

**TESTIMONY OF PROFESSOR BRET WELLS
BEFORE THE US SENATE COMMITTEE ON FINANCE
AT THE HEARING ON
INTEGRATING THE CORPORATE AND INDIVIDUAL TAX SYSTEMS:
THE DIVIDENDS PAD DEDUCTION CONSIDERED**

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My name is Bret Wells, and I am an Associate Professor of Law at the University of Houston Law Center. I would like to thank Chairman Hatch, Senator Wyden and the other members of the committee for inviting me to testify. I am testifying in my individual capacity, and so my testimony does not represent the views of the University of Houston Law Center or the University of Houston. I request that my full written testimony be included in the record.

Our tax system is in need of fundamental tax reform. Finding a path to rationalize the taxation of active business income in the United States is an important goal, and integration of shareholder and corporate taxation can achieve that goal. Corporate integration has been extensively studied for decades by prior administrations, the American Law Institute, and numerous highly-respected academics—one of whom joins me on this panel.¹ As this committee's staff has recently written,² a broad consensus exists that significant efficiencies can be achieved through corporate integration. Thus, before one gets enmeshed in the important details of how to create an appropriately functioning corporate integration regime, it is important to say that reform along these lines can significantly improve our tax system. Focusing specifically on the dividends paid deduction regime, this particular method of achieving corporate integration would,

¹ See e.g., MICHAEL J. GRAETZ & ALVIN C. WARREN, INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND THE AMERICAN LAW INSTITUTE REPORTS (1998).

² See REPUBLICAN STAFF OF THE SENATE FINANCE COMMITTEE, COMPREHENSIVE TAX REFORM FOR 2015 AND BEYOND at 122-237, 113th Cong., S. Prt. No. 113-31 (Dec. 2014).

as to distributed earnings, harmonize the tax treatment between debt and equity and would level the playing field between pass-through entities and C corporations.³ There is much to commend this proposal.

I. Three Key International Tax Challenges

But, notwithstanding the potential benefits of a corporate integration regime, the reality is that business tax reform must carefully consider the international tax implications of any new paradigm, and to that end the United States must ensure that its tax regime withstands at least the following three systemic international tax challenges.⁴

First, a critical international tax challenge is the inbound earning stripping challenge,⁵ and this earning stripping challenge can be further categorized along the following types of base erosion strategies: (1) related party Interest Stripping Transactions; (2) related party Royalty Stripping Transactions; (3) related party Lease Stripping Transactions; (4) Supply Chain restructuring exercises; and (5) related party Service Stripping Transactions.

The second key international tax challenge relates to corporate inversions.⁶ Corporate inversions are often categorized as a discreet, stand-alone tax policy problem,

³ See JOINT COMMITTEE ON TAXATION, *Overview of Approaches to Corporate Integration* at 32 (JCX-44-66) (May 13, 2016).

⁴ These same tax challenges exist whether or not Congress adopts a dividends paid deduction regime, retains its classic double taxation of corporate earnings, or bolts-on a territorial tax regime to either of these two paradigms. For a more in depth analysis of my views of the base erosion and profit shifting challenges created under a territorial tax regime, see Bret Wells, “*Territorial Taxation: Homeless Income is the Achilles Heel*,” 12 HOUS. BUS. & TAX L.J. 1 (2012).

⁵ My views on the genesis of the “Homeless Income mistake” and its solution are set forth in Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX LAW REV. 535 (2012).

⁶ For a more in depth discussion of my views on the corporate inversion phenomenon and what it means to US tax policy, see Bret Wells, “*Corporate Inversions and Whack-a-Mole Tax Policy*,” 143 TAX NOTES 1429

but, in my view, the corporate inversion phenomenon provides unmistakable evidence of the enormity of the inbound earning stripping advantage that exists for all foreign-based multinational corporations. A foreign-based multinational corporation can engage in an inbound related party Interest Stripping Transaction, an inbound related party Royalty Stripping Transaction, and an inbound related party Lease Stripping Transaction without any concern about the US subpart F regime, whereas these very same inbound transactions would create a subpart F inclusion if conducted by a US multinational corporation. Corporate inversions represent an effort by US multinational corporations to place their US businesses into an overall corporate structure that affords them the full range of inbound US earning stripping techniques without being impeded by the backstop provisions of the US subpart F rules.

Third, fundamental tax reform must deal with the so-called lock-out effect.

II. International Implications of Dividends Paid Deduction Regime⁷

As to the earning stripping challenge and its alter ego the corporate inversion phenomenon, the dividends paid deduction regime, by itself, does not equalize the tax position of a US multinational corporation with that of a foreign-based multinational corporation. Even though the dividends paid deduction regime provides a corporate level tax deduction for dividend payments, the dividend payment is subject to a corresponding shareholder withholding tax. In comparison, a foreign-based multinational corporation

(June 23, 2014); Bret Wells, "*Cant and the Inconvenient Truth About Corporate Inversions*," 136 TAX NOTES 429 (July 23, 2012); Bret Wells, "*What Corporate Inversions Teach Us About International Tax Reform*," 127 TAX NOTES 1345 (June 21, 2010).

⁷ For a more in depth assessment of my views on the international tax implications of a dividends paid deduction proposal, see Bret Wells, "International Tax Reform By Means of Corporate Integration," 19 FLA. TAX REV. ____ (2016) (forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2766618.

can engage in all five of the previously enumerated earning stripping strategies to create a comparable US corporate tax deduction without incurring a corresponding withholding tax. Thus, the dividends paid deduction regime does not eliminate the financial advantages that motivate earning stripping or that fuel the corporate inversion phenomenon. In order to address these two key international tax challenges, the United States must impose an equivalent withholding tax, or a surtax, on all of the related party base erosion strategies and not just on Interest Stripping Transactions or Royalty Stripping Transactions.

As to the lock-out effect, the dividends paid deduction regime should substantially eliminate the lock-out effect with respect to the repatriation of low-tax foreign earnings. For companies that repatriate a significant amount of low-tax foreign income, the dividends paid deduction regime will likely represent a net benefit versus existing law. But, outside that low foreign tax context, the interplay of the dividends paid deduction regime with the US foreign tax credit regime creates complex trade-offs. In particular, where a high percentage of a company's total income constitutes foreign income that has been subjected to high foreign taxes, the dividends paid deduction regime likely represents a net cost over existing law.⁸

Finally, under a dividends paid deduction regime, a new tax design challenge will be added to our tax laws. In this regard, to the extent that the shareholder withholding tax

⁸ Consequently, companies in this posture may forgo the dividend deduction allowed under the dividends paid deduction regime and instead rely on the US foreign tax credit regime to offset a substantial portion of its corporate level tax and in turn might then distribute cash to shareholders through share repurchases that are eligible for Section 302 treatment. This strategy would provide shareholders the potential for favorable capital gains treatment and in any event avoids the new shareholder dividend withholding tax. The interplay of whether to utilize the foreign tax credit regime to offset corporate level tax or instead to rely on the dividend paid deduction regime creates a new complexity.

can be cross-credited against the shareholder's residual income tax liability arising from other income, the marketplace will attempt to structure transactions that will exploit that cross-crediting opportunity and, if successful, will create a new set of tax distortions to plague the US tax laws. Thus, if a dividends paid deduction regime were adopted, it would be important to ensure that the incidence of the shareholder dividend withholding tax cannot be shifted, cross-credited against other shareholder income, monetized, or reduced. Congress is likely to receive pleas from various constituencies to exempt specific sympathetic groups from the shareholder dividend withholding tax or the complimentary taxes that would need to be imposed on all base erosion payments, but Congress must resist those calls or else another source of tax distortions will be created through the tax system.

III. Conclusion

Let me conclude my oral testimony by stating that an appropriately structured corporate integration regime has much to offer. The committee is to be commended for considering fundamental business tax reform, but at the same time this committee must ensure that the dividends paid deduction regime is structured to withstand the systemic international tax challenges that face the United States. Thank you for allowing me to speak at today's hearing. I would be happy to answer any of your questions.