Testimony of U.S. Senator Byron Dorgan before the Senate Committee on Finance Hearing on Offshore Tax Issues

September 26, 2007

Mr. Chairman, I want to applaud you, Senator Grassley and other members of the Finance Committee for holding this series of hearings this year to grapple with complicated tax issues involving U.S. companies and their offshore affiliates and business activities.

The issue of American companies off-shoring good paying U.S. manufacturing jobs, and using overseas tax havens and other tax scams to avoid paying U.S. taxes they rightfully owe, has been around for many years. But today these companies are getting more scrutiny from federal policymakers and Internal Revenue Service (IRS) officials because of the size of their tax dodging and blatant manipulation of our tax laws.

The evidence suggests that we have a serious tax haven problem and it may now be costing the U.S. Treasury tens of billions of dollars every year. That's why I have authored legislation with Senator Levin, S. 396, which we believe will give the IRS new tools to combat offshore tax haven abuses and ensure that U.S. multinational companies pay their share of U.S. taxes.

Curbing U.S. Corporate Offshore Tax Haven Abuses

American taxpayers have a right to be angry when they read or hear news accounts about how corporate taxpayers are shirking their tax obligations by actively shifting their profits to foreign tax havens or using other inappropriate tax avoidance techniques.

A few years ago, this Committee passed legislation, which I supported and is now law, that addresses the troubling problem of corporate inversions that involved a couple dozen U.S. corporate expatriates that reincorporated their headquarters overseas. That behavior was a shameful, unpatriotic tax scam that was shut down by Congress.

However, that legislation hit just the tip of the iceberg. It did nothing to deal with the problem of U.S. companies setting up foreign tax-haven subsidiaries offshore to avoid their taxpaying responsibilities.

Around the time of the debate on corporate inversions, a *New York Times* story hit the nail on the head, suggesting that "instead of moving headquarters offshore, many companies are simply placing patents on drugs, ownership of corporate logos, techniques for manufacturing processes and other intangible assets in tax havens…The companies then charge their subsidiaries in higher-tax locales, including the U.S., for the use of these intellectual properties. This allows the companies to take profits in these havens and pay far less in taxes."

How pervasive is the tax-haven subsidiary problem? Several years ago, the Government Accountability Office (GAO), the investigative arm of Congress, issued a report that Senator Levin and I requested that sheds some light on the potential magnitude of this tax avoidance activity.

The GAO found that 59 out of the 100 largest publicly-traded federal contractors in 2001 -- with tens of billions of dollars of federal contracts in 2001-- had established hundreds of subsidiaries located in offshore tax havens. According to the GAO, Exxon-Mobil Corporation, the 21st largest publicly traded federal contractor in 2001, had some 11 tax-haven subsidiaries in the Bahamas. The same report revealed that the Halliburton Company had 17 tax-haven subsidiaries, including 13 in the Cayman Islands, a country that has never imposed a corporate income tax, as well as two in Liechtenstein and two in Panama. It turned out that the now infamous Enron Corporation had 1,300 different foreign entities, including some 441 located in the Cayman Islands.

But the poster child for offshore tax haven abuses, in my opinion, is a five-story building located on Church Street in the Cayman Islands that thousands of companies call home. According to a very good investigative report published by David Evans with Bloomberg News in the summer of 2004, the Ugland House in Grand Cayman is used as the address for 12,748 companies. In case you haven't seen it, I have carried along a picture of the Ugland House.

A recent study suggests that nearly half of the money U.S. companies earn overseas is accounted for in tax havens like the Cayman Islands. A former Joint Committee on Taxation economist released a study with an extraordinary finding: U.S. multinational companies had moved hundreds of billions of dollars in profits to tax havens in 1999-2002, the latest years for which IRS data was available.

The legislation that Senator Levin and I authored would help the IRS stop these avoidance schemes. Specifically, our legislation denies tax benefits, namely tax deferral, to U.S. multinational companies that set up controlled foreign corporations in tax haven countries. This tracks the same general approach in legislation passed by the Congress and enacted into law that was designed to curb the problem of corporate inversions. Our bill builds upon the good work of your Committee by extending similar tax policy changes to cover this case.

Specifically, our legislation would treat U.S. controlled foreign subsidiaries that are set up in tax haven countries -- <u>but are not engaged in a real and active business</u> -- <u>as domestic companies for U.S. tax purposes</u>. In other words, we would simply treat these companies as if they never left the United States, which is essentially the case in these tax avoidance motivated transactions.

The bill's list of specific tax haven countries subjected to the new rule is based upon previous work by the Organization for Economic Cooperation and Development. However, our legislation does give the Secretary of the Treasury the ability to add or remove a foreign country from this list in appropriate cases. We also give businesses until December 31, 2008 to restructure their tax haven operations if they so choose.

As I mentioned, our legislation effectively ends the deferral tax benefit for U.S. companies that shift income to offshore, inactive tax haven subsidiaries. This means, for example, that:

- Any efforts by a U.S. company to move profits to the subsidiary through transfer pricing schemes will not work because the income earned by the subsidiary would still be immediately taxable by the United States.

- Likewise, any efforts to move otherwise active income earned by a U.S. company in a high-tax foreign country to a tax haven would cause the income to be immediately taxable by the United States.

- Under this bill, companies that try to move intangible assets – and the income they produce – to tax havens would be unsuccessful because that income would still be immediately taxable by the United States.

The Joint Tax Committee says this legislation will prevent these companies from draining nearly $15 billion in revenues from the U.S. Treasury over the next decade.

But let me be very clear about one thing. This legislation, like other legislation I have been working on for many years that deals with runaway U.S. manufacturing plants, does not take a shotgun approach with respect to ending the U.S. deferral tax break. This proposal, and other proposals I have authored, would not repeal tax deferral in all cases.

In fact, the Dorgan-Levin tax haven legislation will not adversely impact U.S. companies with controlled foreign subsidiaries located in tax havens, if they are doing legitimate and substantial business. The legislation expressly exempts a U.S.-controlled foreign subsidiary from its tax rule change when almost all of its income is derived from the active conduct of a trade or business within a tax haven country.

It's grossly unfair to ask our Main Street businesses to operate at a competitive disadvantage to large multinational businesses simply because our tax authorities are unable to grapple with the growing offshore tax avoidance problem. It is also outrageous that tens of millions of working families, who pay their taxes on time every year, are shouldering the tax burden of large profitable U.S. multinational companies using these tax haven subsidiaries.

In a recent *International Tax Notes* article, "A Statutory Proposal for U.S. Transfer Pricing", Michael Durst, a former IRS official and now counsel to a prestigious law firm, suggests that, "based on extensive practice, that retaining the current [arm's length pricing] system is not a viable option" for dealing with current transfer pricing abuses and that "a revised ,concededly more "formulary" system…would offer substantial relative advantages." I think he is dead right and I have advocated for a federal formulary apportionment system for multinational taxation for decades.

But until we move in that direction, my proposal with Senator Levin is a simple, straightforward way to deal with transfer pricing abuses in cases that involve U.S. companies parking profits in offshore tax havens.

End the Wrong-headed Tax Subsidy for Runaway Manufacturing Plants

I have worked very hard with Senator Mikulski and a number of our colleagues to end the large ill-conceived federal tax break provided to U.S. companies that close down a U.S. manufacturing plant, fire its American workers and move those good-paying jobs to countries like China.

I have forced the U.S. Senate to vote on my proposal to end this tax subsidy four times since the early 1990s, but the majority in the Senate has said no. As a result, hardworking Americans whose jobs are cut and moved overseas are forced to help foot the bill of companies that move production offshore – a bill which the non-partisan Joint Tax Committee suggests will cost taxpayers $15.5 billion over the next decade. We can no longer afford to ignore this matter. The federal debt is expected to hit $9 trillion at the end of the year and continue climbing to over $11 trillion in just five years.

Our proposal, S. 1284, would end the insidious tax subsidy in the tax code that rewards U.S. firms that move their production overseas and then turn around and import those products back to the United States for sale. When a U.S. company closes down a U.S. manufacturing plant, firing its American workers to move those good-paying jobs to China or other locations abroad, U.S. tax laws allow these firms to defer paying any U.S. income taxes on the earnings from those now foreign-manufactured products until those profits are returned, if ever, to this country. This tax break is not available to American companies that make the very same products here on American soil. So the U.S. company that decides to stay at home suffers a competitive disadvantage -- a disadvantage that our tax laws have helped to create. Multinational companies ought to pay the same taxes that domestic companies pay. At a minimum, U.S. companies that keep their jobs here should not be put at a competitive disadvantage by federal tax policy.

The notion that granting large tax breaks to companies that move their manufacturing operations offshore is good for this country is utter nonsense. Among other things, those who support this fiscal policy claim that shutting down U.S. manufacturing operations and moving them abroad will result in more U.S. jobs and increase our exports.

However, this assertion is not supported by the facts. According to the latest available data, the number of foreign manufacturing affiliates has grown from 7,420 to 8,490, up some 14 percent since 1993. From 1993 though 2004, U.S. companies moved one million manufacturing jobs offshore to their foreign affiliates.

Throughout this entire period, this perverse deferral break has been in effect. Has it resulted in new U.S. manufacturing jobs? No. We have lost some 3.1 million U.S. manufacturing jobs since 2000 alone. Has this misguided tax subsidy resulted in higher exports from U.S. companies to their foreign affiliates, as the proponents of this tax subsidy suggest? No. In fact, imports into the United States from the foreign subsidiaries of U.S. companies more than doubled from $92 billion in 1993 to $203 billion in 2004. And the balance of trade with foreign affiliates of U.S. firms plummeted to a $72 billion deficit in 2004 as compared to $3.4 billion in 1997.

I have described stories on the Senate floor about a number of American companies that have moved production overseas. These companies include: Huffy bicycles and Radio Flyer little red wagons moved to China; Samsonite went to Mexico and then China; Levi's are now made all over the world, everywhere except in the very country that invented them; Maytag now makes appliances in Mexico and Korea; and Fruit of the Loom moved to Mexico. This tax deferral break given to companies like Radio Flyer or formerly to Huffy bicycles is not available to American companies that make the very same products on U.S. main streets.

In a similar refrain, let me share with you something from a recent article that describes the problem relating to manufacturing jobs so well. This story was part of a recent Washington Post article regarding a small town in North Carolina.

> " 'We didn't see it coming,' the furniture man grimly declared. Michael K. Fugan once ran Henredon Furniture Industries, which operated a plant in Spruce Pine, a former mining town in the rugged mountains in the western part of the state.
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> There the company made hand-carved wooden bedroom furniture, once employing more than 1,000 people. Many lacked high school diplomas and some were illiterate, yet the factory provided a way for these workers to support families and to acquire modest homes and cars.

> It paid roughly $14 an hour, plus health and pension benefits. Henredon's four-poster beds retailed for about $5,000 in the early 1990s, Dugan recalled. A few years later, similar models started showing up from the Philippines for less than $2,000. Now they can be found for $799, produced by workers in southern China who earn as little as 40 cents an hour.
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> Henredon first trimmed its workforce. Three years ago, it shut down the plant, eliminating 350 positions…For 26 years, Phillip Wilson worked at Henredon as a master carver. Now, on most days, he wakes before dawn and drives to his new job – the 5:30 a.m. shift as a prison guard... his pay down 15 percent, forcing him into a second job at a used-appliance store to make ends meet."

Still we run into stiff opposition from many U.S. multinational companies, their lobbyists and some policymakers who claim our proposal would impede the ability of U.S. firms to compete and grow in the global economy. That's hogwash. To hear the proponents of cutting corporate taxes, one might be lead to believe that somehow U.S. companies are struggling to compete in the international arena. But that is simply not the case.

My proposal with Senator Mikulski certainly does nothing to hinder U.S. multinationals that produce abroad from competing with foreign firms in foreign markets. The legislation we have introduced is carefully targeted; it ends the deferral tax break only where U.S. multinationals produce goods abroad, and, then ship those products back to the U.S. market.

Once again, I'd like to remind everyone that the tax experts with the Joint Committee on Taxation estimate that this pernicious tax break will cost U.S. taxpayers some $15.5 billion over the next decade. It is no wonder that the powerful lobby for the largest U.S. multinational firms has fought to keep this tax loophole fully intact.

Given our exploding deficits and debt, I hope the Senate Finance Committee will pass this initiative to shut down this loophole. But if not, I will bring this proposal to the Senate floor with Senator Mikulski and others again and again until this wrong-headed tax subsidy is finally repealed.

I understand that some U.S. companies will still choose -- with or without this tax subsidy -- to dislocate thousands of workers in America in search of cheaper labor, lax regulation and greater profits abroad at whatever the cost. They will be free to do so. But at least U.S. taxpayers will not be asked to provide billions of dollars in tax subsidies for those who do.

End Tax Benefits for Abusive Foreign Cross-Border Leasing Transactions

In S. 554, I authored a proposal that would put a death nail in the heart of abusive cross-border foreign leasing transactions. Specifically, this provision adjusts the effective date for the application of the JOBs Act of 2004's anti-leasing abuse prohibition. The loss limitation rules would apply to leases with foreign entities, regardless of when the lease was entered into.

This provision relates to one of the most scandalous tax abuses I can remember in recent years. A few years ago, PBS's Frontline program aired stories that uncovered massive tax shelter scheme dealing with cross-border leasing abuses, known as Lease-In/Lease-Out Transactions (LILOs), and later known as Sale-In/Lease-Out Transactions (SILOs). The stories discussed how city accountants in Germany and other European countries had generated large cash payments for selling or leasing their streetcars, water purification plants, sewage systems, town halls, rail systems and school buildings to large U.S.

corporations that artificially generated large rental or depreciation deductions to pay little or no U.S. taxes. This Committee is very familiar with this issue.
With Rev. Ruling 2002-69 and by regulation, the IRS challenged the rental and interest deductions generated by LILOs. This effectively put an end to the use of tax loss-creating LILO transactions. However, the industry regrouped and replaced LILOs with SILOs, and, then asserted that the IRS rulings did not cover these "unique and different" transactions.

One of the worst SILO cases I am aware of involves Wachovia Bank (formerly First Union Bank), which reportedly entered into a SILO transaction involving its purchase of sewer pipes in Bochum, Germany. Under the transaction, Bochum sold its underground sewer pipes to Wachovia for $500 million. The city then immediately leased those pipes back, thus retaining use of its sewer system and repaying the lease over a period of many years with the proceeds from the "sale." In return, Bochum was immediately paid a $20 million fee. Wachovia would eventually get its money back – absent the fee, and the Bank reportedly generated about $175 million in tax savings coming primarily from depreciation deductions over time.

From the standpoint of the entities involved in these deals, there was little or no financial risk. When the deal was closed, the tax-exempt indifferent entity, say a foreign municipality, continued to use the property it "sold" but was leased back under the agreement and the U.S. taxpayer now gets the following tax benefits:

1) <u>Large depreciation deductions</u> that are worth more than the "payments" made to "purchase" the property and the fee they pay to the tax indifferent party;

2.) <u>Amortization of transaction costs</u> (cost of setting up the deal) over the period of the deal; and

3.) <u>Interest deductions</u> for the loans the taxpayer used to "purchase" the property.

In 2004, Congress limited the tax benefit available in these transactions by allowing U.S. taxpayers to take tax breaks only up to the amount of income recognized on a year-by-year basis under the leasing agreement. However, there are some foreign leasing transactions entered into prior to March 12, 2004, where the lessee is a foreign tax exempt entity that is not affected by this law change. We should close this international tax scam completely**.** This means that large U.S. companies that already had completed foreign SILO transactions will siphon the Treasury General Fund – and therefore the American taxpayers – of an estimated $4 billion over the next decade. That result can not be allowed to stand and I look forward to working with the Committee to finally pull the plug on these unbelievable tax scams.

In the words of Cologne's city accountant, "After all, the Americans should know themselves what they do with their money. If they subsidize this kind of transaction, we gratefully accept."

In conclusion, Mr. Chairman and members of the Committee, I look forward to working with you to stop those profitable U.S. multinational companies that benefit from our legal system, our national defense and other government protections, but do not believe they should contribute their fair share of taxes to keep this country strong.