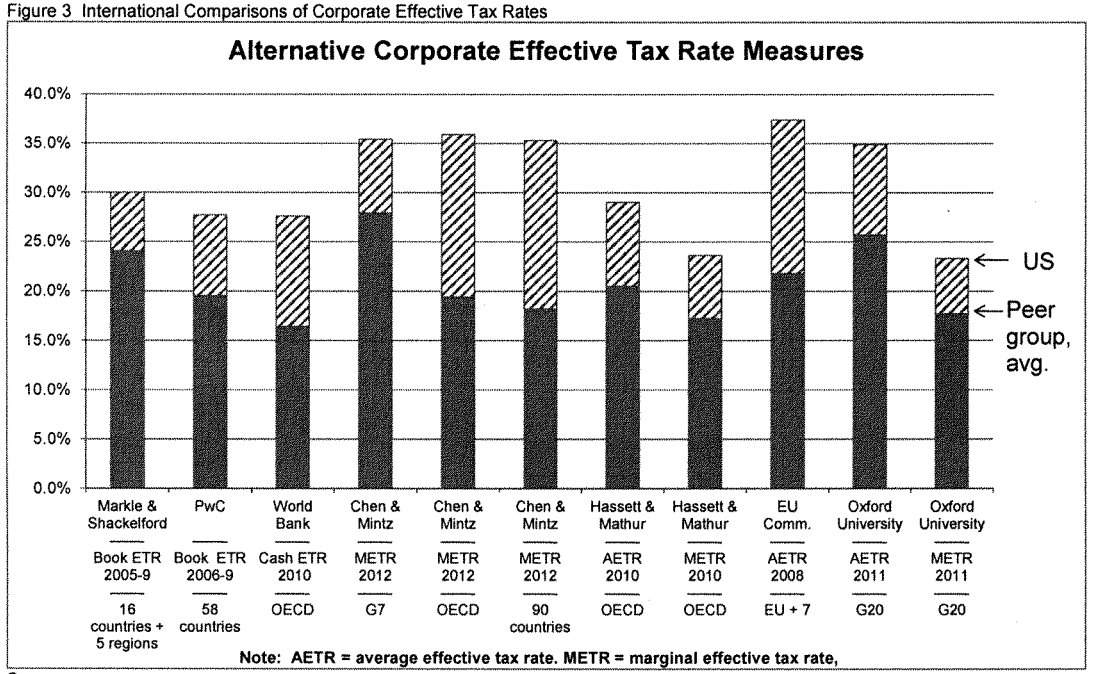
2013
2014
Source: OECD Tax Database and PwC calculations

Table 2.— OECD Countries with Territorial and Worldwide Tax Systems, 2014

Taxation of foreign subsidiary income	OECD Member Countries	Dividend exemption percentage
Territorial tax systems	Australia, Austria, Canada, Czech Republic, Denmark, Estonia, Finland, Greece, Hungary, Iceland, Luxembourg, Netherlands, New Zealand, Poland, Portugal, Slovak Republic, Spain, Sweden, Turkey, United Kingdom	100%
	Norway	97%
	Belgium, France, Germany, Italy, Japan, Slovenia, Switzerland	95%
Worldwide tax systems	Chile, Ireland, Israel, Korea, Mexico, United States	none

Source: PricewaterhouseCoopers, *Evolution of Territorial Tax Systems in the OECD*, The Technology CEO Council, April 2, 2013.

Figure 3 International Comparisons of Corporate Effective Tax Rates



Sources:

K. Bilicka, M. Devereux and C. Fuest, "G20 Corporate Tax Ranking 2011" Oxford University, Centre for Business Taxation, July 2011.

D. Chen and J. Mintz, "Corporate Tax Competitiveness Rankings for 2012." Cato Institute, September 2012.

M. Devereux., C. Elschner, D. Endres, and C. Spengel, "Effective Tax Levels Using the Devereux/Griffith Methodology." Centre for European Economic Research, October 2009 (Report prepared for the EU Commission).

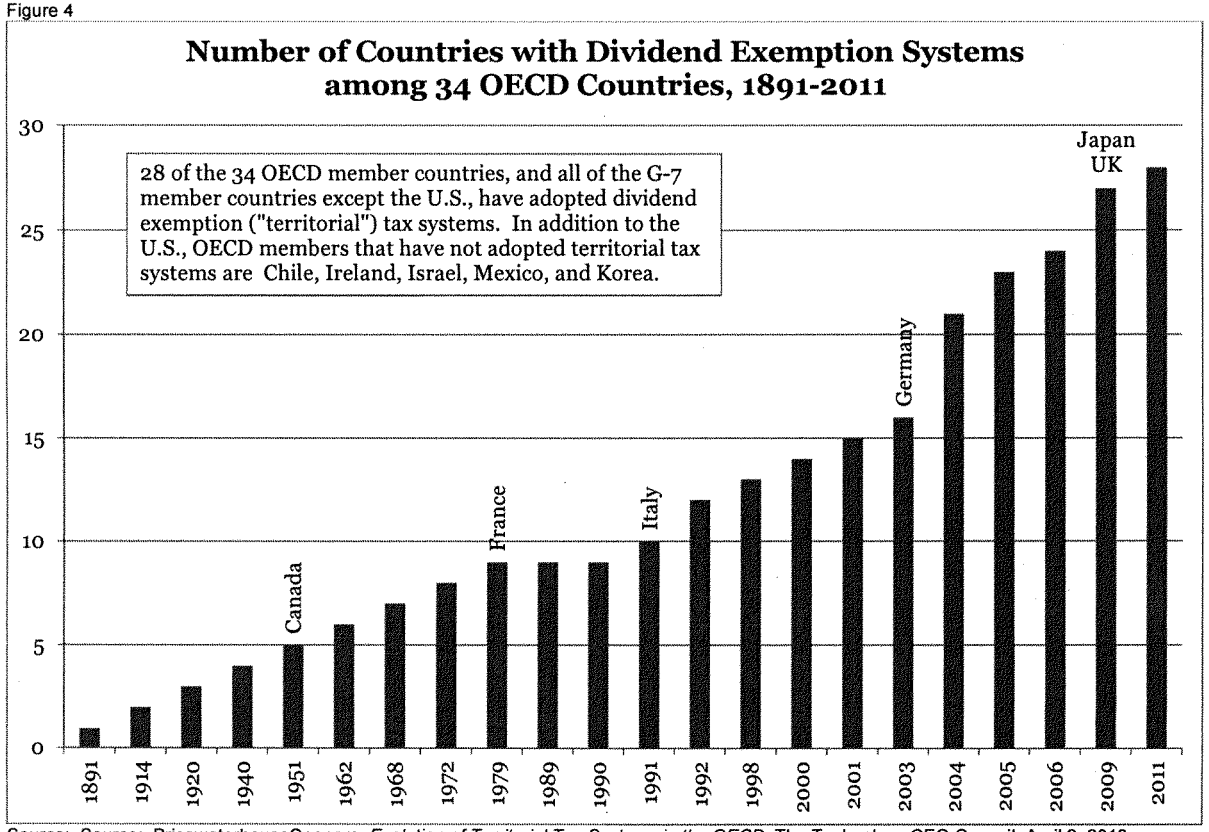
K. Hassett and A. Mathur, "Report Card on Effective Corporate Tax Rates: United States Gets an F." AEI, February 2011.

K. Markle and D. Shackelford, "Cross-Country Comparisons of Corporate Income Taxes." NBER working paper 16839, February 2011.

PwC, "Global Effective Tax Rates." April 14, 2011 (Report prepared for Business Roundtable).

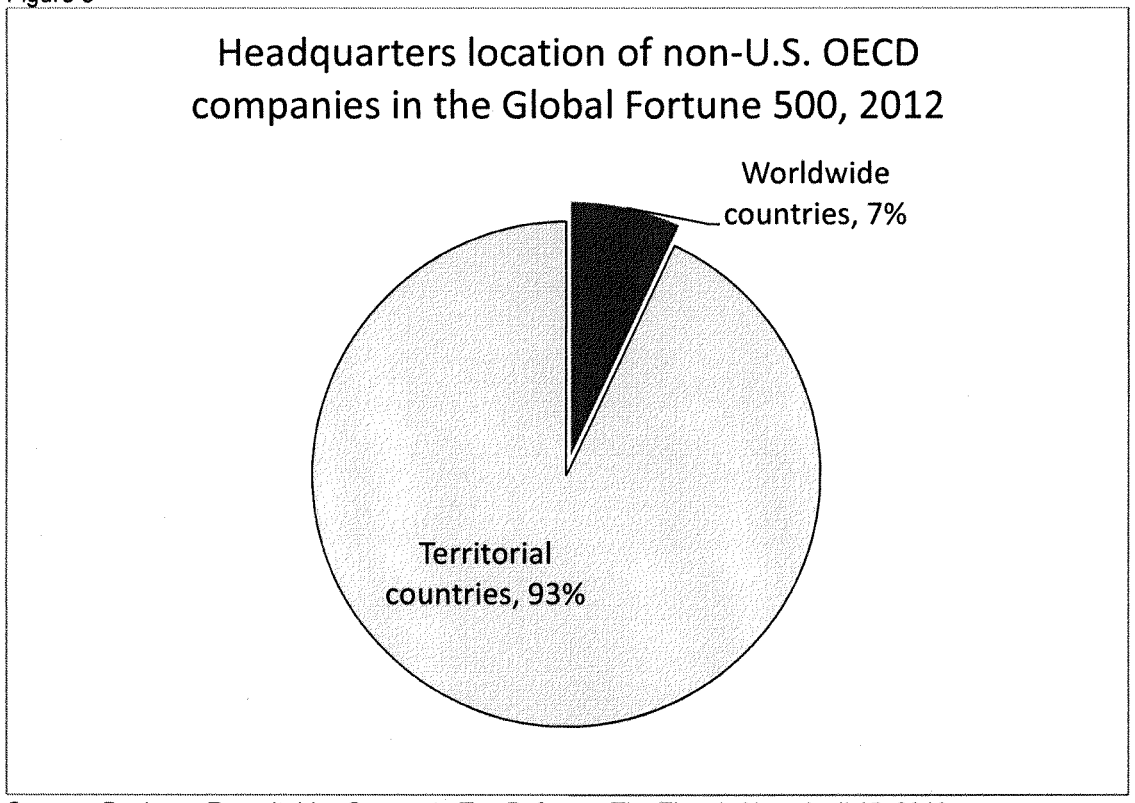
PwC, "Paying Taxes 2011: The Global Pictures," prepared for the World Bank and IFC Doing Business 2011 report.

Figure 4



Source: Source: PricewaterhouseCoopers, *Evolution of Territorial Tax Systems in the OECD*, The Technology CEO Council, April 2, 2013.

Figure 5



Source: Business Roundtable, *Corporate Tax Reform – The Time is Now*, April 15, 2013

Table 3. Controlled Foreign Corporation Regimes in OECD Countries, January 2014

Country	CFC Regime	EU member
Australia	Yes	
Austria[1]	Alternate	Yes
Belgium	None	Yes
Canada	Yes	
Chile	None	
Czech Republic	None	Yes
Denmark	Yes	yes
Estonia	Yes	Yes
Finland	Yes	Yes
France	Yes	Yes
Germany	Yes	Yes
Greece	Yes	Yes
Hungary	Yes	Yes
Iceland	Yes	
Ireland	None	Yes
Israel	Yes	
Italy	Yes	Yes
Japan	Yes	
Korea	Yes	
Luxembourg	None	Yes
Mexico	Yes	
Netherlands[2]	Alternate	Yes
New Zealand	Yes	
Norway	Yes	
Poland	None	Yes
Portugal	Yes	Yes
Slovak Republic	None	Yes
Slovenia[3]	Alternate	Yes
Spain	Yes	Yes
Sweden	Yes	Yes
Switzerland	None	
Turkey	Yes	
United Kingdom	Yes	Yes
United States	Yes	
OECD member countries		**34**
No CFC regime		11
EU member with CFC regime		12
Non-EU member with CFC regime		11

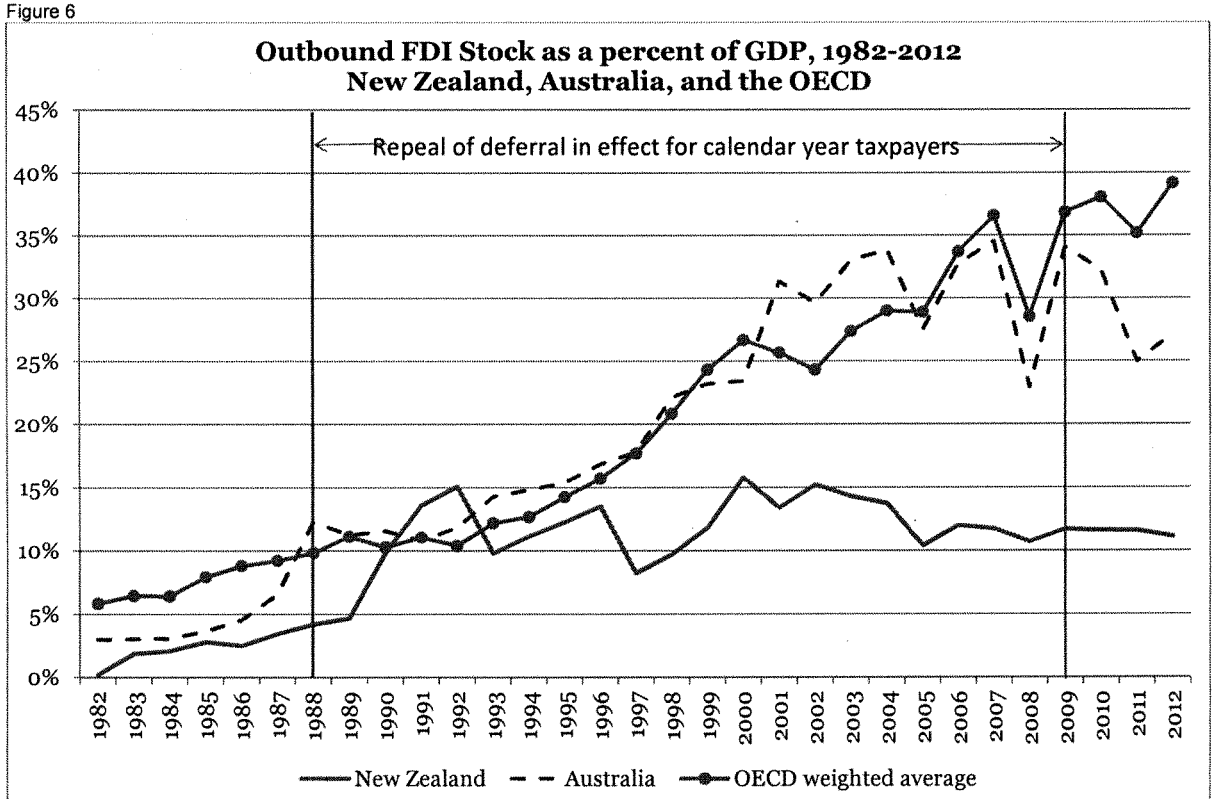
[1] Austria's dividend exemption system excludes certain passive income.

[2] The Netherlands has a passive foreign investment company regime.

[3] Slovenia imposes withholding tax on payments for certain services and interest to persons established in certain low-tax jurisdictions.

Source: Deloitte, *Guide to Controlled Foreign Company Regimes* , January 2014

Figure 6



Source: UNCTAD (downloaded July 2014). Weighted average based on 2012 GDP from the IMF, *World Economic Outlook*, April 2014.

Testimony of Leslie Robinson
Associate Professor, Tuck School of Business at Dartmouth

Before the
United States Senate Committee on Finance
Hearing on International Corporate Taxation

July 22, 2014

Chairman Wyden, Ranking Member Hatch, and distinguished members of the Committee, it is an honor to appear today to testify on the important topic of international corporate taxation. I am an associate professor at the Tuck School of Business at Dartmouth College. I teach financial accounting and taxation and my research centers on multinational corporations (MNCs). The views I am expressing are my personal views.

Abandoning our current approach to international corporate taxation in favor of one of the many alternatives would be a major policy move and deserves careful analysis. It is clear that reform is needed – the international system is one of the most technically complex areas of the U.S. tax code but raises little revenue.

In this testimony, I would like to offer my views on: (i) the problem(s) with the current system, (ii) some strengths and weaknesses of reform alternatives, and (iii) financial reporting considerations when formulating international tax policy. As my views are shaped by my own research and the research of my colleagues, I will summarize extant work guiding many of the assessments I offer in my testimony.

A. What is the problem with the current system of U.S. international corporate taxation?

Comparative tax burdens

Public debate surrounding reform of U.S. international corporate taxation often features claims that the current system is not 'competitive'. The top U.S. federal corporate income tax rate is 35 percent. At present, this is the highest federal tax rate of all OECD countries, and far exceeds the 23.5% average of all other OECD countries. Generally speaking, U.S.-based MNCs face this relatively high tax on worldwide profits, whereas non-U.S.-based MNCs face a relatively low tax on domestic profits and no residual home country tax on foreign profits. Thus, a common assertion is that U.S. MNCs are at a competitive disadvantage because they face larger corporate tax burdens than their competitors under a worldwide, rather than territorial, tax system.

Yet there is no evidence to support this assertion. Some studies compare global accounting effective tax rates (ETRs) across countries with the goal of informing the

debate on competitiveness.[1] Markle and Shackelford (2011) finds that firms resident in countries with a worldwide tax system have ETRs that are 1.4% lower than firms resident in countries with a territorial tax system.[2] Avi-Yonah and Lahav (2011) finds that U.S. MNCs have ETRs that are 4% lower than MNCs based in the EU.[3] Finally, Maffini (2012) finds that, after controlling for statutory tax rates in the home country, there is no difference in ETRs of firms operating under a worldwide versus territorial tax system.[4]

The issue of competiveness is often raised when advancing reform towards adoption of a territorial system. Embodied in such a system is the concept of capital import neutrality that requires the same tax on firms with different nationalities that invest in a given location. Comparing global ETRs will not detect violations of capital import neutrality because they, in part, reflect differences in location decisions.

Since each MNC has a different geographic footprint, a comparison of ETRs within a single jurisdiction operated by MNCs resident in different countries would seem more appropriate. For instance, how does the tax burden (including both source and host country taxes) on operations in a given country compare between U.S. MNCs and non-U.S. MNCs?[5] We do not know the answer to this question, nor is there good data to answer it. At best, we observe the source country tax, but do not observe any home country tax imposed on profits earned in a specific country.

Both Markle and Shackelford (2011) and Maffini (2012) move closer to making the relevant comparison when they examine the impact of location decisions on global ETRs for firms resident in different countries. The former study finds that by operating a subsidiary in the Netherlands, a U.S. firm reduces its global ETR by 0.1% whereas a Swedish firm lowers its global ETR by 7.3%. The latter study finds that a tax haven subsidiary yields a greater reduction in the global ETR for territorial firms, relative to worldwide firms. The reality is that we know very little about how the tax burden in any particular jurisdiction depends on the parent company's country of residence.

There is no evidence that U.S. MNCs face greater tax burdens as a consequence of how foreign profits are taxed, relative to their competitors. Further, researchers

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[1] Due to the ability to defer tax expense recognition for expected U.S. repatriation taxes under APB 23 in U.S. firms' financial statements, accounting ETRs will not reflect the expected residual U.S. tax, which may be indefinitely deferred. Thus, APB 23 puts U.S. MNCs 'on par' with MNCs based in territorial countries in terms of the accounting ETR.

[2] Markle, Kevin, and Douglas Shackelford (2011). Cross-Country Comparisons of Corporate Income Taxes, NBER Working Paper 16839.

[3] Avi-Yonah, Reuven, and Yaron Lahav (2011). The Effective Tax Rate of the Largest US and EU Multinationals. University of Michigan Public Law Working Paper 255.

[4] Maffini, Giorgia (2012). Territoriality, Worldwide Principle, and Competitiveness of Multinationals: A Firm-Level Analysis of Tax Burdens. Centre for Business Taxation WP 12/10.

[5] It is entirely possible that, for a given profit generated in a low-tax country, a non-U.S. MNC faces a higher tax burden due to 'strong' anti-abuse rules taxing those source country profits in the MNC's home country, while the U.S. firm faces indefinite deferral of home country tax under 'weak' anti-abuse rules.

cannot make comparisons by jurisdiction that would seem necessary to resolve the competitiveness issue. This is of particular importance when the public debate frames the problem with the current tax system as violating capital import neutrality and calls for the adoption of a territorial tax system.

The implicit cost of tax deferral

The burden associated with the current U.S. system includes both the explicit residual tax on actual repatriations and the implicit cost of avoiding repatriation. The explicit cost of the repatriation tax would show up in firms' ETRs, but the implicit cost of avoiding the tax would not. Such implicit costs might include high leverage in the U.S. to finance domestic investment, or making foreign investments with lower rates of return than could be earned domestically. Thus, it may be more fruitful to search for evidence that the U.S. tax system lacks competitiveness by examining implicit, rather than explicit, costs.

The implicit tax associated with avoiding repatriation is estimated at about 1% of pre-tax income (1.7% in tax havens).[6] However, the unexpectedly large repatriations under the 2005 tax holiday that reduced the repatriation tax rate to 5.25% suggests that these estimates are too low. The reason is that MNCs will not repatriate until the effective tax rate on locked-out earnings falls below the cost of deferral.

In light of the tax holiday, Grubert and Altshuler (2008) re-examines these estimates and finds that the implicit costs are increasing in the stock of deferrals, an issue that was previously not considered.[7] That is, the cost of using complex structures to avoid repatriation taxes increases as the amount of undistributed earnings rises. Consistent with this, Lewellen and Robinson (2013) documents a significant difference in both the size and age of foreign operations between U.S. MNCs that use complex internal ownership structures (i.e., affiliates are indirectly owned by the parent), relative to those that do not.[8]

An important implicit cost of deferral is the failure to allocate economic resources in an efficient manner. As U.S. taxation of foreign earnings only takes place when earnings are repatriated, firms have incentives to keep foreign earnings abroad. As a consequence, in times of limited foreign investment opportunities and high profitability, these funds are likely to be held abroad in the form of cash – referred to as the "lock out" effect or "trapped cash". Foley, Hartzell, Titman, and Twite (2007) finds that the repatriation tax

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[6] Grubert, Harry, and John Mutti (2001). Taxing International Business Income: Dividend Exemption versus the Current System. American Enterprise Institute, Washington DC.; Desai, Mihir, Fritz Foley, and Jim Hines (2001). Repatriation Taxes and Dividend Distortions. *National Tax Journal* 54 (4), 829-851.
[7] Grubert, Harry, and Rosanne Altshuler (2008). Corporate Income Taxes in the World Economy: Reforming the Taxation of Cross-Border Income. In Diamond, John W. and George R. Zodrow (eds.). *Fundamental Tax Reform: Issues, Choices, and Implications*, 319-354. MIT Press, Cambridge, MA.
[8] Lewellen, Katharina, and Leslie Robinson (2013). The Internal Ownership Structures of Multinational Firms. Tuck School of Business working paper.

helps explain cash holdings abroad in U.S. MNCs.[9] Hanlon, Lester and Verdi (2014) and Blouin, Krull, and Robinson (2014) develop proxies for trapped cash in U.S. MNCs and examine the economic effects of these cash holdings.[10]

Hanlon et al. documents that foreign acquisitions are more likely for firms with trapped cash, and that market reaction to the announcement of such acquisitions is negative. The inference is that foreign investments financed by trapped cash are value decreasing, possible reflecting agency issues. Blouin et al. documents that domestic investment of firms with trapped cash is less responsive to U.S. investment opportunities and is more sensitive to domestic cash flows than foreign cash flows. Further, this finding holds only in a sample of financially constrained firms (i.e., those with limited access to external capital markets). The authors conclude that trapped cash creates frictions in firms' internal capital markets.

There is also evidence consistent with the implicit cost of the lock out effect making U.S. MNCs less competitive in the market for corporate control. Huizinga and Voget (2009) finds that countries with worldwide tax systems are less likely to attract the parent companies of newly created MNCs following cross-border M&A transactions.[11] They estimate that U.S. adoption of a territorial system would increase the proportion of cross-border takeovers resulting in a U.S. parent firm from 53% to 58%. Feld, Ruf, Scheuering, Schreiber, and Voget (2013) finds that the number of cross-border M&A transactions featuring a Japanese or UK acquirer increased after these countries adopted a territorial system. Based on their results, they estimate that U.S. adoption of a territorial system would increase the number of cross-border transactions featuring a U.S. acquirer by 17%.

Balakrishnan, Blouin, and Guay (2012) documents another implicit cost by showing that firms engaging in more extensive tax planning have less transparent (internal and external) information environments due the organizational complexities associated with implementing various tax strategies.[12] Finally, Creal, Rogers, Robinson and Zechman

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[9] Foley, Fritz, Jay Hartzell, Sheridan Titman, and Garry Twite (2007). Why Do Firms Hold So Much Cash? A Tax-Based Explanation. *Journal of Financial Economics*, 86 (3), 579-607. However, this role of taxes is challenged in a recent working paper that compares cash holdings across firms resident in different countries. The authors find a number of results inconsistent with tax-induced cash holdings in MNCs resident in different countries. See Pinkowitz, Lee, René Stulz, and Rohan Williamson (2012). Multinationals and the High Cash Holdings Puzzle. Ohio State University working paper.

[10] Hanlon, Michelle, Becky Lester, and Rodrigo Verdi (2014). The Effect of Repatriation Tax Costs on U.S. Multinational Investment. *Journal of Financial Economics*, forthcoming; Blouin, Jennifer, Linda Krull and Leslie Robinson (2014). The Location, Composition, and Investment Implications of Permanently Reinvested Earnings. University of Pennsylvania working paper.

[11] Huizinga, Harry, and Johannes Voget (2009). International Taxation and the Direction and Volume of Cross-Border M&A. Journal of Finance 64(3), 1217-1249; Feld, Lars, Martin Ruf, Uwe Scheuering, Ulrich Schreiber, Johannes Voget (2013). Effects of Territorial and Worldwide Corporation Tax Systems on Outbound M&As. ZEW Discussion Paper 13-088.

[12] Balakrishnan, Karthik, Jennifer Blouin, and Wayne Guay (2012). Does Tax Aggressiveness Reduce Financial Reporting Transparency? University of Pennsylvania working paper.

(2014) fail to find evidence that the valuation premium in U.S. MNCs, relative to the value of a benchmark portfolio of firms operating independently in the same geographic footprint, is associated with the MNCs ability to shift income, suggesting that implicit costs reduce the value of tax benefits from shifting income.[13]

There is evidence supporting the notion that U.S. MNCs face non-trivial implicit costs of deferral that may put them at a competitive disadvantage, but there is no comparison of these costs to MNCs based in other countries. Competing firms operating under territorial tax systems may also bear implicit costs of avoiding home country tax through the need to navigate anti-abuse rules in the home country. The implicit cost is assumed to be low for non-U.S. MNCs, relative to U.S. MNCs. However, the validity of this assumption is not clear.

Corporate inversions

A recent wave of 'inversions' is underway, urging policymakers to enact U.S. tax reform quickly. However, to my knowledge, there is no good data compiled indicating the extent of U.S. MNCs' involvement in inversion transactions as compared with non-U.S. MNCs, nor a thorough understanding of the precise tax motivations for the relocation choice. Voget (2011) reports that 6% of a sample of about 2,000 MNCs from 19 countries inverted over the period 1997-2007.[14] Interestingly, 10% of the sample relocated from the U.S. to another country, while the remaining firms were initially based in other EU countries, including EU tax havens. Thus, not all inversion transactions follow the fact pattern generally documented in the recent business press.[15]

Of the 27 firms that relocated from the U.S., 6 relocated to the U.K., 5 to France, 4 to Canada, and 4 to Germany. Though none of these countries has a particularly low statutory rate, they all operate a territorial tax system. Voget (2011) documents that both home country taxes on the repatriation of foreign profits and the introduction of controlled foreign corporation (CFC) legislation have a positive effect on the probability of relocation. Thus, it is not only the existence of a worldwide system that provides incentives for firms to relocate, but also the existence of anti-abuse legislation.

Similarly, Markle and Robinson (2012) examine the use of tax haven subsidiaries across MNCs based in 28 countries and document that both the existence of a worldwide system, and the existence of CFC legislation, reduces the probability of tax haven use. Moreover, Markle and Robinson consider the 'strength' of countries' CFC legislation by creating an index based on whether seven types of provisions contained in the legislation

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[13] Creal, Drew, Jonathan Rogers, Leslie Robinson, and Sarah Zechman (2014). The Multinational Advantage. University of Chicago working paper.

[14] Voget, Johannes (2011). Relocation of Headquarters and International Taxation. *Journal of Public Economics* 95 (9-10), 1067-1081.

[15] E.g. Hoffman, Liz, and Hester Plumridge (July 14, 2014). "Race to Cut Taxes Fuels Urge to Merge" Wall Street Journal.

are likely to broaden the tax base. In subsequent analyses, the authors find that 'stronger' CFC legislation, as opposed to simply its existence, is associated with a lower probability of tax haven use. Interestingly, the U.S. ranks right in the middle, in terms of the strength of its CFC legislation, among the 18 countries in the sample with CFC legislation.

The significant number of recent actual or proposed inversions by U.S. companies is likely a signal that tax reform is needed soon. However, it would be useful to have comparative data on the extent to which non-U.S. firms are currently engaging in corporate inversions. This would be an indirect way of evaluating the implicit costs of avoiding home country tax on foreign source income across MNCs based in different countries. Note that even firms in territorial countries likely bear implicit costs associated with circumventing anti-abuse rules.

Overall, the problem is that a relatively high tax rate and worldwide system with deferral creates incentives to shift income (and real economic activity) to low-tax countries, and discourages repatriation. Research offers considerable support that the present system raises little revenue, is complicated, creates incentives for income shifting, and interferes with companies' efficient use of capital as they try to avoid the repatriation tax. However, research offers little in the way of guidance as to how things would look under an alternative system. Moreover, comparisons of the U.S. to other countries, or worldwide countries to territorial countries, have only limited use because the U.S. differs from other countries along many important dimensions. Finally, all countries, in practice, use a hybrid system with anti-base erosion rules that broaden or narrow the tax base, limiting inferences made from comparisons between worldwide and territorial systems.

B. What are some of the strengths and weaknesses of reform alternatives?

Territorial taxation versus worldwide taxation

A recent KPMG survey of nearly 1,700 tax professionals and senior executives indicates that 49% are in favor of a relatively pure territorial tax system, 16% are in favor of the current system of worldwide taxation with deferral, 3% are in favor of a relatively pure worldwide system (without deferral), and 27% are unsure. It is not surprising to see many more members of the business community interested in a pure territorial system than a pure worldwide system, but preferences become less clear when proposals to lower the statutory rate under a pure worldwide system and introduce anti-based erosion legislation under a territorial system enter the picture.

Appropriately framing the objective of tax reform is important when choosing among alternative solutions. If the objective were to make U.S. firms more competitive by reducing the U.S. tax burden on their foreign income, then this would naturally lead one to want to support the adoption a territorial system. However, if the goal is to reduce the

implicit costs of avoiding the repatriation tax, the path forward becomes less clear. That is because this goal can be achieved either by maintaining a worldwide system but eliminating deferral, or by adopting a territorial system.

It is also important to keep in mind that worldwide versus territorial systems are methods for alleviating double taxation of income. When framed in this fashion, it seems reasonable that a well-designed territorial system would appropriately limit eligibility for dividend exemption to income that has been subject to a robust tax system abroad. Thus, as eligibility becomes more and more restrictive on certain types of income taxed at low rates abroad, the pendulum swings back to that resembling a worldwide system without deferral.[16] Thus, it is possible for a well-designed territorial system to be more burdensome on a U.S. MNC than the poorly designed worldwide system we have now.

Territorial taxation and incentives to shift income

The first major concern with adopting a territorial tax system is that it will increase incentives to shift income to low-tax jurisdictions. The validity of this concern depends on (i) the new U.S. statutory tax rate, (ii) the anti-base erosion rules in place, and (iii) the extent to which U.S. firms are shifting income under the current tax system.

There is an extensive literature consistent with income shifting in MNCs. Estimates of the magnitude and trend in income shifting differ across studies that examine U.S.-based MNCs versus EU-based MNCs. In a sample of EU-based MNCs, a 10% decrease in the tax rate is associated with an increase in reported income ranging from 4% to 13%. These studies indicate that profit shifting is decreasing over time.[17] Research using a sample of U.S. MNCs paints a different picture. In particular, Klassen and LaPlante (2012) report a larger semi-elasticity of 17% and show that U.S. MNC profit shifting is increasing over time.[18]

Two studies attempt to compare income shifting by firms subject to a worldwide versus territorial system. Markle (2012) estimates the extent of income shifting in a sample of MNCs resident in different countries. Territorial firms engage in more shifting than *financially constrained* worldwide firms, while there is no difference between territorial firms and *financially unconstrained* worldwide firms.[19] If a firm can access

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[16] In other countries, the scope of their territorial systems differs based on how broadly or narrowly the eligibility rules are for the exemption. Take Japan for instance, with a 20 percent minimum tax. This resembles a worldwide system without deferral, at least with respect to activity in low-tax jurisdictions.

[17] Huizinga, Harry, and Luc Laeven (2008). International Profit Shifting Within Multinationals: A Multi-Country Perspective. *Journal of Public Economics* 92 (5-6), 1164-1182; Lohse, Theresa, and Nadine Riedel (2013). Do Transfer Pricing Laws Limit International Income Shifting? Evidence from European Multinationals. CESifo working paper 4404.

[18] Klassen, Ken, and Stacie LaPlante (2012). Are U.S. Multinational Corporations Becoming More Aggressive Income Shifters? *Journal of Accounting Research* 50 (5), 1245-1285.

[19] Markle, Kevin (2012). A Comparison of Tax-Motivated Income Shifting of Multinationals in Territorial and Worldwide Countries. Oxford Centre for Business Taxation Working Paper 12/06.

external capital or generate sufficient internal domestic capital to fund their domestic investments, the repatriation tax should have no effect on the firm's investment. Using financially unconstrained U.S. MNCs as a proxy for how U.S. MNCs would behave under a territorial system, Dyreng and Markle (2013) estimate that constrained MNCs would shift up to 19% more income out of the U.S. under a territorial system.[20]

Incentives to shift income out of the U.S. would likely increase for financially constrained firms under a territorial system. Incentives to shift income would also still exist for firms with excess foreign tax credits under a worldwide system without deferral. However, these incentives would depend on the new U.S. statutory tax rate (under a worldwide system without deferral, the rate would determine the number of firms with excess foreign tax credits). Proposals differ on the new U.S. statutory tax rate – for instance, the Camp proposal sets the new rate at 25% while the Obama proposal sets the new rate at 30%. A reasonable rate would be one that approximates the actual effective tax rate on foreign income under the current system.

These incentives also depend on anti-base erosion legislation in place under a territorial system. The Camp proposal, for instance, appropriately introduces such anti-base erosion provisions. However, many of these provisions would be difficult to enforce, and would present new opportunities for tax planning.

Territorial taxation and intellectual property

A second major concern with adopting a territorial tax system is that it will increase incentives to shift royalty income out of the U.S. in order to turn it into tax-exempt dividend income. This would most likely be accompanied by a shift in real R&D activities abroad. Moreover, this incentive will be stronger for U.S. MNCs shielding their royalty income using excess foreign tax credits under the existing system.

The Camp proposal appropriately addresses this issue with three possible anti-abuse rules. Options that reduce the effective tax rate on intangible income may be likely to keep R&D operations in the U.S. that are most likely to contribute to the U.S. economy. Christof, Richter, and Riedel (2013) finds that reducing income tax rates on R&D output (as opposed to other incentives) attracts relatively more innovative projects with higher earnings potential.[21]

Taxing the existing stock of undistributed earnings

A final issue, regardless of the new tax system, is how to treat the current stockpile of undistributed foreign earnings. Various proposals differ on this issue. For instance, under

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[20] Dyreng, Scott, and Kevin Markle (2013). The Effect of Financial Constraints on Tax-Motivated Income Shifting by U.S. Multinationals. Duke University working paper.
[21] Ernst, Christof, Katharina Richter, Nadine Riedel (2013). Corporate Taxation and the Quality of Research and Development. CESifo working paper 4139.

the Camp proposal, the undistributed earnings would be subject to tax at the rate of 5.25% and the tax obligation could be paid over 8 years. The foreign dividends, when repatriated under the new exemption system, would then be subject to an additional tax a the rate of 1.25% (25%*5%). The Baucus proposal would subject undistributed earnings to a one-time tax at a rate of 20%, as would the Obama proposal. Each proposal trades off being harsh compared to the current system (under which many firms may never repatriate) with providing unnecessary windfall benefits.

It is important, when deciding how to tax currently undistributed earnings, to understand (i) the size of the potential pool of earnings, (ii) the effective tax rate on those earnings, and (iii) the extent to which earnings are tied up in a non-liquid form. Blouin, Krull, and Robinson (2014) provide an analysis of permanently reinvested earnings (PRE) in a sample of 870 large U.S. MNCs and report that the aggregate ratio of PRE to foreign retained earnings is 59%, 24% of PRE is held in tax havens, and 45% of PRE is held in liquid assets. These descriptive data suggest that the pool of undistributed earnings that would be subject to tax is larger than PRE, not all PRE will have a significant residual tax liability associated with it, and the imposition of a transition tax on PRE is not likely to create a hardship on most MNCs.[22]

Finally, it is my conjecture that the recent build-up of undistributed earnings since the 2005 tax holiday is at least, in part, driven by the expectation of a potential future tax holiday. Thus, taxing undistributed earnings at any rate lower than 5.25% would seem to provide a windfall benefit to firms that have shifted income out of the U.S. in anticipation of such a holiday. That is, it is difficult to argue that much of this shifted income would have never been repatriated under the current system.

My view is that our current system of international taxation can be adequately reformed. We need not entirely abandon our current system in favor a fundamentally different system. Limiting deferral and lowering the statutory tax rate would generally reduce incentives to shift income, eliminate the implicit costs of avoiding repatriation, reduce complexity and uncertainty, be easier to enforce and administer, and lower the overall burden of the tax system on U.S. MNCs, relative to a territorial tax system that would necessarily feature anti-base erosion measures. That is, pleas for a more competitive tax system can be answered through a careful combination of base broadening and lower rates.

C. Are there other issues to consider when deciding on the path to reform that might not have been considered so far?

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[22] Note that the current stock of foreign earnings held abroad is often estimated for tax policy purposes by looking to PRE reported in firms' financial statements. This will underestimate undistributed earnings.

The accounting literature has recently documented a financial reporting cost of repatriation that is at least as significant to many U.S. MNCs as the cash tax cost – the decrease to financial accounting earnings related to the recognition of the residual U.S. tax. Under APB 23, accounting rules permit U.S. MNCs to defer recognition of the U.S. residual tax expense until repatriation, while the foreign income is recognized in accounting earnings immediately. All else equal, this creates a timing difference whereby accounting earnings increase in the period that foreign income is generated, and decrease in the year of repatriation.

Blouin, Krull and Robinson (2012) estimate that repatriations by U.S. MNCs would increase by approximately 17 - 20 percent annually if APB 23 were repealed, while Graham, Hanlon, and Shevlin (2011) survey executives who indicate that the importance of the tax expense recognition for accounting is as important as the cash tax when making repatriation decisions.[23] Either the elimination of deferral or the adoption of a territorial tax system would render APB 23 unnecessary. **Both revenue and rate estimates of various reform options should take into account the potential increase in repatriations attributable to changes in financial reporting costs.**

Adoption of International Financial Reporting Standards (IFRS)

Over 100 countries use IFRS as set by the London-based International Accounting Standards Board and U.S.-listed foreign firms have been allowed to file financial reports with the SEC in IFRS since 2007. Use of a common set of accounting standards in the EU expands the opportunity set of benchmark firms available to MNCs for substantiating tax-advantaged transfer prices. De Simone (2013) finds a positive association between IFRS adoption and income shifting in EU affiliates.[24]

There is no clear roadmap for adopting IFRS for U.S. firms. This may serve as a constraint on future income shifting out of the U.S. for U.S. MNCs, as the number of benchmark firms is limited to firms reporting under U.S. GAAP. **Any constraints on shifting income posed by the decision not to adopt IFRS in the U.S. should be considered when evaluating the extent of income shifting that might occur under a new tax system.**

Financial reporting disclosures and tax reporting

Financial reporting disclosures may affect firms' tax reporting decisions. Hope, Ma and Thomas (2013) find that firms voluntarily discontinuing disclosure of geographic

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[23] Graham, John, Michelle Hanlon, and Terry Shevlin (2011). Real Effects of Accounting Rules: Evidence from Multinational Firms' Investment Location and Profit Repatriation Decisions. *Journal of Accounting Research* 49 (1), 137-185; Blouin, Jennifer, Linda Krull, and Leslie Robinson (2012). Is U.S. Multinational Dividend Repatriation Policy Influenced by Reporting Incentives? *The Accounting Review* 87(5), 1463-1491.

[24] De Simone, Lisa (2013). Does a Common Set of Accounting Standards Affect Tax-Motivated Income Shifting for Multinational Firms? Stanford University working paper.

earnings after the implementation of SFAS 131 have lower ETRs than other firms. SFAS 131 relaxed the requirement to reports earnings for geographic segments, and only required disclosure of sales and assets.[25] Akamah, Hope and Thomas (2014) find that disclosure aggregation for geographic operations is more prevalent in firms with tax haven subsidiaries. These findings imply that geographic segment data may facilitate the enforcement of transfer pricing rules, consistent with proposed regulations in the EU (OECD 2014).[26]

Dyreng, Hoopes, and Wilde (2014) examine a U.K. requirement to disclose the name and location of all subsidiaries. Firms that did not comply with these requirements, but were subsequently forced to do so, exhibit an increase in the accounting ETR and a decrease in tax haven usage relative to firms that were in compliance.[27] Gupta, Mills, and Towery (2014) find that mandatory disclosure requirements in the U.S. regarding tax uncertainty increase firms' state income tax expense as well as state income tax collections.[28]

The association between financial reporting disclosures and tax reporting behavior has two important implications. First, tax policy makers should consider any role of accounting disclosures in evaluating behavioral responses to various reform options. Second, tax disclosure requirements could be considered as additional policy measures to aid in the enforcement of tax policy.

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

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[25] Hope, Ole-Kristian, Mark Ma, and Wayne Thomas (2013). Tax Avoidance and Geographic Earnings Disclosure. *Journal of Accounting and Economics* 56(2), 170-189; Akamah, Herita, Ole-Kristian Hope, and Wayne Thomas (2014). Tax Havens and Disclosure Aggregation. Rotman School of Management working paper 2419573.

[26] Discussion Draft on Transfer Pricing Documentation and CBC Reporting. 30 January 2014. http://www.oecd.org/ctp/transfer-pricing/discussion-draft-transfer-pricing-documentation.pdf

[27] Dyreng, Scott, Jeff Hoopes, and Jaron Wilde (2014). Real Costs of Subsidiary Disclosure: Evidence from Corporate Tax Behavior. Duke University working paper.

[28] Gupta, Sanjay, Lillian Mills, and Erin Towery (2014). The Effect of Mandatory Financial Statement Disclosures of Tax Uncertainty on Tax Reporting and Collections: The Case of FIN 48 and Multistate Tax Avoidance. *The Journal of the American Taxation Association*. **doi:** http://dx.doi.org/10.2308/atax-50766

Testimony of Pascal Saint-Amans
Director, Centre for Tax Policy and Administration,
Organisation for Economic Co-operation and Development (OECD)
Before the United States Senate Committee on Finance
July 22, 2014

Chairman Wyden, Ranking Member Hatch, and Members of the Committee, thank you for inviting me to testify today regarding the work of the Organisation for Economic Co-operation and Development (OECD) on base erosion and profit shifting (BEPS).

The OECD is an international organization founded by the United States and other nations in the aftermath of World War II. The OECD includes 34 market economy democracies from North America, Europe, and Asia, and has five key partners (Brazil, China, India, Indonesia, and South Africa) among emerging economies. Officials from the levels of experts to Ministers meet at the OECD to address common problems, develop international standards, guidelines, principles, and best practices, and monitor performance through peer reviews. The common thread of our work is a shared commitment to market economies backed by democratic institutions and focused on the well-being of all citizens.

The work of the OECD is done by consensus. That is, measures cannot be adopted without the consensus of all member countries. Moreover, the results of the work at the OECD are generally tools that countries can use to address problems they themselves agreed to put on the OECD agenda. Each country ultimately must make its own policy choices. The OECD's goal is to produce better policies, in part by allowing countries to coordinate with one another, and in so doing improve the quality of people's lives.

In developing our polices, we consult with business, including through the Business and Industry Advisory Committee to the OECD, and with labor, including through the Trade Union Advisory Committee to the OECD. We also engage with civil society organizations and academic researchers.

Our commitment to external stakeholders is strong. For instance, the Committee on Fiscal Affairs (CFA), which is the forum at the OECD for addressing issues affecting taxation, has provided numerous opportunities for comment on the various discussion drafts the OECD's member countries and partners agreed to release over the last twelve months. These discussion drafts have generated more than 3,500 pages of comments, and provoked a large number of participants from all constituencies commenting at 5 public consultations. The OECD's public webcasts of these consultations and our updates on the project have attracted over 10,000 viewers.

Background

Taxation is at the core of countries' sovereignty and each country is free to set up its corporate tax system as it chooses. When independent sets of rules created by sovereign countries interact, however, it can lead to gaps where corporate income is not taxed at all, and to frictions where income is taxed by multiple countries. Since at least the 1920s, it has been recognized that the interaction of domestic tax systems can lead to overlaps in the exercise of taxing rights that in turn can result in double taxation. Countries have long worked and are strongly committed to eliminating such double taxation in order to minimize trade distortions and impediments to sustainable economic growth, while affirming their sovereign right to establish their own tax rules. However, there are gaps and frictions among different

countries' tax systems that were not taken into account in designing the existing standards and which are not dealt with by bilateral tax treaties. Thus, the modern global economy requires countries to collaborate on tax matters in order to be able to protect their tax sovereignty.

Inheriting work initiated in the 1920s, the OECD countries have worked together to elaborate standards and instruments to eliminate double taxation. Adopted by consensus, these soft law instruments provide an international framework, and include a Model Tax Convention (which serves as the basis for over 3,000 bilateral tax treaties) and Transfer Pricing Guidelines (which provide common standards for allocating taxable income among members of a group of affiliated companies). These instruments have been critical in supporting the OECD agenda to promote cross border investments and competitive tax systems. In that vein, as illustrated in the report Tax Policy Reform and Economic Growth (http://dx.doi.org/10.1787/9789264091085-en), the OECD recommends that countries favor broad bases and lower rates for corporate income taxes.

Need for International Tax Reform

Over time, the current rules have failed to keep pace with economic developments, and have begun to show weaknesses. While the key international tax standards are intended to eliminate double taxation by providing for principles to allocate taxing rights on a bilateral basis between the countries involved, they are now facilitating double non-taxation in a significant number of instances. This results from changes in the international economic environment such as the globalization of businesses and economies of countries becoming increasingly intertwined.

In the global economy of the 21st century, multinational enterprises (MNEs) represent a large proportion of global GDP, and intra-firm trade represents a growing proportion of overall trade. Globalization has resulted in a shift from country-specific operating models and a bilateral paradigm for direct investment to global models based on matrix management organizations and integrated supply chains that centralize several functions at a regional or global level. Moreover, the growing importance of the service component of the economy, and the increasing centrality of intellectual property to value creation has made it much easier for businesses to locate both productive activities and legal rights in geographic locations that are distant from the physical location of their customers. These developments have been exacerbated by the sophistication of tax planners in identifying and exploiting the legal arbitrage opportunities and the boundaries of acceptable tax planning, thus providing MNEs with more confidence in taking aggressive tax positions.

The international tax rules similarly do not have an overall principle of coherence. In the domestic context, coherence is usually achieved through a principle of matching: a payment that is deductible by the payer is generally taxed in the hands of the recipient unless it is explicitly exempted. The lack of a similar principle to address the interaction between tax systems at the international level creates opportunities for cross-border arbitrage by taxpayers in which income can be made to disappear for tax purposes.

As a result, the current set of rules has proven to create unforeseen opportunities to artificially reduce taxable income or to shift profits to low-tax jurisdictions for base erosion and profit shifting (BEPS) by MNEs. BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to

arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place.

Non- or low-taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the various activities that generate it. In other words, what creates tax policy concerns for countries participating in the BEPS project is that, due to gaps and frictions in the interaction of different tax systems, and in some cases because of the application of bilateral tax treaties and transfer pricing rules, income from cross-border activities may go untaxed anywhere, or be subject to unduly low taxation.

As a result, the current consensus-based international framework is at risk.

First, it no longer fully meets its objectives of allocating taxing rights between countries where companies operate. Instead, it facilitates the divorce between the location of the profit and the location of value creation. The consequence is that the existing international tax system in many cases allows structures and tax results **that no longer pass a basic test of common sense**. For example, as taxpayers increasingly rely on intangible assets as a value-driver, it has become easier for taxpayers to rely on existing principles to transfer legal ownership of those intangible assets to "cash boxes" in low-tax jurisdictions that receive a large share of profit but perform no or hardly any activity. Trillions of untaxed dollars are now located in such entities, in compliance with the existing rules. It is hard to imagine that this is what was intended when these rules were designed. Another striking example is where the features of a bilateral treaty cause investments in one country to be channeled through a particular jurisdiction by third-country investors. For example, as shown in IMF data, more than one quarter of direct investment into India was from Mauritius between 2010 and 2012.

Second, the current situation creates an uneven playing field in which some businesses, such as those which operate cross-border and have access to sophisticated tax expertise, receive unintended competitive advantages compared with enterprises that operate mostly at the domestic level or that use less aggressive tax planning techniques. This uneven playing field leads to an inefficient allocation of resources by distorting investment decisions towards activities that may have lower pre-tax rates of return, but higher after-tax rates of return. This also encourages resources to be spent on tax planning rather than productive business operations that could lead to job creation and innovation. These phenomena are by no means limited to U.S. multinational corporations: 74% of the Fortune Global 500 companies are non-U.S.-headquartered companies.

Third, these flaws in the current system undermine the sovereign right of countries to set tax policy. Countries must be able to set their own tax policy in the way they consider appropriate, in order to respond to their particular revenue needs. An international tax system that allows for unjustifiable results undermines this ability to exercise policy autonomy. BEPS activities threaten the tax bases of countries around the world. In the U.S., for example, a recent Congressional Research Service study reported that BEPS activities are estimated to reduce U.S. corporate tax revenue by $10-60 billion annually.

Finally, the fact that tax planning that complies with the technical tax rules can reach results that defy common sense has led to increased tax controversy and litigation with tax administrations frustrated with the implementation of the current rules. The increased number of international tax disputes also makes it harder for taxpayers to anticipate tax results, and can result in taxpayers being subjected to double taxation. This is exacerbated in some cases by the increasing prominence of emerging economies that did not participate in

the development of the existing rules because they are not members of the OECD. The weaknesses of these rules make it harder for these countries to join the international consensus, which further increases uncertainty for taxpayers.

As a result of this growing concern over BEPS activities, many countries have considered action to protect their tax bases. Protecting the tax base is one of the recurrent features of corporate tax reform proposals in many countries, including the United States.

Unilateral action by countries on an uncoordinated basis, however, has the potential to replace the problem of non-taxation with the proliferation of uncoordinated legislative measures that will lead to excessive compliance costs for MNEs, as well as the potential for double or multiple taxation of the same income, undermining the existing consensus-based standards and replacing them with chaos. It also has the potential to encourage protectionist measures that would be detrimental to international trade.

In addition, the fact that BEPS arises from the interaction between different countries' tax systems means that unilateral action by individual countries is incapable of fully addressing the problem. If only a small number of countries attempt to solve BEPS, they may in fact further jeopardize their tax base as businesses move to jurisdictions that have not yet implemented preventive measures or that choose not to do so in order to gain a competitive advantage.

In the aftermath of the financial crisis, however, worldwide attention has been focused on international tax avoidance at the highest political levels and in many countries at the level of the man on the street. In some cases, this focus has increased pre-existing tensions, as individual companies have found themselves scrutinized by the media and by the public. **This increased focus, however, has also created a unique opportunity to modernize global standards, restore their coherence, and renew worldwide commitment to principled, consensus-based rules.**

A Coordinated Approach to Reform: The BEPS Project

Recognizing the threat to the existing standards for relieving double taxation, the OECD published its report, *Addressing Base Erosion and Profit Shifting*, in February 2013, which provided results of an in-depth analysis of BEPS identifying the problems and the different factors that cause them. The report was discussed at the February 2013 G20 meeting of finance ministers, who expressed strong support for the work done and urged the development of a comprehensive action plan.

In response to this request from the G20, the OECD published an Action Plan on Base Erosion and Profit Shifting in July 2013, which was fully endorsed by G20 finance ministers and G20 Leaders. The objective of the Action Plan, approved by consensus, is to restore coherence and common sense to the international tax system, keeping the overall approach, but updating it so that it continues to function in the modern context in which countries impose tax locally but businesses act globally. In this way, the fundamental goals of eliminating double taxation and providing certainty for business remains at the core of the work of the OECD in tax matters.

In order to achieve this objective, **the BEPS Project brings together 44 countries, comprising 90% of the world's economy, working on an equal footing**: all OECD members and accession countries as well as the 8 non-OECD G20 countries, i.e. Argentina,

Brazil, People's Republic of China, India, Indonesia, Russia, Saudi Arabia, and South Africa. In addition, over 80 developing countries and other non-OECD/non-G20 economies have been consulted and their input has been fed directly into the BEPS process. This broad participation is aimed at reaching as broad a consensus as possible, creating a level playing field among countries so that countries that implement the measures do not risk losing their tax base to those that do not, or finding their MNEs placed at a competitive disadvantage. In this way, the work can restore the sovereign taxing rights of countries, giving them the tools to preserve their tax base.

The Action Plan is designed to take a principled, holistic approach to addressing BEPS. This is not a "revenue grabbing" exercise but one intended to fix existing deficiencies of the current standards. It focuses on ensuring the *coherence* of corporate tax systems in a cross-border environment, introducing *substance* requirements in the area of tax treaties and transfer pricing, and ensuring *transparency* while promoting certainty and predictability.

Recognizing that any discussion of tax changes raises uncertainty, **the Action Plan focuses not only on closing gaps that have led to tax avoidance, but also on improving dispute resolution** to ensure that new double taxation is not created and existing frictions are reduced. The worldwide and U.S. business community, as well as civil society and academics, have been extensively consulted throughout the process so far. This engagement will continue throughout the BEPS Project.

Addressing BEPS is critical for countries and must be done in a timely manner to be useful. Indeed, before the launch of the BEPS project, countries around the world had begun to explore ways to address BEPS unilaterally. Many have put those unilateral actions on hold in favor of participating collaboratively in the BEPS work. Failure to deliver concrete results in a timely manner thus would create a risk of unilateral actions, which would not only fail in many cases to address the core of the BEPS issue, but would lead to a risk of increased double taxation of businesses around the world. **This is why countries agreed to deliver on the Actions within a two-year time frame.** If it is important to come up quickly with detailed principles, it is also important to take some more time to provide detailed guidance for the implementation, so that technical quality and certainty are maximized. It is recognized that after guidance is developed, governments and taxpayers will need time for implementation.

The Action Plan takes the form of 15 actions, and calls for a series of concrete deliverables in response to these actions. A first set of deliverables is due in 2014, with a second set due in 2015. The 2014 deliverables are due to be delivered in September 2014, and will represent substantial progress toward providing countries with tools they can use to address BEPS.

The 2014 deliverables will help ensure the coherence of corporate income taxation at the international level by providing draft recommendations for new international tax and treaty standards to neutralize hybrid mismatch arrangements. They will show progress made in relation to work to tackle harmful tax practices. They will also help to restore the intended effects and benefits of international standards by providing recommendations to prevent the abuse of tax treaties and to address transfer pricing issues in the key area of intangibles. They will help to ensure better transparency and promote increased certainty and predictability by providing draft recommendations for improved transfer pricing documentation and a template for country-by-country reporting to be provided to tax administrators for high-level risk assessment. In addition, the 2014 deliverables will include a report on addressing the tax challenges of the digital economy, as well as a report on the feasibility of developing a

multilateral instrument to amend bilateral tax treaties and enable swift implementation of treaty measures developed in the course of the BEPS work.

The need to provide certainty and limit the cost of compliance to businesses while providing useful instruments to countries is at the core of the work and has been fully taken into consideration. Country by country reporting is a good illustration of possible risks and tensions but also, at the same time, of the benefits of a multilateral approach. For several years now, many have advocated the need for more transparency in the reporting of MNEs. A number of countries, starting with the United States, have already enacted legislation to improve such reporting or intend to do so in the future. While this type of reporting increases the compliance burdens for MNEs, a common agreed framework is likely to limit this burden by taking a consistent approach that reduces the differences between country-specific requirements. Indeed, a number of countries have agreed to limit the scope of information requested from MNEs in order to pursue a multilateral approach that will guarantee efficient reporting while maintaining confidentiality. As a result of the multilateral approach, countries will run a more efficient reporting mechanism and businesses will face less burdensome compliance costs.

Completion of the work under the Action Plan will give countries the tools they need to ensure that profits are taxed where the economic activities generating the profits are performed and where value is created. It will also give businesses greater certainty. Finally, the international tax framework will make more sense, thereby strengthening consensus and reinforcing the ability of governments to eliminate double taxation.

Conclusion

Taxation remains at the core of national sovereignty, and each country must ultimately make its own tax policy choices. The BEPS Project developed out of the recognition that opportunities for BEPS arise from the interaction of different countries' tax systems, making it impossible for a single country acting unilaterally to effectively address BEPS. BEPS opportunities impair the ability of countries to achieve their tax policy goals, effectively undermining their sovereignty. Uncoordinated, unilateral action by individual countries to exert taxing rights over cross-border activity would only make the problem worse, resulting in double or multiple taxation, increasing disputes for business and among governments, and harming economic growth. The work on BEPS is intended to produce tools that countries can use to address BEPS, in order to ensure that the international tax system continues to function, and that a broader, more robust consensus to eliminate double taxation can be established.

The OECD has long recommended that countries reduce the distortive impacts of their tax regimes, and thus improve economic growth, by broadening the tax base (in which measures to address BEPS can be an important part) and lowering the rate. We hope that our work, including the work on BEPS, can support the ongoing tax policy reform discussions around the world and in the United States. BEPS is an important issue no matter what direction US international tax policy takes.

I would like to thank the Committee for the opportunity to provide testimony on this important work, and I look forward to answering your questions.

Annex: The BEPS Action Plan

The measures contemplated in the Action Plan will ensure the *coherence* of the international tax system by providing recommendations to neutralize "hybrid mismatch" arrangements that take advantage of differing treatment of entities or instruments in multiple jurisdictions to generate multiple deductions for the same payment, or deductions in one jurisdiction with no taxable income in another jurisdiction (**Action 2**). Coherence will be further improved by providing recommendations for the design of effective controlled foreign company (CFC) rules that tackle the issue of large amounts of untaxed income being routed through offshore affiliates in no-tax jurisdictions (**Action 3**), and for rules to prevent base erosion via excess interest deductions and other financial payments (**Action 4**). The work will also help jurisdictions counter harmful tax practices more effectively, particularly in the area of IP regimes, based on the recognition that tax competition through harmful preferential tax regimes left unchecked could ultimately lead to a "race to the bottom" that would drive tax rates on mobile sources of income to zero for all countries (**Action 5**).

The Action Plan is also intended to realign taxation with the *substance* of the activities of taxpayers. "Treaty shopping" by third country investors through shell companies in jurisdictions with broad tax treaty networks, along with other forms of treaty abuse, have allowed treaties to be used to generate double non-taxation. To prevent this abuse and allow tax treaties to serve their intended function of relieving double taxation, the Action Plan therefore calls for model treaty provisions to prevent the abuse of tax treaties (**Action 6**) and to prevent the artificial avoidance of taxation by abusing the permanent establishment standard used to determine taxing jurisdiction (**Action 7**). It will restore substance in the area of transfer pricing by ensuring that profits cannot be separated from the location in which economic activity occurs and value is created, in the key areas of intangibles (**Action 8**), risks and capital (**Action 9**), and other high-risk transactions (**Action 10**).

The Action Plan is also intended to ensure increased *transparency* in several respects. The work will recommend methodologies for collecting and analyzing data on the scale and effects of BEPS and on the impact of the actions to address it (**Action 11**). To ensure that tax administrations have access to comprehensive and relevant information on tax planning strategies, recommendations will be developed regarding the design of mandatory disclosure rules for aggressive or abusive tax structures (**Action 12**). In addition, the quality of information provided to tax administrations will be improved by developing improved and better coordinated transfer pricing documentation (**Action 13**). Finally, to ensure that actions to counter BEPS do not detract from certainty and predictability for business, solutions to ensure effective dispute resolution between jurisdictions will be developed (**Action 14**).

In addition to work in these three key areas, the work will address the cross-cutting issue of the tax challenges raised by the digital economy (**Action 1**). Recognizing the need for a way to implement agreed changes quickly and uniformly, particularly in the area of tax treaties, a multilateral instrument to enable jurisdictions to implement measures developed in the course of the BEPS work and to amend bilateral tax treaties will be developed (**Action 15**).

Statement of

Allan Sloan

Senior Editor at Large, Fortune magazine

Before the

Senate Committee on Finance

Corporate Inversions and Other Tax Games

July 22, 2014

Chairman Wyden, Ranking Member Hatch, and Members of the Committee: thank you for inviting me to participate at this hearing. I'm honored to have a chance to address you directly rather than having to write a newspaper or magazine article and hope that you pick it up and read it. Before I proceed, please note that I am speaking for myself alone. I am not speaking for my editors; or for my employer, Fortune magazine; or for Fortune's parent company, Time Inc. I am also not speaking for the Washington Post, which has run my articles for many years.

Part of the way that I have made my living since becoming a business journalist in 1969 is by writing about strange and complicated transactions designed to allow corporations (and on occasion, individuals or families) to minimize or eliminate tax obligations. I try to do this by explaining these transactions in what I call "a language approaching English." For example, when the Smucker jelly company acquired Jif peanut butter from Procter & Gamble in a tax efficient transaction, I called it a merger of peanut butter with jelly, rather than a Reverse Morris Trust. When the RJR Nabisco tobacco-grocery conglomerate tried to turn its food company into an independent entity, I talked about RJR trying to separate cookies from cancer.

When I worked at the late, lamented New York Newsday, which was owned by the late, lamented Times Mirror Co., I specialized in writing nasty stories about the tax-dodging tactics of Times Mirror and its controlling family at the time, the Chandlers. After Tribune Co. bought Times Mirror, the Chandlers grew disenchanted and forced Tribune to sell out to Sam Zell. I knew the Chandlers were really angry with Tribune management, because they agreed to have the company do a taxable transaction with Zell. He calls himself the Gravedancer, but I took to calling him the Artful (Tax) Dodger.

I'm telling you this so you can see that I've been around the tax avoidance business for a long time and that I'm either intellectually honest enough or foolish enough to bite the corporate hand that feeds me. I used to consider corporate tax avoidance an indoor sport of sorts. Up until inversions, many of the transactions I wrote about amused me—but I'm not amused now.

I consider inversions to be a threat not only to the public fisc, but to the public psyche. Enough of a threat for my editorial superiors at Fortune—who aren't exactly anti-capitalist—to have asked me to write what turned into Fortune's recent cover story about inversions, called "Positively Un-American." (I've attached it to the end of this testimony.)

One of the things I find most disconcerting about inversions is that many people aren't scared of them enough. These are something entirely different from the tax dodges I'm going to describe in a bit. They're different from the income-shifting games that companies like Apple and Caterpillar play that have gotten so much attention. Inversions have the potential to totally undermine the corporate tax system, because we're beginning to see the dynamic change from "what's an inversion?" to "sign me up."

I have watched corporations and financial markets for more than 40 years, with the eyes of an English major who has learned about business, as opposed to an economics student who started out with theories. I can sense the corporate stampede out of this country coming. And once it happens—which it will, absent some quick action, followed by fundamental corporate tax reform—it will be irreversible.

You don't have two or three or four years to look at this problem, consider it, listen to all the usual suspects, and legislate. If you don't do something quickly to halt inversions, by the time you get around to dealing with them as part of corporate tax reform, the corporate tax base will have been so diminished that it will be extremely difficult for you to come up with any sort of revenue-neutral program.

To be sure—which I consider the three most dangerous words in journalism--I don't have any statistics to support this. That's because we don't have any reliable statistics—at least, none that I'm familiar with—about how many inversions we've had, how many are pending, how much tax revenue inversions they have cost the rest of us and are likely to cost in the future. (I will elaborate on this problem later in my testimony.) If the projections you hear for individual companies are remotely accurate—I have no idea if that's the case, no one does—the JCT projection of $19.5 billion of tax revenue lost to inversions over the next 10 years absent legislation is way, way low. Make that way, way, way low. It's not the staff's fault—the dynamic has changed.

If I thought inversions were really only a $2 billion a year item—not that $2 billion isn't money—I wouldn't have written what I did. And if this committee thought it was such a relatively small problem, I would not be testifying here today.

Now, to my testimony. I will talk about some tax-dodging games that I have seen and written about over the years, and hope that they will put the current wave of corporate inversions into historical context. I will also try to demonstrate that these inversions are a vastly more serious threat to public well-being than even the most blatant of these transactions. And finally, I will give you my thoughts about how I would deal with the inversion problem if American voters took leave of their senses and elected me to public office.

MORRIS TRUSTS

Until 1997, these were used as a routine, tax-efficient way to separate companies into their component pieces. A company would stick a business it wanted to unload into a new corporation owned by its shareholders, which is a tax-free transaction. A nanosecond later, a buyer would acquire the new corporation in a tax-free stock-for-stock deal. Company holders would thus end up with shares in both the original company and in the buyer of the business being unloaded.

For example, Affiliated Publications, which owned the Boston Globe, had somehow ended up with a bloc of shares of McCaw Cellular, which was becoming more valuable than the newspaper. So Affiliated did a deal with McCaw, in which McCaw traded its shares in return for shares in an Affiliated subsidiary that owned more shares of McCaw than McCaw issued to acquire the subsidiary. So at the end of the day, Affiliated shareholders owned McCaw shares in addition to their Affiliated shares, and McCaw was able to reduce its number of shares outstanding. No harm, no foul, no capital gains taxes.

But instead of simply confining themselves to tax-efficient separations, which no rational person could oppose, Morris Trusters over reached. They created the "Cash-Rich Morris Trust," in which corporations got lots of cash in what in effect was a tax-free sale masquerading as a corporate split-up. Disney's sale of the newspapers it acquired when it bought Capital Cities Communications, and General Motors' sale of its defense business got the most ink, part of it from me. Congress tightened the rules. But loophole openers then created…

REVERSE MORRIS TRUSTS

These require that shareholders of the selling company end up with a majority stake in the acquiring company — a big disincentive to buyers. But P&G managed to find buyers for three such deals: Smucker in 2002 for Jif; and in 2008 for Folger's coffee, enhancing Smucker's breakfast brand presence; and in 2011, a company called Diamond Food for Crisco. I calculated that these transactions saved P&G a combined $2 billion in capital gains taxes. Fortunately for the public fisc, Diamond stock fell apart, the Crisco deal collapsed and P&G unloaded Crisco in what I think was a straight-up, regular sale.

SPLIT-OFFS

This is another common technique that morphed from being an efficient way to split up companies into something excessive.

A corporation that owned a business that it no longer wanted would turn that business into a new, independent company. Then it would offer shares in the new company to its shareholders in return for some or all of their shares. At the end of the day, the company would have disposed of the business it didn't want, and reduced the number of its own shares that were outstanding. It was really sort of neat. It was equivalent to a company selling the unwanted business for cash,

and using the cash to buy in some of its own shares. But a sale would have generated taxes. A split-off didn't.

Some notable split-offs were Loews Corp., a conglomerate (in which I now own stock) that did a split-off with its big stake in Lorillard tobacco. McDonalds with Chipotle Mexican Grill. Bristol Myers Squibb with Mead Johnson, which makes baby food. These are all reasonable deals in which a company unloaded an unwanted business in a tax-efficient way, setting the business free to find its destiny.

But naturally, companies—and their advisors—weren't satisfied with a tax-free separation. So they created....

CASH-RICH SPLIT-OFFS

These are much more like a sale than a simple, tax-efficient separation. The first one of these was in 1999, when the Janus mutual fund company swapped its 28% stake in DST Systems for a small DST business and $999 million of cash. It was a sale in a split-off's clothing, and the business, which was barely a rounding error in the overall transaction, was a necessary part of the deal to make it tax-free. Liberty Media swapped cash and a few properties to Comcast for $1 billion of Liberty stock that Comcast owned. Time Warner traded a bunch of money and the Atlanta Braves to Liberty for a big piece of Time Warner stock.

Congress got annoyed, and in 2006 passed legislation requiring that from May 17, 2006 through May 17, 2007, the business thrown into the pot had to be "somewhat more than a quarter" of the consideration being paid, and since then, it has had to be "somewhat more than a third." So now you've got deals tip-toeing right up to that line.

The one that comes screaming to mind involves Graham Holdings (the old Washington Post Co.) and Berkshire Hathaway (which needs no introduction). The exact numbers aren't yet available, but earlier this month, Graham swapped about $400 million of Berkshire Hathaway stock that it owned, plus about $388 million of cash, plus a TV station that it valued at something like $394 million, for about $1.2 billion of Graham Holdings stock that Berkshire had owned for 40 years or so, and in which it had an ultra-low cost basis. This saved the firms a total of close to $700 million of taxes. (I own shares in both companies, and I like and respect both Don Graham and Warren Buffett.)

The way to stop this silliness is to require that the operating business be at least 80 percent of the transaction. But that's not our topic today.

This brings us to.....

INVERSIONS

There's a huge, huge difference between these games that I've described involving Morris Trusts, Cash-Rich Morris Trusts, Reverse Morris Trusts, Split-Offs and Cash-Rich Split-Offs and inversions.

All of these transactions are generally one-time things. They don't involve a company renouncing its corporate citizenship to save money, but expecting to be treated as if it were a regular, legitimate American company.

The attached article, which underwent rigorous editing (unlike this presentation), explains the history and workings of inversions far better than I could in this testimony. It also has some telling examples of intellectual inconsistency—I don't want to violate Senate decorum by using the term "hypocrisy"—that the package's primary editor uncovered with the aid of several of our Fortune colleagues. Plus, the graphics are pretty good.

We've now got a tidal wave of inversions—or we will have them unless the people at the podium in this room and your colleagues do something about it. Quickly. Inversions beget inversions, both for competitive reasons and because there's now a critical mass of players such as corporate raiders (who like to call themselves "investor activists") who care only about getting a stock's price up today; investment bankers who get fees from these deals; and all sorts of hangers-on.

We will end up with almost every company capable of doing an offshore deal doing it, and putting increasing pressure on every corporate manager of an inversion candidate who wants to do the decent, economically-patriotic thing, and finds this kind of behavior abhorrent.

Let me offer up a telling piece of history.

The first inversion was in 1983 when McDermott International, a builder of offshore drilling platform and underwater pipelines, moved its domicile to Panama.

In its April of 1984 issue, Fortune carried a short story about McDermott, and mentioned that it had been thrown out of the Fortune 500 for no longer being an American company. It also noted that two Canadian companies—Inspiration Resources and Lafarge Corp.—had moved their domiciles to the U.S., and were added to the 500. You don't see companies inverting into the U.S. these days, which is a sign that things have changed.

One reason that inversions haven't attracted much attention until recently is that until Pfizer tried to invert, there hadn't been any big, household-name firm visibly trying to leave the country. Pfizer trying to go offshore by buying AstraZeneca shocked me into paying much closer attention to inversions, and I think it shocked a lot of people.

One of the problems I ran into almost immediately was answering a basic question: how many inversions have we had. Two of the major sources of lists—the Congressional Research Service and Bloomberg—are flawed. Tracking this stuff is extremely difficult. One of my colleagues at Fortune, a research librarian at a major law firm in his previous life, is trying to assemble a definitive database. But it is taking a lot of time and effort.

Part of the problem is what I call the "never-heres": companies whose ancestors were U.S. corporations, but that in their current incarnation have always been offshore. Therefore, they get

upset when you call them inverters—which we at Fortune have decided to do. And that you should do, too. Examples include Accenture when it was spun off from Arthur Andersen; Seagate (in which I bought stock several years ago, not realizing it wasn't a U.S. company) when it was relocated after being acquired in a leveraged buyout; Delphi when it reorganized after its bankruptcy.

A contributing problem is that although we have overall Treasury numbers about how much federal corporate tax is collected, we don't know how much any individual corporation pays for a given year. That's not one of the dozen-plus tax metrics that publicly-traded corporations are required to disclose. That makes it impossible to do a rigorous analysis of the tax situation of any inverting or would-be inverting company. We can solve this problem—or you can—by asking the SEC or the Financial Accounting Standards Board to require publicly-traded corporations to disclose this information by taking two numbers from their corporate tax returns: taxable income for a given year, and taxes paid for that year. This is easily accessible to companies—though not to anyone else—because all they need to do is look at their tax returns. My estimate is that it would take one person-hour a year per company to generate this information, which companies have refused to give me when I asked. FASB and the SEC have basically blown me off, but they won't blow you off.

If you talk to companies about inversions, which my Fortune colleagues and I have been doing for several months, you hear things like "this is only part of our strategy, it's not why we're doing the transaction." Or, "we will continue to pay taxes in America."

This is, forgive me, misleading nonsense. Ask a company why, if inversion isn't a major purpose of the deal with the foreign company, it's not doing a straight-up acquisition. Ask how much it would be paying for the foreign company if inversion weren't part of the package. I haven't gotten answer to this, but you probably could, especially if you asked them these questions in public. You can also ask inverters if their contract with their inversion partners contains a clause giving the inverter to right to modify or cancel the deal if inversion rules change. I think you'll get a "yes."

As for the "we will continue to pay U.S. taxes" story, ask how much the company will pay in U.S. corporate income tax as an inverted company compared to what it would have paid had it not inverted. I can't get answers to this, but you can. I suspect the answers will upset you.

MY SUGGESTIONS

I know little—almost nothing, actually—about the political dynamics that go into the making of tax legislation. The one thing I can see is that the inversion question is becoming even more politically toxic than most things that I write about.

I saw that House Democrats forced an up-or-down vote by trying to attach the Sander Levin legislation to the depreciation-extender bill. It got voted down on a party-line vote. Of course, I saw Secretary Lew's letter. And I saw Senator Hatch's response. With all due respect, this struck me as political theater, not substance. And we need to deal with substance. It would be

absolutely tragic if we let the inversion question descend into soundbites, political rhetoric and attack ads.

Looking at this as an outside observer, I think it's glaringly obvious what need to be done. First, you pass the Levin legislation—I prefer the Senate version, for reasons you'll see in a bit—to enact changes that would require inversions to change management and shareholder control of inverting companies. You adopt the March 8 cutoff date. No, that wouldn't be unfair retroactive legislation. Ever since Senator Wyden's op-ed ran in the May 8 Wall Street Journal, corporate America has been on notice that a May 8 date is on the table. (An aside: when I saw that article in the Journal, I let loose a string of obscenities, because he had written what I had hoped to write as my Fortune-Washington Post column. Being beaten by a competitor is part of the game—but I'd never been beaten to the news by a Senator before.)

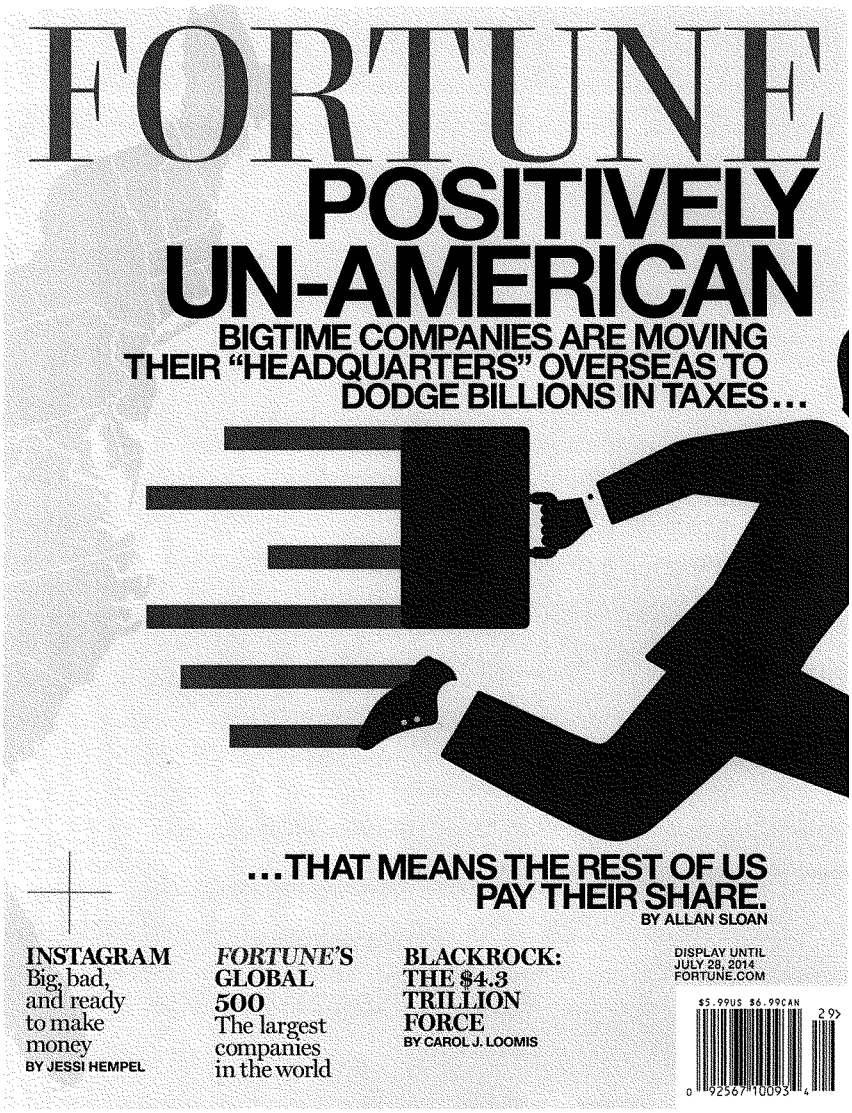
If I were you, I would adopt the Senate version of Levin legislation, so that there's a cut-off date, and so that averting inversions for awhile doesn't totally remove the pressure to do something about the corporate tax code reasonably quickly. I found aspects of Rep. Camp's proposal interesting, but I don't pretend to have any expertise in drawing up tax legislation. That's what you do. It's not what I do.

Lookit, as we used to say when I was growing up in Brooklyn. Tax reform has been kicking around Washington for years, but doesn't seem to happen. You have to do something. It's not a partisan issue, it's a national issue.

Inversions are a symptom of the underlying disease, which is the tax code. But as my daughter the ER doctor would tell you if she were testifying, sometimes you have to address the immediate symptom before going on to the cure. If you're bleeding out, you need to put on a tourniquet, then deal with the wound. You can't say, "there's no point in stopping the bleeding if the wound hasn't been healed." You can treat the symptom quickly, and spend some time—but not too much—trying to cure the disease. You shouldn't say that inversions and the code need to be treated simultaneously.

Inversions aren't an obvious emergency, the way that helping people and businesses recover from floods and hurricanes is. But they are an economic emergency whose outlines are becoming clear to anyone willing to see them. Despite the toxic climate around here, you have occasionally managed to surmount partisanship and spin and accomplish worthwhile things. Please do something about this looming financial disaster before it's too late.

Thank you.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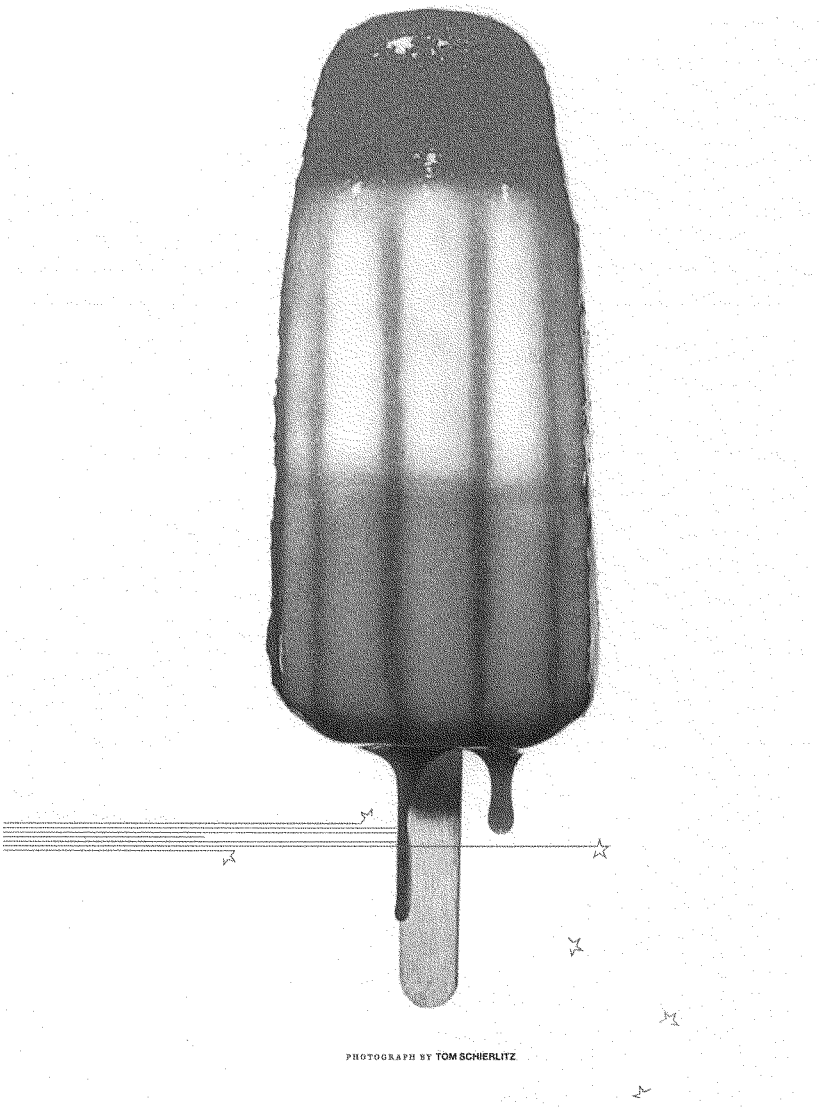
BIGTIME COMPANIES ARE MOVING THEIR "HEADQUARTERS" OVERSEAS TO DODGE BILLIONS IN TAXES... THAT MEANS THE REST OF US PAY THEIR SHARE.

By ALLAN SLOAN

Ah, July! What a great month for those of us who celebrate American exceptionalism. There's the lead-up to the Fourth, countrywide Independence Day celebrations including my town's local Revolutionary War reenactment and fireworks, the enjoyable days of high summer, and, for the fortunate, the prospect of some time at the beach. ¶ Sorry, but this year, July isn't going to work for me. That's because of a new kind of American corporate exceptionalism: companies that have decided to desert



PHOTOGRAPH BY TOM SCHIERLITZ

our country to avoid paying taxes but expect to keep receiving the full array of benefits that being American confers, and that everyone else is paying for.

Yes, leaving the country—a process that tax techies call inversion—is perfectly legal. A company does this by reincorporating in a place like Ireland, where the corporate tax rate is 12.5%, compared with 35% in the U.S. Inversion also makes it easier to divert what would normally be U.S. earnings to foreign, lower-tax locales. But being legal isn't the same as being right. If a few companies invert, it's irritating but no big deal for our society. But mass inversion is a whole other thing, and that's where we're heading.

We've also got a second, related problem, which I call the "never-heres." They include formerly private companies like Accenture, a consulting firm that was spun off from Arthur Andersen, and disc-drive maker Seagate, which began as a U.S. company, went private in a 2000 buyout and was moved to the Cayman Islands, went public in 2002, then moved to Ireland from the Caymans in 2010. Firms like these can duck lots of U.S. taxes without being accused of having deserted our country because technically they were never here. So far, by *Fortune*'s count, some 60 U.S. companies have chosen the never-here or the inversion route, and others are lining up to leave.

All of this threatens to undermine our tax base, with projected losses in the billions. It also threatens to undermine the American public's already shrinking respect for big corporations.

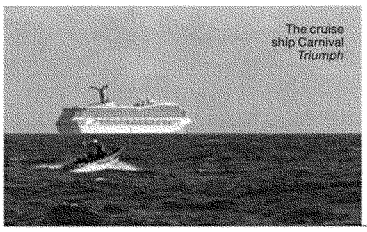
Inverters, of course, have a different view of things. It goes something like this: The U.S. tax rate is too high, and uncompetitive. Unlike many other countries, the U.S. taxes all profits worldwide, not just those earned here. A domicile abroad can offer a more competitive corporate tax rate. Fiduciary duty to shareholders requires that companies maximize returns.

My answer: Fight to fix the tax code, but don't desert the country. And I define "fiduciary duty" as the obligation to produce the best long-term results for shareholders, not "get the stock price up today." Undermining the finances of the federal government by inverting helps undermine our economy. And that's a bad thing, in the long run, for companies that do business in America.

Finally, there's reputational risk. I wouldn't be surprised to see someone in Washington call public hearings and ask CEOs of inverters and would-be inverters why they think it's okay for them to remain U.S. citizens while their companies renounce citizenship. Imagine the reaction! And the punitive legislation it could spark.

10 TOP AMERICAN CORPORATE

The S&P 500 stock index supposedly includes the largest public American companies. It turns out that 28 of them are incorporated in places like Ireland and Switzerland to avoid high U.S. tax rates. These 10 companies sure seem American—except when it comes to paying taxes. For the full list, visit fortune.com/unamerican.



The cruise ship Carnival *Triumph*

JEFF KATZ MCCORMICK—U.S. COAST GUARD VIA GETTY IMAGES; DONALD CIPRIANO—GETTY IMAGES; MCGAVICK, PETER POLEY—GETTY IMAGES

Carnival Corporation

U.S. HEADQUARTERS: MIAMI

CEO Arnold Donald runs this cruise ship giant, which is incorporated in Panama and Britain for tax reasons but benefits from Uncle Sam. When the Carnival *Triumph* caught fire last year, the U.S. Coast Guard helped get the crippled cruise ship to Mobile. Perhaps embarrassed about not paying its fair share of U.S. taxes, the company reimbursed the government.

TAX RESIDENCE: PANAMA

XL Group PLC

U.S. HEADQUARTERS: STAMFORD, CONN.

CEO Mike McGavick likes America, but his giant insurance company, formerly in the Cayman Islands, is now registered in Ireland. In a previous existence, McGavick was the unsuccessful 2006 Republican U.S. Senate candidate in Washington State. His platform: Eliminate the estate tax and deploy more troops in Iraq. Who's going to pay?

TAX RESIDENCE: IRELAND

Fortune contacted every company on our list of tax avoiders (above) and asked why they incorporated overseas. Four of them—Carnival, Garmin, Invesco, and XL—said they were never U.S. companies. In other words, they are never-heres. Five more—Actavis, Allegion, Eaton, Ingersoll Rand, and Perrigo—said they inverted mainly for strategic purposes. The tenth, Nabors, refused to respond to our multiple requests.

Companies that have gone the inversion or never-here route

TAX AVOIDERS

Eaton PLC

U.S. HEADQUARTERS: CLEVELAND

CEO Alexander Cutler registered his Cleveland maker of circuit breakers and truck transmissions in Ireland to lower taxes. Ironically, he also happens to be a member of the Campaign to Fix the Debt, a nonpartisan organization that advocates cutting government spending and increasing tax revenue. He wants to close tax loopholes—but he sure isn't proposing to return his corporation to full U.S. taxpaying status.

TAX RESIDENCE: IRELAND

Ingersoll Rand PLC

U.S. HEADQUARTERS: DAVIDSON, N.C.

The board of directors of this company, whose jackhammers carved Mount Rushmore, voted to move its domicile to Bermuda barely a month after the 9/11 attacks. CEO Michael Lamach says one place Ingersoll Rand gets its engineering and technical talent is "our U.S. military veteran recruiting program." The company, whose brands include Thermo King, Trane, and Club Car golf carts, subsequently moved to Ireland.

TAX RESIDENCE: IRELAND

Perrigo PLC

U.S. HEADQUARTERS: ALLEGAN, MICH.

The world's largest seller of over-the-counter store-brand drugs is headquartered in Michigan but incorporated in low-tax Ireland. CEO Joseph Papa counts on the (tax-supported) FDA to clear prescription drugs to be sold OTC. Perrigo is suing the FDA (for which the company doesn't pay its fair share) for allegedly not moving quickly enough to allow its testosterone gel to be sold without a prescription.

TAX RESIDENCE: IRELAND

Nabors Industries Ltd.

U.S. HEADQUARTERS: HOUSTON

Anthony Petrello is CEO of Nabors, a major oil and gas drilling company domiciled in Bermuda for tax reasons that benefits greatly from fracking technology. But you know what? Fracking would not have been a commercially viable process without heavy R&D investment by the federal government. The industry also receives substantial federal subsidies.

TAX RESIDENCE: BERMUDA

Garmin Ltd.

U.S. HEADQUARTERS: OLATHE, KANS.

Gary Burrell and Min H. Kao founded Garmin in 1989 in Kansas. Today the company, a leading maker of GPS systems, has its headquarters in Olathe but registered in Switzerland for tax reasons. Guess who invented the GPS? Would you believe Uncle Sam? You should. And by the way, the company's first customer was the U.S. Army.

TAX RESIDENCE: SWITZERLAND

Invesco Ltd.

U.S. HEADQUARTERS: ATLANTA

This Atlanta-based investment firm, which has $791 billion under management, is incorporated in Bermuda for tax purposes. Does that bother CEO Martin Flanagan, who in a 2007 speech at Terry College of Business in Atlanta, said, "If we're not financially sound as a country... you become much less competitive in the global marketplace... Ultimately it is a situation that's not sustainable for a country"? Apparently not.

TAX RESIDENCE: BERMUDA

Allegion PLC

U.S. HEADQUARTERS: CARMEL, IND.

This $2-billion-a-year maker of locks (the Schlage brand) and steel doors, which was spun off from Ingersoll Rand in 2013, is domiciled in Ireland. CEO David Petratis, though, happily accepted $2 million in tax credits from Indiana for keeping its North American headquarters in Carmel.

TAX RESIDENCE: IRELAND

Actavis PLC

U.S. HEADQUARTERS: PARSIPPANY, N.J.

CEO Paul Bisaro incorporated his New Jersey pharma company in Ireland for tax purposes but decided to keep the company headquarters close to where he lives. "Everybody loves New Jersey too much," Bisaro told analysts on a conference call announcing the deal. "Nobody's willing to go." His office remains in Parsippany.

TAX RESIDENCE: IRELAND

but that act American include household names like Garmin, Michael Kors, Carnival, and Nielsen. Pfizer, the giant pharmaceutical company, tried to invert this spring, but the deal fell through. Medtronic, the big medical-device company, is trying to invert, of which more later. Walgreen is talking about inverting too—it's easier to boost earnings by playing tax games than by fixing the way you run your stores.

Then there's the "Can you believe this?" factor. Carnival, a Panama-based company with headquarters in Miami, was happy to have the U.S. Coast Guard, for which it doesn't pay its fair share, help rescue its burning Carnival *Triumph*. (It later reimbursed Uncle Sam.) Alexander Cutler, chief executive of Eaton, a Cleveland company that he inverted to Ireland, told the City Club of Cleveland, without a trace of irony, that to fix our nation's budget problems, we need to close "those loopholes in the tax system." Inversions, I guess, aren't loopholes.

Before we proceed, a brief confessional rant: The spectacle of American corporations deserting our country to dodge taxes while expecting to get the same benefits that good corporate citizens get makes me deeply angry. It's the same way that I felt when idiots and incompetents in Washington brought us to the brink of defaulting on our national debt in the summer of 2011, the last time that I wrote anything angry at remotely this length. (See "American Idiots" in the Sept. 5, 2011, issue or on Fortune.com.) Except that this is worse.

Inverters don't hesitate to take advantage of the great things that make America America: our deep financial markets, our democracy and rule of law, our military might, our intellectual and physical infrastructure, our national research programs, all the terrific places our country offers for employees and their families to live. But inverters do hesitate—totally—when it's time to ante up their fair share of financial support of our system.

Inverting a company, which is done in the name of "shareholder value"—a euphemism for a higher stock price—is way more offensive to me than even the most disgusting (albeit not illegal) tax games that companies like Apple and GE play to siphon earnings out of the U.S. At least those companies remain American. It may be for technical reasons that I won't bore you with—but I don't care. What matters is the result. Apple and GE remain American. Inverters are deserters.

Even though I understand inversion intellectually, I have trouble dealing with it emotionally. Maybe it's because of my background: I'm the grandson of immigrants, and I'm profoundly grateful that this country took my family in. Watching companies walk out just to cut their taxes turns my stomach.

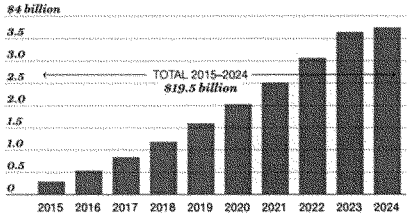
Okay, rant over.

The current poster child for inversion outrage is Medtronic Inc., the multinational Minnesota medical-device company that once exuded a cleaner-than-clean image but now proposes to move its nominal headquarters to Ireland by paying a fat premium price to purchase Covidien, itself a faux-Irish firm that is run from Massachusetts except for income-tax-paying purposes. For that, it's based in Dublin. That's where the new Medtronic PLC would be based, while its real headquarters would remain on Medtronic Parkway in Minneapolis. Of course, the company is unlikely to return any of the $484 million worth of contracts the federal government says it has awarded Medtronic over the past five years.

If the Medtronic deal goes through, which seems likely, it will open the floodgates. Congress could close them, as we'll see—but that would require our representatives and senators to get their act together. Good luck with that.

$19.5 BILLION

U.S. TAX REVENUE THAT COULD BE LOST TO FUTURE INVERSIONS



Now let's have a look at some of the more interesting aspects of the proposed Medtronic-Covidien marriage. I'm not trying to pick on Medtronic—but its decision to become the biggest company to invert makes it fair journalistic game.

Medtronic is one of those U.S. companies with a ton of cash offshore: something like $14 billion. That's money on which U.S. income tax hasn't been paid. Medtronic told me it would have to pay $3.5 billion to $4.2 billion to the IRS if it brought that money into the U.S.: That's the difference between the 35% U.S. tax rate and the 5% to 10% it has paid to other countries. Among other things, inverting would let Medtronic PLC use offshore cash to pay dividends without subjecting the money to U.S. corporate tax.

I especially love a little-noticed multimillion-dollar goody that Medtronic is giving its board members and top executives. Years ago, in order to discourage inversions, Congress imposed a 15% excise tax on the value of options and restricted stock owned by top officers and board members of inverting companies. Guess what? Medtronic says it's going

GRAPHIC SOURCE: CONGRESS'S JOINT COMMITTEE ON TAXATION

to give the affected people enough money to pay the tax.

We're talking major money—major money that I'm glad to say isn't tax-deductible to Medtronic. The company wouldn't tell me how much this would cost its stockholders. So I did my own back-of-the-envelope math, starting with chief executive Omar Ishrak. Using numbers from Medtronic's 2014 proxy statement and adjusting for its stock price when I was writing this, I figure that his options and restricted shares are worth at least $40 million, and the "equity incentive plan awards" that he might get are worth another $23 million. Allow for the fact that Medtronic will "gross up" Ishrak et al. by giving them enough money to cover both the excise tax and the tax due on their excise tax subsidy, and you end up with $7.1 million to $11.2 million just for Ishrak. And something more than $60 million for Medtronic as a whole.

Why does Medtronic feel the need to shell out this money? The company's answer: "Medtronic has agreed to indemnify directors and executive officers for such excise tax because they should not be discouraged from taking actions that they believe are in the best interests of Medtronic and its shareholders."

But you know what, folks? These people are fiduciaries, who are legally required to put shareholders' interests ahead of their own. If they believe that inverting is the right thing to do (which, it should be obvious by now, I don't) they ought to pay any expenses they incur out of their own pockets, not the shareholders'. It's not as if these people lack the means to pay—the directors get $220,000 a year (and up) in cash and stock for a part-time job, and Ishrak gets a typical hefty CEO package.

One more thing: Normally, a company's shareholders don't have to pay capital gains tax if their firm makes an acquisition. But because this is an inversion, Medtronic shareholders will be treated as if they've sold their shares and will owe taxes on their gains. However, the deal won't give them any cash with which to pay the tab.

The company asked me to mention that its executives and directors, like other holders, will be subject to gains tax on shares that they own outright, and Medtronic won't compensate them for it. Okay. Consider it mentioned.

Second, the company contends that this deal will be so good for shareholders that it will more than offset their tax cost triggered by the board's decision to invert. Well, we'll see.

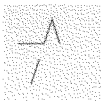
A major barrier to inversion used to be that companies moving offshore were kicked out of the Standard & Poor's 500 index. Given that more than 10% (by my estimate) of the S&P 500 stocks are owned by indexers, getting tossed out of the index—or being added to it—makes a big, short-term difference in share price. In 2008 and 2009, S&P, which has a few never-heres, tossed nine companies off the 500 for inverting. But four years ago, S&P changed course,

THE SPECTACLE OF U.S. CORPORATIONS DESERTING OUR COUNTRY TO DODGE TAXES WHILE EXPECTING TO GET THE SAME BENEFITS AS GOOD CORPORATE CITIZENS MAKES ME DEEPLY ANGRY.

for business reasons. Companies were angry at being excluded, and index investors wanted to own some of the excluded companies. Moreover, S&P feared that a competitor would set up a more inclusive, rival index.

So in June 2010, S&P changed its definition of American. Now all it takes to be in the S&P 500 is to trade on a U.S. market, be considered a U.S. filer by the Securities and Exchange Commission, and have a plurality of business and/or assets in the U.S.

The result: S&P now has 28 non-American companies in the 500.



How much money are we talking about inverters sucking out of the U.S. Treasury? There's no number available for the tax revenue losses caused by inverters and never-heres so far. But it's clearly in the billions. Congress's Joint Committee on Taxation projects that failing to limit inversions will cost the Treasury an additional $19.5 billion over 10 years—a number that seems way low, given the looming stampede. But even $19.5 billion—$2 billion a year—is a lot, if you look at it the right way. It's enough to cover what Uncle Sam spends on programs to help homeless veterans and to conduct research to create better prosthetic arms and legs for our wounded warriors.

Rep. Sandy Levin (D-Mich.) and his brother, Sen. Carl Levin (D-Mich.), have introduced legislation that would stop Medtronic in its tracks by making inversions harder. Under current law, adopted in 2004 as an inversion stopper, a U.S. company can invert only if it is doing significant business in its new domicile and shareholders of the foreign company it buys to do the inversion own at least 20% of the combined firm.

The Levins propose to require that foreign-firm shareholders own at least 50% of the combined company for it to be able to invert and also that the company's management change. This would really slow down inversions—but the chances of Congress passing the Levin legislation are somewhere between slim and none.

Conventional wisdom holds that companies are inverting now because they've despaired of getting clean-cut reform that would widen the tax base and lower rates. But John Buckley, former chief Democratic tax counsel for the House Ways and Means Committee, has a different view. Buckley thinks that we're seeing an inversion wave not because there's no prospect of tax reform but because there *is* a prospect of reform. If reform comes, he says, there will be winners and losers—and it's the likely losers-to-be that are inverting. "Even minimal tax reform would hurt a lot of these companies badly," he says.

For example, Buckley says, a company that inverts before reform takes effect will be able to suck income out of the U.S. to lower-tax locales much more easily than if it were still a U.S. company. "A revenue-neutral tax reform requires there to be winners and losers," Buckley says. "But by inverting, the companies that would be losers are taking themselves out of the equation ... They're taking advantage of both U.S. individual taxpayers and other corporations."

If you're a typical CEO who has read this far, about now you're shaking your head and thinking, "What a jerk! Just cut my tax rate and I'll stay." To which I say, "I wouldn't bet on it." In the widely hailed 1986 tax reform act, Congress cut the corporate rate to 34% (now 35%) from 46%, and closed some loopholes. Corporate America was happy—for awhile. Now, with Ireland at 12.5% and Britain at 20% (or less, if you make a deal), 35% is intolerable. Let's say we cut the rate to 25%, the wished-for number I hear bandied about. Other countries are lower, and could go lower still in order to lure our companies. Is Corporate America willing to pay any corporate rate above zero? I wonder.

So what do we need? I'll offer you a bipartisan solution—no, I'm not kidding. For starters, we need to tighten inversion rules as proposed by Sandy and Carl Levin, who are both bigtime Democrats. That would buy time to erect a more rational corporate tax structure than we have now—bolstered, I hope, by input from tough-minded tax techies.

We also need loophole tighteners along the lines of proposals in the Republican-sponsored, dead-on-arrival Tax Reform Act of 2014. One part would have imposed a tax of 8.75% a year on cash and cash equivalents held offshore, and 3.5% a year on other retained offshore earnings.

Another thing we need to do—which the SEC or the Financial Accounting Standards Board could do in a heartbeat, but won't—is require publicly traded U.S. companies and U.S. subsidiaries of publicly traded foreign companies to disclose two numbers from the tax returns they file with the IRS: their U.S. taxable income for a given year, and how much income tax they owed. This would take perhaps one person-hour a year per company.

UNTIL—AND UNLESS—WE GET OUR ACT TOGETHER ON CORPORATE TAX REFORM, COMPANIES WILL KEEP LEAVING OUR COUNTRY.

That way we would know what firms actually pay instead of having to guess at it. Then we could compare and contrast companies' income tax payments.

What we don't need is another one-time "tax holiday," like the one being proposed by Sen. Harry Reid (D-Nev.), to let companies pay 9.5% rather than 35% to bring earnings held offshore into the U.S. It would be the second time in a decade we've done that, and would signal tax avoiders that they should keep sending tons of money offshore, then wait for a tax holiday—presumably not on the Fourth of July—to bring it back.

Until—and unless—we somehow get our act together on corporate tax reform, companies will keep leaving our country. Those that try to do the right thing and act like good American corporate citizens will come under increasing pressure to invert, if only to fend off possible attacks by corporate pirates—I'm sorry, "activist investors"—who see inversion as a way to get a quick uptick in their targets' stock price.

Now, two brief rays of sunshine: one in England, one here.

Starbucks, embarrassed by a 2012 Reuters exposé showing that it paid little or no taxes in England despite telling shareholders it made big profits there, has recently apologized and now makes substantial British tax payments. And eBay, God bless it, decided to bring $9 billion of offshore cash into the U.S. and pay taxes on it.

So I'm feeling a bit better about July than when I started writing this. In any event, a happy summer to you and yours. ■

ADDITIONAL REPORTING: ***Marty Jones***
Mehboob Jeelani, Phil Wahba, and Michael Casey

Testimony of Robert B. Stack, Deputy Assistant Secretary (International Tax Affairs)
U.S. Department of the Treasury
Before the Senate Finance Committee
July 22, 2014

Chairman Wyden, Ranking Member Hatch, and distinguished members of the Committee, I appreciate the opportunity to appear today to discuss some key international tax issues, including the G-20's Base Erosion and Profit Shifting (BEPS) project. We appreciate the Committee's interest in these issues and the great amount of attention and effort the Committee has devoted toward reforming the international tax system in a way that would improve its sustainability and improve the U.S. system of taxation

I would like to begin by describing the work we are doing in the BEPS project and then link that discussion to a consideration of the need for general corporate and international tax reform, as well as measures to address U.S. base stripping and inversion transactions that are outlined in the Administration's FY2015 budget proposals.

In June 2012, at the G-20 Summit in Los Cabos, Mexico, the leaders of the world's largest economies identified the ability of multinational companies to reduce their tax bills in high-tax countries by shifting income into low- and no-tax jurisdictions as a significant concern. They instructed their governments to develop an action plan to address these issues, which was developed over the course of 2012-2013 and endorsed by G-20 leaders last September at the G-20 Summit in St. Petersburg. The Organization for Economic Cooperation and Development (OECD) has hosted this process, but G-20 governments, some of whom are not members of the OECD, are driving the process.

The BEPS Action Plan adopted last year outlines 15 specific areas where governments need to work to change the rules of the road that encourage companies to shift their income at the expense of the global tax base. The action items are generally aimed at developing recommendations to help countries combat BEPS. Ultimately, these recommendations will require changes to countries' domestic laws and changes to the OECD model income tax convention, and there is even discussion of a multilateral treaty to address BEPS. The BEPS project is expected to release its first set of recommendations on policies related to transfer pricing documentation and country-by-country reporting, transfer pricing with respect to intangibles, treaty abuse, hybrid mismatch arrangements, harmful tax practices, and the digital economy this fall. The BEPS project is set to conclude at the end of 2015 with final recommendations under all of the action items.

To provide some context for the BEPS project, I would like to discuss a number of factors that gave rise to the need for the BEPS project. First, the interaction of various countries' rules for taxing cross-border income creates incentives for companies to let tax decisions drive corporate policy in order to pay very low rates of tax or even to entirely avoid paying tax anywhere on large portions of their income. Public frustration arises when companies that do business in one country pay low or no tax there or anywhere else. While it is national governments that write the tax laws, and companies should not be expected to pay more tax than they owe, much of the global interest nonetheless centers around the activities of U.S.-based multinational companies because, as global household names, their activities have received the most publicity perhaps and also because various government inquiries here and abroad have focused on them. This frustration on the part of the public and also national governments, in turn, is not surprisingly reflected in the political arena such that, as noted above, the G-20 leaders came together in an effort to rein in this activity through the G-20/OECD BEPS Project.

The United States has a great deal at stake in the BEPS project and a strong interest in its success. Our active participation is crucial to protecting our own tax base from stripping by multinational companies, much of which occurs as a result of exploiting differences in national regimes. A key goal of BEPS is to seek to identify those differences and write rules that plug the holes. Because the United States provides a foreign tax credit to companies for taxes they pay overseas, the United States also has a direct financial stake in rules that enjoy broad international consensus. In addition, as the home of some of the world's most successful and vibrant multinationals, we have a stake in ensuring that companies and countries play by tax rules that are clear and administrable and that companies can avoid unrelieved double taxation, as well as time-consuming, expensive tax disputes. Both the United States and our companies also have a strong interest in access to robust dispute resolution mechanisms around the world. In contrast, failure in the BEPS project could well result in countries taking unilateral, inconsistent actions thereby increasing double taxation, the cost to the U.S. Treasury, and the number of tax disputes.

The principal target of the BEPS project is so-called "stateless income," basically very low- or non-taxed income within a multinational group. Low and non-taxed income located in various jurisdictions around the world is an inviting fiscal target for other countries. The existence of large amounts of stateless income in a time of global austerity has put pressure on the longstanding, widely accepted international tax rules. This pressure is increased in a global economic environment in which superior returns can accrue to intangibles that can be easily located anywhere in the world and that are often the result, for example, of intensive research and development activities that a single multinational may conduct in many countries, or marketing intangibles can be exploited in one country but owned and financed from another, often low-tax, country. Some countries with large markets believe that some of these premium profits enjoyed by multinationals should be taxed in those market countries, whereas current international norms attribute those profits to the places where the functions, assets, and risks of the multinational firm are located – which are often not in the market countries.

The G-20/OECD BEPS project is made even more challenging by the reality that some of the gaps in the international tax rules are created by countries intentionally seeking to attract mobile income through various special tax regimes. Left unchecked, these regimes could result in an unproductive race-to-the-bottom in tax competition. When otherwise legitimate practices, such as the desire to subsidize research and development, drop any pretense linking the tax break to activity in the country itself, these regimes become no more than open invitation to strip more highly taxed income from countries like the United States.

I am happy to report that the OECD BEPS project has had a promising beginning and there are areas where commendable work is being done to resolve gaps in existing international rules and where broad consensus should be possible. These areas include minimizing potential for hybrid mismatches (situations in which a multinational issues an instrument that gives rise to a tax deduction in one country without a corresponding inclusion in another); helping countries minimize abuse of their bilateral income tax treaties, including through so-called "treaty shopping"; requiring country-by-country reporting of profits and taxes by multinationals so that they can be made available to tax administrators for purposes of risk assessment; designing interest limitation rules that can be applied across borders; updating the transfer pricing rules on the application of the "arm's length" standard to intangibles and endorsing "special measures" when those rules produce stateless income; and updating the rules on permanent establishment to minimize the artificial avoidance of those rules.

As the work moves into 2015, there is more that can be achieved, and also several areas where we must guard against bad outcomes. One of the key 2015 action items will focus on making dispute resolution more efficient, which we hope will include a significant broadening of the use of mandatory arbitration to resolve tax disputes between the tax authorities of the two countries. When countries know that tax disputes will be settled by a neutral arbitrator, it improves the dispute resolution process from beginning

to end. In 2015, we will also work closely with other countries to limit the base stripping that results from excessive interest deductions, a topic of strong interest to the United States and that, as discussed below, is also the subject of one of the President's FY2015 budget proposals.

We must also work hard in several areas to preserve our national interest in rules based on principles and not merely individual country revenue interests. Let me highlight just a few. In the area of transfer pricing, we must ensure that the currently-used arm's length standard is clearly articulated and that profits are attributable to the place of economic activity – that is, where the assets, functions, and risks of the multinational are located. We must further ensure that any "special measures" agreed at the OECD are firmly anchored in these principles, and that legal and contractual relationships are ignored in determining intercompany prices only in unusual circumstances. The arm's length standard has been a bedrock of international taxation for over 50 years, and while it is not perfect, it is the best tool available to deal with the difficult issue of pricing among affiliates of a multinational group. We must steadfastly avoid turning longstanding transfer pricing principles into a series of vague concepts easily manipulated by countries to serve their revenue needs at the expense of the U.S. tax base and our multinationals.

With respect to country-by-country reporting by multinationals of income and tax information, we must strongly support measures that ensure that the information is used by countries' tax administrators solely as a risk assessment tool. Country-by-country data is useful to tax administrators because it will permit them to identify companies that have shifted income into low- or no-tax jurisdictions. In those cases, countries may appropriately feel that such a company deserves a closer look on audit to determine whether income has been shifted out of their jurisdiction through non-arm's length pricing. Given the potentially sensitive nature of this information, we must ensure that information of U.S.-based multinationals is made available only through our treaty and information exchange networks so as to ensure its confidentiality and appropriate use by our treaty or information exchange partners. Finally, this work should contain a remedy in the event countries misuse the information to make tax adjustments that do not conform to agreed international standards.

In the area of digital businesses, we must guard against the desire of some countries to use new business models as a pretext for taxing income beyond that which arises from the functions, assets, and risks located in those countries. We continue to believe that long standing, widely accepted rules that require a physical presence in another country before that country receives the right to impose an income tax is the most administrable and appropriate rule even in a digital age, and we are very encouraged by the work at the OECD to further adapt the rules concerning value added taxes to the digital age – so that countries with a VAT can have a revenue source from the digital economy without resorting to new, exceedingly complex and difficult to administer income tax solutions. Finally, as a matter of U.S. tax treaty policy, the United States took the international lead in limiting treaty abuse by adopting "limitation of benefits" provisions in our treaties. We believe that they have worked fairly and effectively to limit treaty shopping. In the G-20/OECD BEPS project we will continue to propose the limitation on benefits provision as a solution to protect against treaty shopping and will oppose proposals to include a main purpose test (or principal purpose test) in our own treaties as this test is too vague and subjective and creates unacceptable uncertainty about how such rules will be administered. In short, the remainder of 2014 and 2015 will be a very challenging time in the G-20/OECD BEPS Project. The United States needs to remain deeply engaged in moving the project to a successful conclusion.

While the international negotiations over BEPS progress, it is worth acknowledging steps the United States could take today to reform our own tax system to improve competitiveness, secure our tax base, and reduce incentives for profit shifting by U.S. firms.

As the President has proposed, we should reform our business tax system by reducing the rate and broadening the base. It is frequently noted that the United States has a high statutory corporate rate, but much lower effective tax rates. High statutory rates encourage multinationals to find ways to shift profits, especially on intangible income, to other jurisdictions. So lowering our statutory rate while broadening the base could be a start toward reducing stripping of the U.S. base.

But it would only be a start, because even with lower rates U.S. multinationals would continue to aggressively seek ways to lower their tax bills by shifting income out of the United States. So what other tools do we have at our disposal? We can examine the ways multinationals lower their U.S. effective rates and take sensible protective measures.

First, in the international arena specifically, the President's framework for business tax reform proposes a minimum tax on foreign earnings. Other recent tax reform plans have included similar proposals, which would improve on the current complex and porous international tax rules by requiring that companies pay tax on all foreign earnings, but at a somewhat reduced rate.

Whether as part of tax reform or in the context of our current tax system, we should also take a close look at interest deductibility, noting that in this area our thin capitalization rules are inadequate and that our system actually gives an overall advantage to foreign-owned multinationals in this regard. Foreign-owned multinationals typically lend funds into the United States to benefit from interest deductions against income that would otherwise be subject to a 35 percent tax rate, while the related interest income is subject to significantly lower tax rates in the lending jurisdiction. It is especially disconcerting to observe that among the foreign multinationals that can most aggressively take advantage of the deficiencies in our thin capitalization rules are so-called "inverted" companies – that is, foreign-parented companies that were previously U.S.-parented. The Administration's FY 2015 budget contains a proposal that would strengthen our interest-stripping rules and level the playing field by limiting the ability of U.S. subsidiaries of a foreign multinational to deduct a disproportionate amount of the group's global interest expense in the United States. Specifically, this proposal would limit the U.S. group's share of global interest expense deductions by reference to the U.S. group's proportionate share of the multinational's worldwide consolidated earnings, as computed under Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS).

Another Administration FY 2015 budget proposal would limit the deduction of interest expense of U.S. multinationals related to deferred foreign subsidiary income. Our own multinationals typically do all of their borrowing in the United States to benefit from interest deductions against income that would otherwise be subject to a 35 percent tax rate, but they then use borrowed cash throughout the multinational group, financing operations generating income that may not be subject to current U.S. tax. Indeed, we have recently seen examples of U.S. multinationals borrowing in the United States – rather than bringing back cash from offshore – to pay dividends to their shareholders. By aligning the timing of interest expense deductions with the timing of the recognition of the income supported by the proceeds of borrowing, the Administration's proposal would address the mismatch under current law that allows companies to take current deductions for interest related to income that is not subject to current U.S. tax.

In addressing stripping of the U.S. base, it is also important to consider so-called "hybrid arrangements," which may allow taxpayers to claim U.S. deductions with respect to payments that do not result in a corresponding income item in the foreign jurisdiction. These arrangements serve little function other than to produce stateless income and could easily be reined in. To neutralize these arrangements, the Administration's FY 2015 budget proposal would deny deductions for interest and royalty payments made to related parties under certain circumstances involving hybrid arrangements. For example, the proposal would deny a U.S. deduction where a taxpayer makes an interest or royalty payment to a related

person and there is no corresponding inclusion in the payee's jurisdiction, or where the taxpayer is able to claim a deduction with respect to the same payment in another jurisdiction.

Additionally, it has been well documented that shifting intangibles outside the United States is a key avenue through which U.S. base erosion occurs. The principal means of shifting intangible income is to undervalue intangible property transferred offshore or to take advantage of perceived loopholes in our definition of intangibles. Once this intellectual property is offshore, the income that it produces can accrue in low- or no-tax jurisdictions, outside the scope of U.S. taxation. The Administration's FY 2015 Budget contains a number of proposals that would discourage the corporate tax base erosion that occurs via intangibles transfers. One of those proposals would clarify the definition of intangible property to address taxpayer arguments that certain value does not fall within the current definition and therefore may be transferred offshore without any U.S. tax charge. Another proposal would modify our subpart F rules to tax currently certain excess returns of a controlled foreign corporation from intangibles transferred to it by a U.S. person, while yet another proposal would update subpart F to currently tax certain highly mobile income from digital goods and services where the controlled foreign corporation earning the income did not itself make a substantial contribution to the development of the relevant intangible property.

Finally, and as underscored by Secretary Lew's July 15th letter to Congress, I want to emphasize the serious need for the United States to once again directly address the potential loss of federal tax revenues from corporate inversion transactions. Letting our corporate tax base erode through inversions will worsen our fiscal challenges over the coming years. Once companies invert, there is a permanent loss to the U.S. income tax base since it is safe to assume these companies are not coming back to the United States.

An anti-inversion provision has been part of the Internal Revenue Code since 2004, but experience has shown that this provision insufficiently deters inversion given the large tax rate and other tax disparities between United States and the countries to which formerly U.S.-based multinationals have relocated. According to a recent Congressional Research Service report, forty-seven U.S. corporations have reincorporated overseas through corporate inversions in the last 10 years. This is an increase from only 29 inversions in the prior 20 years. And proposed inversions are being reported in the media on a much more frequent basis.

To reinforce the existing anti-inversion statute, the Administration, in the FY 2015 Budget, has proposed to broaden the scope of inversion transactions subject to the statute. As amended, where shareholder continuity in the inverted company after a transaction is more than 50 percent, or where the inverted company meets certain criteria demonstrating that it retains a close connection to the United States and does not have a close connection to the country to which it relocates, the statute would provide that the inverted company would continue to be treated as a domestic corporation for U.S. federal income tax purposes. Regardless of any other base stripping or tax reform legislation adopted, such strengthened anti-inversion legislation is necessary to prevent a permanent reduction in federal corporate income tax revenues. As the Secretary indicated in his June 15 letter, Congress should pass legislation immediately with an effective date of May 2014 to prevent companies from effectively renouncing their citizenship to get out of paying taxes.

In closing, I would like to acknowledge the tireless work and dedication of the office of the International Tax Counsel at the Treasury Department, which has been a leader in providing technical guidance on these issues in the G-20 and at the OECD.

Thank you for the opportunity to speak to you today. I look forward to answering your questions.

Statement of Senator Thune
Senate Committee on Finance Hearing
"The U.S. Tax Code: Love It, Leave It, or Reform It"
July 22, 2014

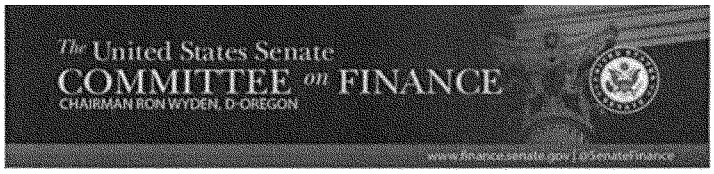
I would like to thank Chairman Wyden and Ranking Member Hatch for holding this important hearing and the witnesses for their willingness to testify.

As we've heard today, there are real differences of opinion regarding how we improve the U.S. tax code, especially as it relates to international tax issues. Yet I suspect that there is uniform agreement among all the members of this committee that we want American companies to compete and win in the global economy.

No matter what your political persuasion, none of us wants American businesses to lose in the global competition for sales and market share. So the issue before this committee isn't how we treat the symptoms of a broken tax system or what window-dressing should be applied to our outdated tax code. The issue before this committee is how do we empower American businesses to compete and win in the global marketplace. And we can only do this by treating the cause of our tax code dysfunction, which is the highest tax rate in the developed world and a completely outdated system for taxing income earned outside our borders.

Rather than the Administration's call today to place new shackles on American businesses, we need a tax system that is about growth and opportunity. We need a tax system for the modern economy, which recognizes that more than 95 percent of consumers live outside the United States and more than 80 percent of global purchasing power is beyond our borders. Someone is going to sell the smart phones, software, agricultural commodities, and manufactured products of the future to the emerging middle-class throughout Latin America, Asia, and Africa. But I fear that these won't be American products from American companies, due to the uncompetitive and incredibly burdensome nature of our tax code.

American entrepreneurs are the most innovative in the world, and they will compete and win, if only we let them. I realize this is an election year and some may see political advantage in demonizing big business rather than offering constructive solutions. I sincerely hope we can turn away from inflammatory terms such as "economic patriotism" and instead focus on the real business of reforming our tax code so that American businesses are equipped to compete and win in a very competitive global marketplace.



Wyden Statement on Corporate Inversions and the Need for Comprehensive Tax Reform

The U.S. tax code is infected with the chronic diseases of loopholes and inefficiency. These infections are hobbling America's drive to create more good-wage, red, white and blue jobs here at home. They are a significant drag on the economy and are harming U.S. competitiveness. The latest outbreak of this contagion is the growing wave of corporate inversions, where American companies move their headquarters out of the U.S. in pursuit of lower tax rates.

The inversion virus now seems to be multiplying every few days. Medtronic, Mylan, Mallinckrodt and many more deals have either occurred recently or are currently in the works. Medtronic's proposed $42 billion merger with Covidien was record-breaking when it was announced in June. But the ink in the record books had barely dried when AbbVie announced its intention on Friday to acquire Shire for almost $55 billion. According to the July 15th edition of Marketplace, "What's going on now is a feeding frenzy ... Every investment banker now has a slide deck that they're taking to any possible company and saying, 'you have to do a corporate inversion now, because if you don't, your competitors will.'"

Congress has been aware of the inversion virus for a long time. In fact, it passed legislation purporting to solve the problem a decade ago. But the underlying sickness continues to gnaw away at the American economy with increasing intensity. The American tax code is an anti-competitive mess. Accountants, lawyers, and fast-buck artists looking for tax shelters feed off it. This mess is driving American investment dollars overseas, and according to the Joint Committee on Taxation, it is costing American taxpayers billions.

On a bipartisan basis, the Finance Committee must respond now. First, let's work together to immediately cool down the inversion fever. The inversion loophole needs to be plugged now. Second, let's use the space created by these immediate steps to apply the indisputable, ultimate cure: comprehensive tax reform.

I've got nine long years of sweat equity in tax reform. With former Senator Gregg, and current Senators Begich and Coats, we have produced what still is the Senate's only bipartisan federal income tax overhaul in almost thirty years. Obviously Senators here have differing ideas about tax reform. Let's recognize that what really counts is that the Finance Committee isn't back here once again discussing inversions a decade from now.

Comprehensive tax reform needs to happen soon. The outbreak of inversions shows that without curing the disease once and for all, the illness will keep plaguing the American economy. It will get tougher to create those red, white and blue American jobs. Our tax base will keep eroding. Cash piles trapped overseas will grow. Investment will be driven elsewhere.

The Finance Committee invited a number of CEOs from the inverting companies to join our discussion today. None accepted our invitation. I hope these executives will soon change their minds and be willing to answer questions Finance Committee members have about this issue.

The fact is, without immediate, comprehensive tax reform, an antidote to the inversion virus is needed now to protect the American economy. This wave of inversions may be good for shareholders, investment bankers and private equity firms, yet it is bad for America. America's free enterprise system is at its best when there is a level playing field. And inversions bestow tax favors on some parties and further distort the free market.

Absent tax reform being enacted immediately, what happens if the inversion virus leads to 20 more inversions over the summer? Many inversions to this point have happened in the medical field, but the Wall Street Journal just reported that there is evidence of inversions spreading to manufacturing and retail. How many more infections can America's economic body endure?

Global markets are expanding. Stockpiles of cash sitting overseas are growing at record levels. Foreign competitors are getting more aggressive in chomping at the bit to get a deal on the backs of the American taxpayer. The time for action is now. This committee needs to move now, on a bipartisan basis, to close the loopholes that are fueling the growth of the inversion virus. Then the Finance Committee needs to cure the disease once and for all with comprehensive tax reform. Let's come together on a bipartisan basis to accomplish both tasks, and I will work with each member of the committee every step of the way.

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COMMUNICATIONS

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The Honorable Senator Wyden, Chairman
The Honorable Senator Hatch, Ranking Member
Senate Committee on Finance
Attn: Editorial and Document Section
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August 1, 2014

Written statement for the Senate Finance Committee Hearing held on July 22, 2014: "The U.S. Tax Code: Love It, Leave It, or Reform It!"

Dear Senator Wyden and Senator Hatch,

American Citizens Abroad, Inc. ("ACA") is a non-profit, non-partisan, volunteer membership organization representing Americans abroad. With offices in Washington, D.C. and membership worldwide, ACA draws on more than three decades of rich experience and knowledge of laws affecting Americans living overseas.

ACA appreciates the opportunity to submit a written statement for the record of the Senate Finance Committee Hearing on July 22, 2014 on the current U.S. system of international taxation.

The Senate Finance Committee hearing of July 22, 2014 focused on the urgent need for U.S. corporate tax reform to lower the tax rate, broaden the tax base, modify S corporation tax rules and move towards a territorial tax system. The hearing also covered the position of the United States in the negotiations with G-20 governments with regard to BEPS (base erosion profit shifting), whereby modifications in international tax rules would reduce the ability for multinational corporations to reduce their taxes by playing one country's tax system against another.

The recent wave of corporate inversions has raised the sense of urgency to act soon on U.S. corporate tax reform. As Chairman Wyden stated, *"Comprehensive tax reform has to happen soon."* Ranking Member Hatch echoed the same urgency when he said, *"As we consider reforms to our tax code, our primary goals should be to make the U.S. a better place to do business and to allow American companies to more effectively compete with their foreign counterparts in the world marketplace."*

The United States currently subjects both U.S. corporations and individuals to taxation on worldwide income. U.S. international tax law needs major reform not only for corporations, as underlined in

several testimonies at the hearing, but also for individuals to allow them to more effectively compete with their foreign counterparts.

American Citizens Abroad, Inc. will limit its comments to the international dimension of personal income taxation of individuals.

The U.S. taxes not only all residents in the country, whether or not they are citizens, but also all U.S. citizens and green card holders who reside outside the United States; this latter policy is referred to as citizenship-based taxation (CBT). All subsequent references to Americans abroad are meant to include both U.S. citizens and green card holders who reside overseas.

The United States is the only country in the world, other than Eritrea, to practice citizenship-based taxation. CBT is incompatible with the need for increasing mobility of individuals in the global economy as it discourages Americans to work overseas and severely penalizes those who do live and work overseas. CBT seriously reduces the competitiveness of Americans in the global economy and, in fact, creates conditions of major discrimination and prejudice against Americans abroad. Coupled with FBAR and FATCA reporting requirements, CBT is shutting off Americans abroad from jobs, from insurance policies, from current and investment bank accounts in the country of residence, from partnerships and investments with foreigners, from investments in mutual funds in the country of residence, from access to efficient savings through foreign pension funds, to name but the most obvious negative impacts of CBT on overseas residents.

This long-arm reach of U.S. taxation inhibits American entrepreneurs abroad due to the onerous CFC (controlled foreign corporation) reporting requirements and the double taxation of social security contributions for those who are self-employed. These reporting and tax rules inhibit small and medium-sized companies from establishing foreign subsidiaries as beachheads to penetrate foreign markets with their American-made products. The cost to the U.S. economy of small and medium-sized American companies not being active enough on the export front is reflected in the unsustainable U.S. trade deficit of hundreds of billions of dollars every year and the lost domestic jobs.

CBT requires double tax filing for both the country of residence and the United States, with the latter filing being of utmost complexity due to the requirement to use the U.S. dollar as the functional currency and hence the need to translate foreign currencies into U.S. dollars, the reporting of foreign tax credits and the foreign earned income exclusion, the reporting of investments classified as PFIC (passive foreign investment companies) and the reporting of foreign trusts.

The United States does recognize that the country of residence has first right of taxation and grants credits for income taxes paid in the country of residence. Hence, after application of the foreign earned income exclusion and foreign tax credits against the U.S. tax liability, the vast majority of Americans resident abroad do not owe any U.S. tax. However, the cost to the taxpayer of filing U.S. taxes can easily exceed $2,000 a year, in addition to surplus personal hours of data collection. It is a burdensome, inefficient administrative exercise for both the IRS and the individuals. Because of CBT, overseas Americans, who are estimated to be 7.6 million individuals, account for only 0.2 % of federal revenues.

Inherent incompatibilities between the U.S. tax rules and foreign tax systems do lead to numerous instances of double taxation despite the application of foreign tax credits. The United States has now legislated pure double taxation through the 3.8% NIIT (net investment income tax), as foreign tax credits are not allowed against this tax; the absurdity of this legislated double taxation relates to the fact that NIIT is destined to finance the U.S. health care system, a system which excludes Americans

abroad. It is the extreme example of the inequity of CBT. One of the fundamental justifications for a government to tax its residents is that the government provides services which benefit the individual. Americans abroad do not benefit from most services provided to U.S. residents.

The requirement to apply the U.S. dollar as the functional currency leads to phantom capital gains on investments in the currency of residence as the U.S. dollar has trended downward against major currencies since the 1970s, when the United States cancelled the definition of the U.S. dollar as 1/35th ounce of gold. An American abroad can have a loss in local currency on the sale of real estate, but a taxable gain in U.S. dollars, yet the individual earns, spends and saves in the foreign currency.

The intent of FATCA was to bring to compliance domestically resident taxpayers with assets and/or revenue hidden abroad. In practice, the impact of FATCA falls most heavily and most unfairly on Americans resident overseas. The implementation of FATCA, which is directly linked to CBT, is the straw that has broken the camel's back. While residents of the United States do not have to report their financial assets in the United States to the IRS and to the Treasury Department, Americans abroad have to report all of their local financial assets in their country of residence to the IRS on Form 8938 and to the Department of the Treasury on the FBAR because those financial assets are viewed as foreign financial assets by the United States. These duplicative reports not only invade privacy, but also carry significant personal risk for Americans abroad as any hacker who might obtain access to those reports would have all vital information needed to commit identity fraud and theft.

For many Americans abroad, the situation has become unsustainable. The international reach of U.S. tax policy and burdensome reporting requirements has negatively impacted the attitudes of Americans abroad towards the United States, and it is a factor leading more people to renounce their U.S. citizenship in order to survive overseas. This movement is detrimental to the United States and to its image in the world. Americans overseas view themselves as collateral damage in the fiscal wars waged by Congress, the Department of the Treasury and the IRS.

American Citizens Abroad recommends Residence-Based Taxation (RBT) as a substitute for CBT

All of these unfortunate consequences of CBT could be resolved if the United States adopted Residence –Based Taxation (RBT), the same system applied throughout the world. ACA has submitted detailed papers recommending RBT; the most recent one, which also references earlier documents, was submitted to the Senate Finance Committee in January 2014.
http://americansabroad.org/files/9613/8987/3227/aca-submission-senate-finance.pdf

RBT is truly a win-win proposal for the United States and for Americans abroad. The revenue stream for the United States would be comparable to that of CBT. The administrative costs to the IRS would be significantly lower as Americans abroad would be taxed in the same way that non-resident aliens are currently taxed, i.e. automatically through withholding taxes on U.S. source income. If a truly dynamic evaluation were made, the potential gain for the U.S. economy through improved competitiveness would be a high multiple of current tax revenue from CBT.

In addition to its strong recommendation to replace CBT by RBT, ACA also advocates several partial reform measures of the U.S. tax code, so as to alleviate some of the unjustified burden on Americans abroad. These partial measures include:

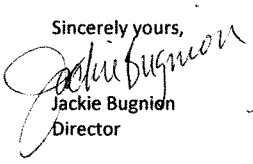
- allowing the local currency, i.e. the currency of the taxpayer's country of residence, to be the functional currency for U.S. tax reporting purposes
- allowing a "same country exception rule" to apply to foreign bank accounts held by Americans abroad in their country of residence so that they would not be subject to FATCA reporting by both foreign financial institutions and overseas tax filers

- increasing or eliminating the cap on the foreign earned income exclusion
- allowing foreign tax credits to be applied against the 3.8% NIIT
- recognizing foreign retirement and pension plans that are comparable to U.S. plans to be treated in the same way as U.S. plans for U.S. tax filing purposes.

However, while these partial solutions may help, they are only stop-gap measures. They do not resolve the fundamental problem that the United States requires tax filing of Americans resident abroad who are already paying taxes in the country where they reside. The only true solution to the dilemma facing Americans abroad is for the United States to adopt RBT and to bring its personal income tax situation in line with the 21st century and the rest of the world.

On behalf of Americans resident throughout the world, we thank you for your attention to the above and look forward to maintaining an ongoing dialogue. If you have any questions, please contact Marylouise Serrato, at info@americansabroad.org .

Sincerely yours,



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E. James (Jim) Ferland
President & Chief Executive Officer

July 22, 2014

The Honorable Ron Wyden
Chairman
Finance Committee
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Orrin Hatch
Ranking Member
Finance Committee
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Wyden and Ranking Member Hatch:

The Babcock & Wilcox Company (B&W) appreciates the opportunity to provide comments regarding international business tax reform. We applaud and encourage the efforts of the Senate Finance Committee to improve the tax code in order to level the playing field so that U.S.-based businesses can be more competitive in the global market place and in attracting capital investment.

Headquartered in Charlotte, N.C., The Babcock & Wilcox Company (B&W) is a leader in clean energy technology and services, primarily for the nuclear, fossil and renewable power markets, as well as a premier advanced technology and mission critical defense contractor. B&W has locations worldwide and employs approximately 11,000 people, in addition to approximately 2,300 joint venture employees. The overwhelming majority of our research and development jobs are located here in the United States.

Currently, the U.S. has the highest marginal corporate income tax rate among Organization for Economic Cooperation and Development member countries, effectively putting domestic companies at a significant global competitive disadvantage. With a 35% rate on corporate profits, the U.S. is out of step with other major industrialized nations that have been cutting their corporate tax rates over the past two decades. Further, it is critical that the U.S. tax code allows and facilitates U.S. companies to compete for capital with a tax rate that is not the highest in the industrialized world.

Our primary message is that U.S. tax policy should help and not hinder U.S.-based companies to compete in the global marketplace. It should provide a level playing field for domestic businesses compared to foreign competitors when conducting business abroad and at home. One essential element in any effort to reform the tax code must be for the U.S. to lower its corporate tax rate to 25%, or below. We believe that much of the debate over other aspects of comprehensive tax reform will take on less importance if we can achieve a fair and competitive U.S. corporate tax rate. We recognize that to reach that rate, certain tax deductions and credits may need to be modified or repealed. We would caution however, that U.S. manufacturers should not bear an undue or disproportionate burden in this process compared to other business and economic sectors.

As an innovative U.S.-based multinational corporation, the reform of international tax policy also is critical to our future success. While we continue to focus on the U.S. market, the demand for our products and services around the world provides tremendous opportunities for expansion outside the United States. B&W makes strategic and operational decisions regarding location and allocation of resources according to market demand, the opportunity to earn a fair return on investment and sound business practices. We do not shop for jurisdictions with favorable tax rates. Our international tax system should facilitate such growth and allow fundamental business principles to drive our decision-making, and not unduly burden U.S. manufacturing companies trying to compete in foreign markets. Depending on the specific design and how base erosion provisions are structured, a Territorial System generally appears best suited to meet that goal since B&W

would then pay the same level of tax as our competitors when conducting business and investing in a foreign country.

Moreover, U.S. multinational businesses should be able to freely and efficiently deploy resources generated from conducting trade or business among its wholly-owned and affiliated entities, to support and sustain growth without incurring additional tax costs. As a leading global supplier of energy products and services, we must locate our operations in proximity to our customers in order to be competitive, and many of our major growth markets are outside of the United States. The current U.S. tax rate and structure make it increasingly difficult to remain competitive in international markets, which in turn impacts the vitality of our business operations and job base here at home.

We hope you find this feedback helpful as you work through these important issues. If you have any questions or would like to discuss any of these comments further, please feel free to contact myself, or Paul Cappiello, Vice President of Tax, at pvcappiello@babcock.com.

Sincerely,

E. James Ferland
President & CEO
The Babcock & Wilcox Company

Statement of the National Association of Manufacturers (NAM)

For the Hearing Record

Of the

Committee on Finance
U.S. Senate

On

The U.S. Tax Code: Love It, Leave It or Reform It!

July 22, 2014

Overview

The National Association of Manufacturers (NAM) is the largest manufacturing association in the United States, representing small and large manufacturers in every industrial sector and in all 50 states. Manufacturing employs more than 12 million men and women, contributes $2.08 trillion to the U.S. economy annually and accounts for two-thirds of private-sector research and development. The manufacturing sector represents 12.5 percent of our nation's gross domestic product (GDP).

NAM members know first-hand that our current tax system is fundamentally flawed and discourages economic growth and U.S. competitiveness. As a result of manufacturing's critical importance to our nation's economy, any effort to rewrite the federal tax code should result in a balanced, fiscally responsible plan that allows manufacturers in the United States to prosper, grow and create jobs and also enhances their global competitiveness.

As outlined in the NAM's *A Growth Agenda: Four Goals for a Manufacturing Resurgence in America*, a key objective for the association is to create a national tax climate that enhances the global competitiveness of manufacturers in the United States and avoids policy changes that would increase the tax burden on the manufacturing sector.

To achieve these goals, we need a comprehensive tax reform plan that both reduces the corporate tax rate to 25 percent or lower and includes lower rates for the nearly two-thirds of manufacturers organized as flow-through entities. It needs to include a permanent and strengthened research and experimentation (R&D) incentive and a strong capital cost-recovery system. We also believe that comprehensive tax reform must include a shift from the current worldwide system of taxation to a modern and competitive international tax system.

Promoting International Competitiveness and Foreign Direct Investment

Manufacturers have a particularly strong interest in our nation's international tax regime. Almost half of U.S. multinationals are manufacturers, and 53 percent of all manufacturing employees in the United States are employed by U.S. companies with operations overseas. Global investment by American companies plays an important role in the growth and vitality of the U.S. economy. Despite the economic benefits of having American companies expand beyond our

shores, U.S. tax laws make it difficult to compete globally. The U.S. tax system, including high corporate tax rates and highly taxed exports, increases the cost of doing business for U.S. companies with global operations.

In addition, the U.S. system taxes income even when it is earned outside of the United States. As a result, American businesses with customers around the world generally have a higher tax burden than their competitors, a significant disadvantage for U.S. companies competing for customers around the world.

In contrast, the vast majority of our trading partners have tax systems that tax income earned within their own borders but does not tax the foreign profits that are repatriated to their own economies. In fact, Japan and the United Kingdom—two of the largest economies—recently abandoned worldwide taxation systems in favor of a territorial approach. Adopting a tax system that is comparable to tax systems in other industrial countries is critical to the ability of manufacturers in the United States to compete in the global marketplace.

If American companies cannot compete abroad, where 95 percent of the world's consumers are located, the U.S. economy suffers from the loss of both foreign markets and domestic jobs that support foreign operations. To make U.S. multinationals more competitive, the NAM supports moving from the United States' current worldwide tax system to a modern, competitive tax system similar to those in most industrialized countries, structured to enhance U.S. competitiveness, not raise additional revenue.

A modern, competitive system also would allow for the free flow of capital from foreign operations back to the United States for reinvestment in the domestic economy. The current high corporate tax rate of 35 percent—even though partially offset by foreign tax credits at lower tax rates imposed outside the United States—often results in a high residual U.S. tax charge on the repatriation of earnings from foreign subsidiaries. This additional charge causes what is often referred to as a "lockout" of earnings, preventing them from being repatriated to the United States without a significant cost. A corporate tax rate of 25 percent or lower coupled with a modern, competitive tax system would reduce this disincentive to repatriate foreign earnings, freeing up resources for investment in the United States.

It also is important to note that businesses headquartered outside the United States that invest in our nation also play an important role in the growth and vitality of the U.S. economy. Like their domestic counterparts, they provide high-paying jobs for millions of Americans and are an important source of U.S. exports. As a result, it is critical that policymakers avoid imposing discriminatory taxes on foreign-owned companies. Congress should focus on tax policies that attract and maintain more capital investment, rather than discourage it.

Avoiding Piecemeal Changes

There is no doubt that the U.S. tax code—which includes the developed world's highest corporate tax rate, outdated international tax rules and a host of temporary provisions—is a drag on economic growth and competitiveness. While the NAM is a strong advocate for comprehensive reform of our current tax code, we also believe it is critically important to keep our current tax system in place until policymakers agree on a final, comprehensive reform plan.

Piece-meal changes or repeal of long-standing rules, like current anti-inversion proposals, will inject more uncertainty into business planning and make companies in the United States less competitive, threatening economic growth and U.S. jobs. Moreover, using "one-off" tax

increases to pay for unrelated policy changes will make it even more difficult to achieve pro-growth tax reform.

Manufacturers want the United States to be the best place in the world to manufacture and attract foreign direct investment. To achieve this goal, it is essential that Congress work to reform the U.S. tax system to put manufacturers in the United States on a level playing field with their competitors in other countries, as well as making the United States a more competitive environment in which to do business. Indeed, comprehensive tax reform should not be a far-off goal but a near-term priority for the Congress and such reform should address the fundamental flaws in our existing system.

Conclusion

Manufacturers very much appreciate the efforts of the members of the Senate Finance Committee for their diligent work to reform the U.S. tax system, particularly their support for developing a corporate income tax structure that attempts to put U.S. business on a level playing field with competitors organized in other countries and to make the United States a more competitive place to do business. The NAM thanks you for the opportunity to share our thoughts and concerns with you, and we look forward to further discussing these issues and working with the Committee to achieve a pro-growth, pro-competitiveness and pro-manufacturing tax system.

July 21, 2014

The Honorable Ron Wyden
Chairman
Committee on Finance
United States Senate
Washington, DC 20510

The Honorable Orrin Hatch
Ranking Member
Committee on Finance
United States Senate
Washington, DC 20510

Dear Chairman Wyden and Senator Hatch:

I am writing to express the National Retail Federation's (NRF) support for tax reform in conjunction with the July 22 Senate Finance Committee hearing, "The U.S. Tax Code: Love It, Leave It or Reform It."

We recognize that much of the focus of the hearing is on the international aspects of the U.S. tax code. Although the retail industry is primarily domestic, the international impact of the U.S. tax code is critically important to the growth of our industry. The U.S. corporate tax rate is the highest rate in the industrialized world. Because the U.S. tax rate is so uncompetitive, foreign-owned companies are investing less in the United States and U.S.-owned companies are moving more of their operations outside the United States. This loss of investment in the United States hurts wages and consumer spending, which is two-thirds of the economy. A recent study performed for the RATE Coalition by Ernst & Young and Tax Policy Advisors found that in the long-term GDP in the United States will be 1.5% - 2.6% lower, real wages will be 1.0% - 1.2% lower, and consumer spending will be 2.3% - 3.3% lower because our high corporate tax rate is a disincentive to investment in the United States.

The retail industry and the U.S economy need Congress to reduce the U.S. corporate tax rate to a rate that is more competitive with the rest of the industrialized world. Reducing the corporate tax rate is the economic boost that our sluggish economy so desperately needs.

NRF is the world's largest retail trade association, representing discount and department stores, home goods and specialty stores, Main Street merchants, grocers, wholesalers, chain restaurants and Internet retailers from the United States and more than 45 countries. Retail is the nation's largest private sector employer, supporting one in four U.S. jobs – 42 million working Americans. Contributing $2.5 trillion to annual GDP, retail is a daily barometer for the nation's economy.

Sincerely,

David French
Senior Vice President
Government Relations

cc: Members of Senate Finance Committee

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July 22, 2014

Dear Chairman Wyden and Honorable Members of the Senate Finance Committee,

On behalf of Public Citizen's more than 300,000 members and supporters, we thank you for holding today's important hearing on international tax issues. We look forward to working with you to implement both short- and long-term solutions to improve the equity and effectiveness of our tax code.

Right now, the tax code is rife with unfairness that makes small, domestic corporations less able to compete with large multinational companies which use accounting gimmicks to game the tax system and take advantage of the uneven playing field. Moreover, our nation's citizens are suffering under fiscal austerity and it's far past time to discuss solutions to the huge problem of lost revenue. The answer to both of these seemingly unrelated problems is to stop multinational corporations from exploiting the loopholes in the tax code. These companies don't pay their fair share for necessary government services which keep our markets functioning.

One of the gimmicks mentioned above is the disturbing loophole of corporate inversions. Inversions occur when corporations purposely renounce their American citizenship, usually by merging with a foreign corporation and reincorporating in a low- or no-tax country (also called a tax haven), to be treated as a foreign corporation and escape U.S. tax liabilities. Companies have been increasing their use of this technique to achieve lower taxes. This is particularly egregious because they are still treated as a foreign company even if a majority of the stock of the newly reincorporated company is held by mostly the same U.S. shareholders or when substantial business operations and management are still located in the United States.

Public Citizen thanks the members of this committee who have already signed on to S. 2360, the Stop Corporate Inversions Act (Senators Cardin, Nelson, Rockefeller, and Stabenow.) For the Senators who have not yet joined as co-sponsors, we urge you to support this commonsense legislation to lower the threshold at which foreign companies will be considered inverted so they will remain characterized as domestic for tax purposes.

Under current law, a newly reincorporated so-called "foreign" company is able to escape the "inverted corporation" label and avoid paying U.S. taxes even if it retained up to 79% of its original U.S. stockholders from the previous iteration of the corporation. S. 2360 would reduce that threshold number to 50% ownership by previous U.S. shareholders. It also would add an additional layer of analysis to capture as inverted those companies where management and control and significant business activities remain in the United States.

The American public is rightly angered when they hear about U.S. companies like AbbVie and Walgreens that are attempting to avoid paying their fair share by merging with a foreign company and renouncing their citizenship to reincorporate in a tax haven for the purpose of reducing their tax bills. Senator Levin's legislation, S. 2360, would go a long way to fix this problem. As news accounts of the wave of incoming new and expected inversions have become public, we believe this committee should take action on this topic as a stand-alone issue in need of an immediate solution.

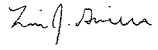
However, there are of course other pressing international tax issues that we hope and expect this committee will take action on. One example is the overarching problem of deferral. Deferral has caused trillions of dollars in lost tax revenue to be booked offshore, and means that multinational corporations aren't required to pay taxes on foreign profits until they are "repatriated" or used in the United States to pay dividends. Companies routinely exploit deferral by booking their U.S.-made profits as generated by foreign subsidiaries by doing accounting tricks like selling intellectual property like patents to the foreign subsidiary and paying huge royalties to the subsidiary thereby erasing U.S. profits (and indefinitely deferring taxes they would pay) just by transferring the profits to the books of the foreign subsidiary. Similar outcomes occur when debt is taken on from the subsidiary with the domestic company paying exorbitant interest rates on the loans in order to transform U.S.-made profits to "foreign-made." In its February 2014 report "Offshore Tax Evasion: The Effort to Collect Unpaid Taxes on Billions in Hidden Offshore Accounts,"the Permanent Subcommittee for Investigations of the Homeland Security and Government Affairs Committee (PSI) estimated that the lost revenue from offshore tax schemes is in the neighborhood of $150 billion per year. Deferral and the associated accounting gimmicks is just one example of a huge loophole which enables profits to be booked offshore, and must be addressed as part of any changes made to the tax code.

In addition, domestic tax code upgrades are also a necessity. Several critical changes that Public Citizen supports and could be made easily are: instituting a tax on Wall Street stock transactions to tamp down high-speed trading (see "A Matter of Perspective: Added Costs from a Financial Transaction Tax Would be Miniscule Compared to Fees Investors Already Pay"), limiting deductions on multi-million dollar executive bonus pay (see "Thanks a Billion (or So): A Small Loophole Inserted 20 Years Ago Helps Companies Avoid Paying the U.S. Treasury Big Money"), and removing deductions for settlements for corporate wrongdoing. We look forward to working with the Committee to move forward existing and new legislation on these fixes.

Public Citizen appreciates the efforts of this committee to advance comprehensive tax reform proposals but urges you to take swift action to stop corporate tax inversions and implement other needed changes that will grow revenue and provide fairness to the code.

Thank you for your ongoing attention to these and other proposals to protect consumers.

Sincerely,



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Tax Inversion: Background

Walgreens, an Illinois-based pharmacy chain, is considering renouncing its U.S. corporate citizenship after its merger with Switzerland-based pharmacy chain Alliance Boots is finalized.[1] This move would be just one example of the growing trend of corporate restructuring known as tax inversion or foreign reincorporation. This process occurs when a U.S.-based corporation purchases a foreign, usually smaller, corporation. Then, the U.S.-based company typically merges with the foreign company and reincorporates as a new company in that non-U.S. country, often to take advantage of that country's lower corporate taxes.[2] Interestingly, under existing law, U.S. stockholders of the former company can still own as much as 79 percent of the shares of the new company, meaning that it is essentially a U.S.-owned company except for its place of incorporation.

Tax inversions are relatively transparent attempts by corporations to reduce their U.S. tax bills while still maintaining many of the advantages of being a U.S.-based company, including preserving access to U.S. markets and a U.S. workforce. However, while these companies wish to escape certain provisions of U.S. law, they continue to remain politically active in an attempt to influence other aspects of U.S. policy.

Inverted Corporations Continue to Spend on Political Activity

The House Ways and Means Committee compiled a list of American companies that have undergone tax inversion since 1983.[3] According to a Public Citizen analysis of Center for Responsive Politics lobbying and campaign finance data, of the 76 companies published by the Ways and Means Committee, 29 have spent money engaging in lobbying activities since they reincorporated. Combined, those 29 companies have spent more than $120 million on lobbying expenses. Table 1 breaks out these expenditures by industry. The Appendix lists the lobbying and PAC expenditures of all companies that have undergone tax inversions since 1983 that have made such expenditures.

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[1] Paul Ziobro, *Walgreen Weighs Riding Tax-Inversion Wave*, WALL STREET JOURNAL (July 15, 2014), http://on.wsj.com/1r3N3TI.
[2] Thomas L. Hungerford, *Corporate Inversions Are All About Avoiding Taxes, Congress Should Act Now*, ECONOMIC POLICY INSTITUTE (July 17, 2014), http://bit.ly/1trurN5.
[3] *List of Tax Inversions*, HOUSE WAYS AND MEANS COMMITTEE (viewed July 18, 2014), http://1.usa.gov/1tglIkh.

Table 1: Post-Inversion Lobbying Expenses, by Industry, Since 1998

Industry	Lobbying Expenses, Post Inversion
Business Services	$56,713,771
Pharmaceuticals/Health Products	$29,050,985
Oil & Gas	$12,065,000
Electronics Manufacturing & Services	$11,162,900
Miscellaneous Manufacturing & Distributing	$7,470,000
Construction Services	$1,900,000
General Contractors	$1,800,000
Chemical & Related Manufacturing	$240,000
Insurance	$180,000
Computers/Internet	$180,000
Other	$100,000
Miscellaneous Energy	$66,000
Total	**$120,928,656**

Source: Public Citizen analysis of Center for Responsive Politics (http://www.opensecrets.org/) lobbying disclosure data. Industry designations are drawn from Center for Responsive Politics classifications. Lobbying expenses are only calculated for the companies listed by the House Ways and Means Committee. Lobbying by subsidiaries of those companies was not included in the company's total. Spending during the year the company was inverted is included in the total.

Additionally, 15 of the 76 companies maintained political action committees (PACs), which have cumulatively spent more than $11 million on political activity since undergoing inversion. Table 2 provides a summary of PAC expenditures by industry.

Table 2: Post-Inversion PAC Expenditures, by Industry, Since 1998

Industry	PAC Expenditures, Post Inversion
Business Services	$5,996,735
Pharmaceuticals/Health Products	$1,808,112
General Contractors	$1,768,114
Miscellaneous Manufacturing & Distributing	$1,290,882
Electronics Manufacturing & Services	$492,251
Oil & Gas	$263,701
Construction Services	$93,806
Miscellaneous Energy	$29,276
Chemical & Related Manufacturing	$7,300
Total	**$11,750,177**

Source: Public Citizen analysis of Center for Responsive Politics (http://www.opensecrets.org/) political action committee data. Industry designations are drawn from Center for Responsive Politics classifications. Political action committee contributions made during the same cycle as the inversion were included.

Conclusion

More and more, U.S. corporations are picking and choosing which rights they wish to maintain and which rights they want to discard. In an attempt to shed their obligation to pay U.S. taxes, many corporations are choosing to reincorporate in a foreign country. However, even after establishing their status as a foreign corporation, many corporations continue to spend significant sums of money on lobbying and politics in the U.S.

Corporations choosing to reincorporate in foreign countries should be required to follow the existing stricter disclosure requirements for foreign governments and foreign political parties. Foreign corporations should not be able to exempt themselves and choose to register under the less robust disclosures of the Lobbying Disclosure Act

Congress should take swift action to pass S. 2360, the Stop Corporate Inversions Act. This legislation would lower the threshold at which foreign companies are considered "inverted" and thus treated as domestic for tax purposes. S. 2360 would reduce the threshold number that triggers the "inverted corporation" label to 50% ownership by previous U.S. shareholders. It also would add an additional layer of analysis to capture as inverted those companies where management and control and significant business activities remain in the United States.

The deck is already stacked in favor of corporate interests. Let's make sure that they cannot also pick and choose which laws apply to them.

Appendix: List of Tax-Inverted Companies With PAC and Lobbying Expenditures

Company	PAC Money Since Inversion	Lobbying Expenses Since Inversion	Year Inverted	Industry
Accenture	$4,035,206	$38,326,358	2001	Business Services
Tyco International	$1,961,529	$18,387,413	1997	Business Services
Covidien	$833,444	$12,660,000	2008	Pharmaceuticals/Health Products
Tyco Electric	$492,251	$11,162,900	2008	Electronics Manufacturing & Services
Weatherford International	$0.00	$7,660,000	2002	Oil & Gas
Herbalife International	$840,828	$5,830,000	2002	Pharmaceuticals/Health Products
Ingersoll-Rand	$48,500	$3,216,000	2002	Miscellaneous Manufacturing & Distributing
Actavis / Warner Chilcott	$30,690	$2,691,590	2013	Pharmaceuticals/Health Products
Endo Health Solutions	$103,150	$2,490,000	2013	Pharmaceuticals/Health Products
Xoma	$0.00	$2,120,000	1999	Pharmaceuticals/Health Products
Cooper Industries	$1,162,067	$1,980,000	2002	Miscellaneous Manufacturing & Distributing
Nabor Industries	$0.00	$1,930,000	2002	Oil & Gas
Fruit of the Loom	$80,315	$1,904,000	1998	Miscellaneous Manufacturing & Distributing
Alkermes, Inc.	$0.00	$1,829,395	2011	Pharmaceuticals/Health Products
Chicago Bridge and Iron (CBI)	$1,768,114	$1,800,000	1996	General Contractors
Foster Wheeler	$93,806	$1,660,000	2001	Construction Services
McDermott International	$263,701	$1,275,000	1983	Oil & Gas
Jazz Pharmaceuticals / Azur Pharma	$0.00	$960,000	2012	Pharmaceuticals/Health Products
Transocean	$0.00	$700,000	1999	Oil & Gas
Noble Corporation	$0.00	$500,000	2002	Oil & Gas
Helen of Troy	$0.00	$370,000	1994	Miscellaneous Manufacturing & Distributing
Perrigo/Elan	$0.00	$310,000	2013	Pharmaceuticals/Health Products
Global Marine	$0.00	$240,000	2001	Construction Services
Tronox Inc	$7,300	$240,000	2012	Chemical & Related Manufacturing
Seagate Technology	$0.00	$180,000	2000	Computers/Internet
White Mountain Insurance	$0.00	$180,000	1999	Insurance
Mallinckrodt Pharmaceuticals	$0.00	$160,000	2009-2014	Pharmaceuticals/Health Products
Stratasys	$0.00	$100,000	2009-2014	Other

Source: *List of Tax Inversions*, HOUSE WAYS AND MEANS COMMITTEE (viewed July 18, 2014), http://1.usa.gov/1n8ghiZ. Public Citizen analyzed data provided by the Center for Responsive Politics (www.opensecrets.org). Lobbying and PAC expenditures begin in 1998.

Written Testimony of Dr. Elaine C. Kamarck and James P. Pinkerton

Co-Chairs, Reforming America's Taxes Equitably (RATE) Coalition

Before the U.S. Senate Committee on Finance
Hearing on the U.S. System of International Taxation:
"The U.S. Tax Code: Love It, Leave It or Reform It!"

July 22, 2014

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Chairman Wyden, Ranking Member Hatch, thank you for the opportunity to submit this testimony before you today. We are Elaine Kamarck and James P. Pinkerton, the bipartisan co-chairs of the Reforming America's Taxes Equitably (RATE) Coalition.

We commend you on holding today's hearing on a topic critical to our economic future. We submit this testimony to you as you consider much-needed reforms to our tax code.

Nearly 30 years have passed since the last major reforms to America's tax system. In the last three decades, the code has become increasingly complex – riddled with exceptions and loopholes – and increasingly unfair. Our corporate tax rate is the highest in the world at 39.1 percent (federal and weighted-state average combined). Thus the competitive edge that America established in 1986 has eroded as other nations have lowered their corporate rates and established more hospitable environments for companies to do business.

Put another way, our world-leading corporate tax rate means U.S. businesses, on average, pay 40 cents on each extra dollar earned. By contrast, the average rate in Europe is 20 cents; in Asia, 22 cents – about half the rate here in America.

And it isn't just the rate. Here at home, business owners large and small have to navigate a maze of complicated procedures to comply with the code. Already a dizzying array of pages, the tax code has grown longer with each passing year.

Some businesses have taken the dramatic step of employing their own armies of tax lawyers to get around the code in order to avoid paying the world-leading rate – in some cases paying little to no taxes. Those who don't have those resources or are ineligible for the wide array of loopholes pay the high rate with virtually no recourse.

This is wrong. Good tax policy should be simple, transparent—and fair to all.
The system is not working for anyone right now – except our foreign competitors. The longer we delay action on this issue, the stronger their positions become.

As the United States continues its recovery from the Great Recession, our leaders must take steps to boost the economy.

Tax reform is the best chance we have, not only to increase U.S. competitiveness, but also to pass major, substantive legislation that benefits the economy with bipartisan support.

President Obama, Speaker Boehner and members of this Committee have all spoken out in favor of revenue-neutral corporate tax reform that broadens the base, lowers the rate, and importantly makes the system, fairer, simpler and more competitive.

We cannot afford to wait any longer. As a direct result of our high corporate rate, according to 2013 estimates from Ernst & Young, U.S. GDP in 2013 was estimated to be reduced by 1.2 percent to 2.0 percent. The same study showed that over the long term, U.S. wages would be depressed by 1.2 percent.

Our unfair tax code is not just making life more difficult for businesses – it is having a real impact on our economy. We need to use every tool in our arsenal to boost the economy and tax reform is not only critical, but achievable.

Until we make reforms to our obsolete system, a growing number of U.S. businesses are taking matters into their own hands to try and reduce their tax burden by moving overseas or looking for ways to move overseas in order to take advantage of more competitive tax rates.

Known as tax inversions, these business decisions represent an ominous development for our economy. This year alone, 14 U.S. companies have adopted this approach.

We believe that tax inversions are the "canary in the coal mine" that will be followed, almost certainly, by the acquisition of U.S. firms by foreign ones and the flow of American jobs overseas.

This trend poses a grave threat to continued economic growth and companies are being very frank about why they are looking for inversion opportunities – America's corporate tax rate.

Members of the Committee, in a rapidly globalizing international marketplace and with competition greater than ever before, U.S. businesses are being forced by macroeconomic trends and fiduciary responsibilities to seriously consider options that previously were beyond the pale.

That our tax code is out-of-date is no secret. For years, experts, business leaders and political leaders have called for comprehensive tax reform and even introduced measures to achieve it.

Problems that were once theoretical have suddenly become very real. At a time when the nation is only beginning to realize real job creation after years of flat employment, we need to do whatever we can to keep the momentum going.

Why pay a high rate and be forced to navigate tens-of-thousands of pages when there are opportunities not to?

The growing alarm regarding inversions has not been lost on our political leaders as many in this body support tax reform or steps to make it more difficult for companies to move overseas – as this hearing demonstrates.

However, recent pieces of legislation or suggestions from the Treasury Department that impose new restrictions and penalize companies for moving abroad while failing to take steps to fix the root of the problem miss the mark. Instead of actually curing the disease, they merely disguise the symptoms.

Tax reform is more than a Band-Aid and we urge you to continue your efforts to make it a reality.

Efforts that can transform today's broken code to something that lowers rates and modernizes the system, making it fairer and more attractive for businesses to remain here or move here from abroad.

Indeed, the solution is not unknown, nor is it unprecedented.

In order to keep our economy growing and urge hiring here in the United States, we believe the answer can be found in the successful precedent of the bipartisan Tax Reform Act of 1986 which brought both sides together, lowered the corporate rate to an internationally competitive level and streamlined the code.

There is widespread agreement on the principles of achieving comprehensive tax reform. As we mentioned, Democrats and Republicans, by and large, concur on the primary goals of reform and how to achieve them.

In fact, there are even examples that Congress can follow. States such as Rhode Island, Indiana and North Carolina, among others, have recently lowered their corporate tax rates in a bid to improve their competitiveness, boost job creation and increase their tax bases.

They are finding some early success. However, even if states were to lower their corporate tax rates to zero, they would still have among the highest rates in the world compared to foreign nations because of America's 35 percent federal rate.

The increasing number of inversions can't be fixed with stopgap, punitive measures. Instead, the United States needs to offer businesses an environment that fosters growth and encourages entrepreneurship.

Just as other nations have reformed their tax systems to attract enterprise – including from our own country – the United States must once again leave no doubt that the best place to do business is right here in America.

We know that this country is where businesses want to be, and we remain confident that, just as in 1986, Democrats and Republicans can come together to simplify the code and lower the rate.

We have the foundation for a bipartisan solution to inversions – and that is tax reform. Now we just need to come together and act.

Thank you for your attention to this critical issue and for allowing us to present our case for tax reform. We stand ready to serve as a resource to this Committee on these and other issues as you continue to address the long-term health and well-being of our economy.

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August 1, 2014

The Honorable Ron Wyden
Chairman, Senate Finance Committee

The Honorable Orrin Hatch
Ranking Member, Senate Finance Committee

Dear Chairman Wyden and Ranking Member Hatch:

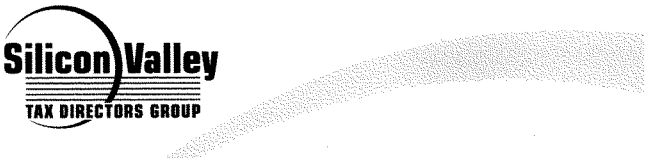
We want to thank you for holding this hearing and for continuing to seek input from tax experts and stakeholders on how to improve our international tax system "to help American businesses stay competitive in the global economy." The Silicon Valley Tax Directors Group is comprised of 78 representatives from leading high technology companies in the United States. A list of SVTDG members is attached for your information.

We are pleased to submit the following comments for the hearing record focused on tax reforms that will promote research and development (R&D) and job growth in the United States. Companies with intellectual property abroad face obstacles in the Internal Revenue Code that effectively preclude them from bringing their intellectual property home to the U.S. We propose that the tax code be amended to eliminate those obstacles.

We believe our current tax system impedes U.S. innovation and discourages retention of global IP in the United States. To enhance growth and ensure that U.S. companies remain highly competitive, changes should be made to our tax code that encourage the development, ownership and commercialization of IP in the United States. It is particularly important that Congress act quickly. If it does not, other developed countries may permanently capture for themselves the IP and related R&D development, as they have (or may put in place) more competitive tax policies.

The current U.S. international tax system is a hybrid—a worldwide tax system that can act like a territorial system because it generally defers U.S. tax until foreign active earnings are repatriated. This can be the worst of all worlds, particularly with respect to IP. The worldwide tax base places U.S. businesses at a competitive disadvantage to their foreign competitors based in jurisdictions that have territorial systems (i.e., exempt foreign income). Moreover, the U.S. tax deferral in the current system, combined with the high U.S. statutory rate, encourages foreign development and ownership of IP. As a result, to remain competitive, U.S. companies are economically compelled to maintain ownership of IP rights (and the attendant income) in lower-taxed jurisdictions, through R&D activities, cost sharing arrangements, and license agreements. Once IP rights are held abroad, even if the U.S. were to lower its rates, the high residual U.S. tax under the current system acts as a disincentive for domestic investment of foreign earnings (referred to as the "lock-out" effect). Together, the effect is that the current international tax system raises little revenue from the foreign activities of U.S. multinational corporations. Even reform proposals that would require a minimum tax would not necessarily raise revenue in the U.S., but simply would encourage foreign jurisdictions to raise their tax rates, with the acquiescence of U.S. multinationals.

In your opening statements to this hearing, each of you acknowledged that the current tax system is adversely affecting U.S. competitiveness. Chairman Wyden called the tax code "an anti-competitive mess," while Senator Hatch said "our primary goals should be to make the U.S. a better place to do business and to allow American companies to compete more effectively with their foreign counterparts in the world marketplace."



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Adoption of an IP Box

The adoption of a U.S. IP box for foreign market income would help make the U.S. tax system more competitive and rationalize the tax rate on IP income derived from serving foreign markets whether earned at home or abroad. In her testimony before the Committee, Professor Leslie Robinson suggested the need for such an approach to retain domestically created IP and enhance innovation:

> Options that reduce the effective tax rate on intangible income may be likely to keep R&D operations in the U.S. that are most likely to contribute to the U.S. economy. Chistof, Richter and Reidel (2013) find that reducing income tax rates on R&D output (as opposed to other incentives) attracts relatively more innovative projects with higher earnings potential. (pg. 8 of her written testimony).

Absent a relative balance between the tax rate on income earned by U.S. companies from the foreign IP they own and income from IP owned by CFCs, U.S. multinationals will continue to have an incentive to create, and maintain ownership of, IP abroad. This is particularly true in the current environment in which other countries are being increasingly aggressive in attracting IP creation and commercialization. In the past decade, at least nine countries have adopted IP or patent box regimes and others have expanded their R&D tax incentives. The OECD BEPS project may in fact serve to increase this trend as companies are faced with decisions on where to invest in response to changes in the current multilateral international tax framework, and countries adopt competitive policies to attract this investment.

Key Features of an IP Box

A properly designed IP box can promote the creation, ownership and commercialization of IP in the United States. The key features of an IP box are an internationally competitive tax rate on income attributed to IP and a tax-neutral mechanism for taxpayers to domesticate IP that is currently offshore.

To help determine gross income attributed to IP and properly allocate and apportion expenses, the proposal could require the creation of a special purpose corporation whose sole purpose is to hold and develop intangible property (an "IP SPV"). The use of an IP SPV is described more fully below. Alternatively, the IP would not be separate, but in connection with the provision of products or services abroad, an amount of the income could be simply allocated to IP exploitation (so called "embedded IP").

Eligible income would be limited to foreign source income (e.g., royalties) attributable to "intangible property."[1] This definition should include foreign source income attributable to patents, know-how, technology, copyrights, trademarks, marketing intangibles, and other IP. To the extent an item is in an existing qualified cost-sharing arrangement, it would generate eligible income. Ineligible income would be subject to ordinary U.S. corporate tax rates.

Domestication of IP

In designing an IP box, it will be critical to remove barriers to the domestication of existing IP by allowing the tax-free transfer to the United States of IP rights that are currently owned offshore by a foreign affiliate. Removing such barriers will encourage development, ownership and commercialization of IP in the United States, reduce business complexity, and strengthen IP and tax procedural protections for U.S. taxpayers, while at the same time increasing U.S. tax revenue on IP income derived from serving foreign markets. This tax-neutral domestication of IP can be made available permanently or for a limited amount of time.

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[1] Eligible income would also include gains from the disposition of IP that would have given rise to foreign source income.

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Under this proposal, a U.S. corporation could elect to treat a distribution of qualifying IP from a CFC as a dividend eligible for a 100% dividends received deduction. The recipient domestic corporation would have a carryover basis in the IP, and in the case of an IP SPV, would step into the shoes of an existing foreign cost-sharing participant for purposes of future cost-sharing payments. The transfer of qualifying IP would not trigger gain at the CFC level, would not affect the CFC's E&P, and would not result in taxable income or a basis step-up to the U.S. corporation.

Use of an IP SPV

As described above, if an IP box is adopted, requiring use of a separate U.S. IP SPV may simplify tax administration and improve compliance by providing a mechanism for attributing income and allocating and apportioning expenses to IP. In such a case, the IP SPV would file a return separate from that of its U.S. parent corporation's consolidated return.

An IP SPV would step into the shoes of an existing foreign cost-sharing participant, and companies would be able to roll their existing cost-sharing arrangement[2] into the IP SPV tax-free and without a basis step up (e.g., in a distribution). Thus, a transfer of currently cost-shared IP to an entity subject to this regime would be tax-neutral for U.S. tax purposes, even though the transfer is from a foreign entity to a U.S. entity. The transferring CFC's E&P would be unaffected.

Payments that are currently included in a cost share arrangement would be similarly cost shared with the IP SPV (and deductible only by it to the extent of its share). For other expenses, existing expense allocation and apportionment rules under section 861 could be used, as could approaches adopted on this issue in sections 199, 936, 1352 (the "tonnage tax"), the FSC regime, etc.

Foreign tax credits and other tax attributes would be calculated separately for an IP SPV. Dividends from an IP SPV to a domestic corporation would be eligible for a 100% dividends-received deduction under section 243. Thus, there would no longer be a lockout effect with respect to IP income from foreign sources.

WTO Compliant

A U.S. IP box that applies to all IP income would clearly not implicate WTO issues regarding export subsidies. Adoption of a U.S. IP box that applies only to income from serving foreign markets, however can also be structured in a manner that complies with the WTO agreements and the Agreement on Subsidies and Countervailing Measures ("SCM Agreement") in particular. The World Trade Organization, through the General Agreement on Tariffs and Trade (GATT) and the SCM Agreement, only disciplines and restricts subsidies provided to the trading of goods.[3] The WTO does not have subsidies obligations related to the trading of services or the trading of intellectual property (e.g., the direct sale or licensing of patents, copyrights, and trademarks). Therefore, a special tax rate under an IP box that is applied only to foreign-sourced intangible income would be WTO compliant.

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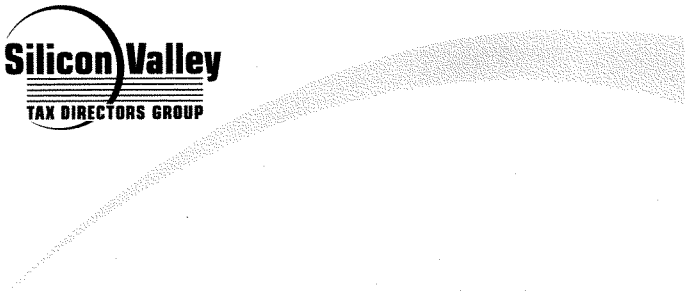
[2] If an existing cost sharing arrangement was entered into prior to January 5, 2009, it would continue to be governed by the prior cost sharing regulations after the transfer of IP to the IP SPV.

[3] Specifically, Annex 1 of the Marrakesh Agreement Establishing the World Trade Organization is divided into three sub-categories. Under "Annex 1A: Multilateral Agreements on Trade in Goods," subsidy obligations are set forth in the General Agreement on Tariffs and Trade and the Agreement on Subsidies and Countervailing Measures. However, such obligations are explicitly excluded from "Annex 1B: General Agreement on Trade in Services," and simply do not exist in "Annex 1C: Agreement on Trade-Related Aspects of Intellectual Property Rights."



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U.S. Revenue Benefit

Somewhat paradoxically, adoption of an IP box and removing current law barriers to domestication of currently offshore IP is likely to increase substantially the amount of U.S. taxable income from foreign exploitation of IP. Under current law, U.S. companies are encouraged to locate IP serving foreign markets overseas and the lockout effect means that the U.S. Treasury is unlikely to see much, if any, revenue from such foreign source IP income. An IP box would reduce current incentives to shift IP development and ownership overseas, while imposing an immediate U.S. tax at a low, competitive rate on foreign source IP income. For example, providing for tax-neutral domestication would help to attract IP back onshore and make it more likely that any income tax imposed on the associated income would be payable fully to the U.S. rather than a foreign government.

Countries have already taken steps to adopt more competitive tax policies to attract investment and IP, and more are likely to do so in response to the OECD BEPS project. Current U.S. tax policy does not provide a competitive response. As a result, the United States risks missing out on the opportunity to attract investment and tax revenue the longer it takes to act on tax reform that includes a low, competitive tax rate on IP income and a mechanism for tax-neutral domestication of offshore IP.

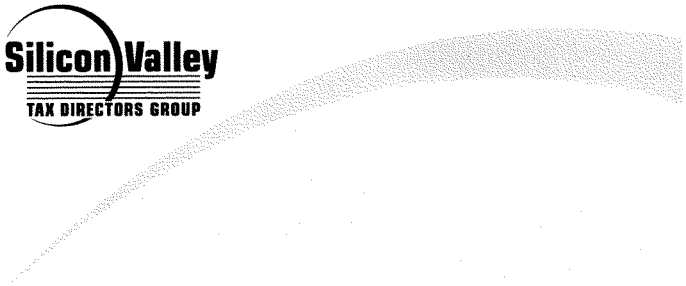
* * *

We very much appreciate the opportunity to submit these comments regarding international tax reform and the long-term benefits to U.S. competitiveness of adopting an IP box. We believe enactment of a U.S. IP box with provisions allowing tax-free domestication of IP will encourage innovation and job growth by U.S. companies, while at the same time increasing revenue for the Federal Government. U.S. companies will also enjoy less complexity by consolidating worldwide IP and greater IP and tax procedural protections by being able to bring IP home. Please do not hesitate to contact Jon Talisman at (202) 289-8700 if you have any questions or comments regarding this submission.

Sincerely yours,

Jeffrey Bergmann
Co-Chair, Silicon Valley Tax Directors Group

Barry Slivinsky
Co-Chair, Silicon Valley Tax Directors Group



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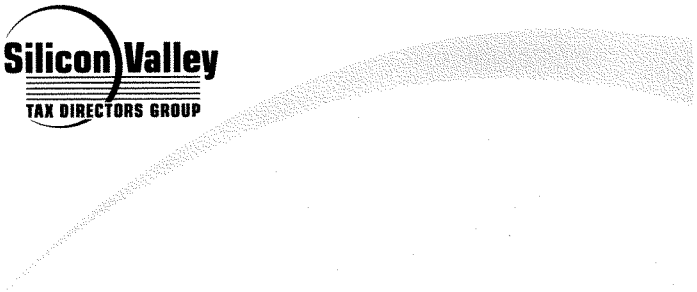

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Uber Technologies, Inc.	Annie Herlitz; Global Head of Tax
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VMware Corporation	Jim Blake; Senior Director of Tax
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Yahoo! Inc.	Bob de Vries; Vice President, Global Tax
Yelp Inc.	Joel Edelmann; Senior Director, Tax and Treasurer

Statement for the Record

Senate Finance Committee Hearing

"The US Tax Code: Love It, Leave It or Reform It!"

July 22, 2014

Submitted by Steelcase Inc.
901 44th Street SE
Grand Rapids, MI 49508

steelcase inc

July 23, 2014

The Honorable Ron Wyden
Chairman, Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510

and

The Honorable Orrin Hatch
Ranking Member, Senate Finance Committee
104 Hart Office Building
Washington, DC 20510

Dear Chairman Wyden and Ranking Member Hatch:

On behalf of Steelcase, Inc., I am writing to comment on the importance of international tax reform to our company. We applaud your efforts and those of the Senate Finance Committee to improve the tax code and thank you for holding a hearing to consider international tax issues. We appreciate the opportunity to participate in this process by respectfully asking that this letter be submitted into the record of the hearing, "The US Tax Code: Love It, Leave It or Reform It!"

Steelcase is the global leader in office environments, with over 10,000 employees and 650 dealers in 92 countries around the world. Founded in 1912 and headquartered in Grand Rapids, Michigan, we are a publicly traded company offering a comprehensive portfolio of workplace products, furnishings and services addressing the three core elements of an office environment: interior architecture, furniture and technology. Recognized in 2013 by Fortune Magazine as one of its "Most Admired Companies," we have a strong commitment to integrity, our employees, our communities and the sustainability of the environment.

While Steelcase continues to grow in the US, there is increasing demand for our products throughout the world. As we respond to meet this demand by expanding worldwide operations, we face stiff competition from our foreign counterparts located in jurisdictions with lower tax rates and more favorable international tax rules than those of the United States. These tax differences alone result in significant cost and bidding advantages for our foreign competitors as we all seek the same customers. For Steelcase, the need for international tax reform is much more than an academic discussion with theoretical consequences; rather, it is a key factor in our ongoing ability to compete, expand, create US jobs and maintain our premier position in the industry.

Steelcase believes that United States tax policy should encourage, not penalize, foreign expansion of manufacturing and marketing operations in order to be competitive and responsive to customers in new markets. The most significant growth in the office environment industry is outside the United States. It is cost effective, logistically efficient, and sometimes legally required to establish operations where our foreign customers are located. We do not control whether our customers are situated in high-tax or low-tax jurisdictions, and we do not locate our manufacturing facilities or make business decisions based on those factors. We locate operations where the demand is located. We routinely reinvest our foreign earnings and do not stockpile large amounts of cash reserves offshore. While we understand that opportunities for base erosion exist, and appreciate the impact that certain profit shifting techniques can have on the US tax base, we believe it is fundamentally inconsistent with the goals of tax reform to structure an international tax system primarily around closing loopholes rather than encouraging and facilitating the growth and expansion of US multinational companies.

steelcase inc

We believe that a territorial tax system, with appropriate base erosion provisions that do not presume that business decisions are primarily tax driven, is best suited to Steelcase's business model and the realities of the modern global economy. Such a system would tax profits in the jurisdiction where they are earned, and allow for the best allocation and use of capital without subjecting foreign earnings to further taxation in the United States or being forced to use complex tax planning or gimmicks just to stay competitive. This would allow Steelcase to bid and sell on a level playing field with foreign competitors, paying the same tax rate they are, without having to overcome cost disadvantages generated by a worldwide system of taxation. Although it is difficult to fully assess the impact of international tax reform without knowing the marginal corporate tax rate, recent tax reform proposals have demonstrated the difficulty in reaching a rate that is low enough to be competitive under a worldwide system. Further, under this scenario, a worldwide system with repeal of deferral would increase the amount of taxes we would be required to pay, making Steelcase less competitive, not more.

Apart from comprehensive international reform, allowing the CFC look-through rule to sunset, repealing check-the-box, and limitations on the deductibility of expenses and the availability of foreign tax credits further impede the ability of a company like Steelcase to efficiently manage operations and direct resources to their most effective use in order to grow the business.

Although it may be premature to focus on transition rules, it is important to note that the treatment of valuable tax attributes including foreign tax credit carryovers must be carefully considered as part of international tax reform in order to allow for a smooth transition without unnecessarily harming the financial well-being of US companies.

We hope that these comments are helpful. Thank you for the opportunity to submit them. Please do not hesitate to contact Dave Sylvester, Sr. VP, Chief Financial Officer at (616) 248-7473 to discuss any of these comments in more detail.

Respectfully yours,

Jim Keane,
President and CEO
Steelcase Inc.

cc:

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