United States Senate
Committee on Finance

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Statement of Sen. Chuck Grassley
Revenue Raisers Related to Offshore Schemes
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Mr. President, I'd like to discuss one of the sources of revenue that the Chairman of the Budget Committee claims will help offset the five-year $916 billion cost of extending existing tax policy: shutting down offshore tax havens.

I have been aggressive in combating abusive tax shelters, offshore or otherwise. As Chairman of the Finance Committee, I worked hard to shut down offshore tax evasion. The 2004 JOBS bill shut down the tax benefits for companies that enter into corporate inversion transactions and abusive domestic and cross-border leasing transactions. The JOBS bill also contained a package of 21 anti-tax shelter provisions.

As Ranking Member of the Finance Committee, I saw to it that the minimum wage/small business tax relief package also contained anti-tax loophole provisions, including shutting off tax benefits for corporations that inverted after Senator Baucus and I issued a public warning that legislation would stop these deals, shutting off tax benefits from abusive foreign leasing transactions that weren't caught by the JOBS bill, and doubling penalties and interest for offshore financial arrangements. But the Democratic Chairman of the Ways and Means committee doesn't appear to be supportive of these provisions, even though he voted for many of them in the public JOBS conference in 2004.

So having studied these issues and legislated in this area, I consider my views on tax policy directed at tax shelters and tax havens to be credible. From what I can tell, the Chairman of the Budget committee views the problem of offshore tax havens in two categories: (1) the ability of U.S. multinationals to shift income to these tax havens; and (2) tax evasion by U.S. individuals who hide assets and income in tax havens.

We have seen Democratic senators, including the Chairman of the Budget Committee, hold up a picture of the Ugland House, a law firm's office building in the Cayman Islands, as home to 12,748 corporations. I'd like to give senators some background on where that picture comes from, and what issue it is aimed at.

That picture comes from an article published in Bloomberg Markets in August 2004, titled "The $150 Billion Shell Game". The article focused on the ability of U.S. multinationals to shift income

to low-tax jurisdictions through transfer pricing. Transfer pricing is the term for how affiliated corporations set the prices for transactions between them. Transfer pricing is important, because it determines how much profit is subject to tax in the different jurisdictions involved in related party transactions. The $150 billion figure is an academic's estimate of the annual amount of profit that corporations shift outside the U.S. with improper transfer pricing.

So this article is aimed at U.S. corporations who artificially shift their income to low tax jurisdictions through improper transfer pricing practices. To illustrate this point, I've reproduced a few quotes from the article. The first one says: "Under U.S. law, U.S. companies can use Cayman subsidiaries and transfer pricing rules to shift sales and profits from other countries, thus reducing their overall tax burden." The second one the author attributes to Senator Dorgan: "A practice called transfer pricing may be the key to how U.S. corporations avoid taxes in the U.S. and other countries."

One of the Democrats' revenue raisers that is still on the shelf purports to target this transfer pricing problem. But you wouldn't know it by looking at the language of the proposal, because it doesn't make any changes to our transfer pricing rules. Instead, the proposal would eliminate deferral for income of any US multinational's foreign subsidiaries incorporated in certain black-listed jurisdictions. It's called the tax haven CFC proposal.

Part of our tax code since 1918, deferral means that US multinationals do not pay tax on the active income of their foreign subsidiaries until that income is repatriated to the US. Passive income is subject to tax on a current basis. Deferral only applies to active income.

I agree with the premise of this proposal that U.S. multinationals should pay their fair share of U.S. taxes. U.S. multinationals that use improper transfer pricing do so to obtain the benefit of deferral on profits that, economically, should be subject to tax in the U.S. on a current basis. Here is my quote from this Bloomberg article: "We have to get on top of corporate accounting and manipulation of corporate books for the sole purpose of reducing taxes."

So my view is that stronger transfer pricing rules and stronger enforcement of those rules is the right way to target this problem in our current international tax system. The IRS is taking steps to tighten our transfer pricing rules. In 2005, the IRS proposed regulations that would overhaul the rules for so-called cost sharing arrangements. These are arrangements by which U.S. multinationals are able to transfer intangible property to subsidiaries in low-tax jurisdictions. Based on the volume of complaining I've seen lobbyists level at Treasury and the IRS, the proposed IRS regulations would go a long way to prevent artificial income shifting. I hope to see these regulations finalized soon.

Others have a different view. They would eliminate deferral all together. Another quote in the Bloomberg article succinctly states this view. This is a quote from Jason Furman, former aide to Senator Kerry: "American companies should pay taxes on their profits in the same way whether they earn them in Bangalore or Buffalo."

So that's where these proposals to eliminate or curtail deferral on a piecemeal basis are headed – the complete elimination of deferral for U.S. multinationals. Without a significant corporate tax rate reduction, eliminating deferral would have the effect of exporting our high tax rates and putting US

multinationals at a competitive disadvantage in the global marketplace. The Senate is on record as wanting to protect the competitiveness of U.S. businesses in the global marketplace. The Senate passed the American Jobs Creation Act in 2004, which contained several international simplification provisions, with the vote of 69 Senators, including 24 Democrats. The Senate version of the JOBS bill, which also contained these provisions, received the vote of 92 Senators, including 44 Democrats.

There has been a longstanding debate about whether our international tax system should be fundamentally changed. Some advocate for taxing all foreign income on a current basis. Others argue for completely exempting active foreign income under a territorial system, as many of our trading partners do. If we want to have that debate, then it's a fair debate to have. But piecemeal cutbacks on deferral for active foreign income would do nothing but complicate the tax code and create opportunities for tax planning around those cutbacks.

The other offshore issue identified by the Chairman of the Budget committee is U.S. tax evasion by individual taxpayers who hide their assets and income in foreign bank accounts and foreign corporations. Since 1913, our tax code has subjected U.S. citizens to tax on their worldwide income. No matter what the internet purveyors of tax evasion say, this principle cannot be avoided by putting passive assets and income into a foreign corporation. The tax code has rules to prevent this. Taxpayers that willingly violate these rules are guilty of tax fraud, in many cases, criminal tax fraud.

So the problem of offshore tax evasion isn't that our laws permit it. The problem is that there are some taxpayers who are intent on cheating and hiding their income from the IRS. The IRS has been successful in catching many of these tax cheats, but more can be done.

The IRS has difficulty detecting tax evasion and obtaining the information necessary to enforce our laws. One important tool for the IRS is information exchange with other jurisdictions. Our double tax treaties contain an article on information exchange designed to help the IRS obtain quality information to enforce our tax laws. In addition, administrations past and present have entered into over 20 tax information exchange agreements with jurisdictions that are often referred to as tax havens. Sensible solutions to this problem should aim to improve on our tax information exchange network, and not put it at risk.

Underreported income is the largest piece of the tax gap. We should keep in mind that hiding assets and income from the IRS isn't just an offshore tax haven problem. It may also be an on-shore problem. A recent article in the USA Today noted that there is "a thriving mini-industry that has capitalized on real or perceived gaps in domestic incorporation laws and virtually non-existent government oversight to promote some U.S. states as secrecy rivals of offshore havens."

The picture of the Ugland House in the Cayman Islands makes for good grandstanding, but there are also office buildings in some states that are listed as addresses for thousands of companies who are incorporated in those states for similar reasons as those incorporated in the Caymans – secrecy of ownership and a permissive regulatory environment. Whatever additional solutions the Finance Committee comes up with to shine sunlight on tax evaders will need to consider both offshore and onshore evasion.

To conclude, I want to emphasize that I'm all for shutting off inappropriate tax benefits from offshore arrangements. The Chairman has said that he thinks we could get $100 billion a year from this source. I haven't seen any proposals scored by the Joint Committee on Taxation that come close to bringing in this kind of money. The last score I've seen for the tax haven CFC proposal is $7.7 billion over 5 years. Senators Levin, Coleman, and Obama have recently introduced a bill that contains several proposals aimed at offshore tax havens, but I haven't seen a JCT score yet.

So once again, it will be the Finance Committee's responsibility to come up with real, sensible, effective proposals to combat offshore and onshore tax evasion, which I am glad to do. But the likelihood that they will be scored by JCT to bring in the kind of money assumed in this budget resolution is remote, at best.