

**FOUNDATION OF INTERNATIONAL TAX REFORM:
WORLDWIDE, TERRITORIAL, AND
SOMETHING IN BETWEEN**

HEARING

BEFORE THE

**COMMITTEE ON FINANCE
UNITED STATES SENATE**

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

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JUNE 26, 2008
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CONTENTS

OPENING STATEMENTS

	Page
Baucus, Hon. Max, a U.S. Senator from Montana, chairman, Committee on Finance	1
Grassley, Hon. Chuck, a U.S. Senator from Iowa	9

WITNESSES

Hines, James R., Jr., professor, University of Michigan Law School, Ann Arbor, MI	3
Shay, Stephen E., partner, Ropes and Gray, Boston, MA	5
Dilworth, Robert H., partner, McDermott, Will, and Emery LLP, Washington, DC	6

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Baucus, Hon. Max: Opening statement	1
Bunning, Hon. Jim: Prepared statement	27
Dilworth, Robert H.: Testimony	6
Prepared statement	28
Grassley, Hon. Chuck: Opening statement	9
Hines, James R., Jr.: Testimony	3
Prepared statement	61
Kerry, Hon. John: Prepared statement	76
Shay, Stephen E.: Testimony	5
Prepared statement	77

COMMUNICATIONS

3M Company	97
Treasury Department, Office of Public Affairs	103
Voinovich, Hon. George V.	109

**FOUNDATION OF INTERNATIONAL TAX
REFORM: WORLDWIDE, TERRITORIAL,
AND SOMETHING IN BETWEEN**

THURSDAY, JUNE 26, 2008

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

The hearing was convened, pursuant to notice, at 10:02 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Conrad, Bingaman, Wyden, Stabenow, Grassley, and Bunning.

Also present: Democratic Staff: Bill Dauster, Deputy Staff Director and General Counsel; Josh Odintz, Tax Counsel; and Cathy Koch, Senior Advisor, Tax and Economics. Republican Staff: Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; Ellen McCarthy, Tax Counsel; and Nick Wyatt, Tax Staff Assistant.

**OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR
FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE**

The CHAIRMAN. The hearing will come to order.

The Italian Renaissance historian Francesco Guicciardini said, “Industries . . . are at their best before . . . people recognize how profitable they are. As soon as that happens, they decline, for strong competition makes them less profitable. Thus, in all matters, it is wise to get up very early.”

Today we will discuss international tax competition. We will try to assess whether we are at our best—or whether strong competition is making us less profitable. Either way, we may find it wise to get to tax reform very early.

Tax competition happens when countries compete with each other about how much they tax multinational businesses.

To understand this competition, we need to explore how America taxes the foreign income of U.S.-based multinational businesses now. And we need to explore the various ways that America could tax that income in the future.

At the extremes, there are two ways to tax foreign income of these businesses. The first is to tax all the activities of the businesses no matter where they take place. This is called “worldwide taxation.” A worldwide system avoids double taxation by allowing a business to take a credit against U.S. taxes in the amount of foreign taxes paid overseas. The second way to tax multinational businesses is for a country to tax only income derived within its bor-

ders. This is called “territorial taxation.” In a territorial tax system, a country taxes this income whether the taxpayer is a resident or not.

In a territorial system, any entity earning income in the resident country will owe tax on that income. And, if the entity earns income outside the resident country, then the entity won’t owe the tax.

Our system is somewhere in between. America’s system is partly worldwide and partly territorial. In 1962, Congress enacted subpart F of the Internal Revenue Code. Subpart F applies when an American company runs an active business in a foreign country. Subpart F allows the company to defer paying tax on the foreign income until it repatriates the foreign income back to America.

Subpart F generally does not allow deferral, however, for passive income. Passive income includes rents, royalties, and interest. This income is mobile. With the aid of the Internet, it can move quickly from one country to another.

Critics of subpart F argue that much has changed since 1962. In 1962, America was a net exporter of capital; now we are a net importer of capital. In 1962, manufacturing dominated America’s economy. Now our economy is quite diverse. Intellectual property is our most important export. After 46 years, it’s time to consider whether subpart F still functions properly. It’s time to consider whether we need to make minor tune-ups to subpart F or start anew.

Congress and the new President will need to work together to ensure that the Internal Revenue Code will collect the revenue that we will need. And at the same time, we will need to ensure that American businesses are able to compete in the global economy.

Other countries are also considering changing how they tax foreign income. The United Kingdom and Japan are looking to modify territorial tax systems. The European Union may consider changes for business activities within the EU. Clearly, we need to keep this competition in mind.

American businesses are competing for capital. They are competing for jobs. Let’s try to be at our best. Let’s ensure that strong competition does not make us less profitable. And let us act wisely and get to tax reform very early.*

Now I would like to introduce the panel. The first witness is Dr. James Hines. He is the Musgrave collegiate professor of economics at the University of Michigan. Welcome, Prof. Hines.

The second witness is Stephen Shay, a tax partner in the Boston office of Ropes and Gray. Mr. Shay was the co-chairman of the American Bar Association’s Tax Force on International Tax Reform.

Finally, we have Robert Dilworth, who is a tax partner in the Washington, DC office of McDermott, Will, and Emery. Mr. Dilworth was a Senior Advisor to the Assistant Treasury Secretary for Tax Policy from 2005 to 2007.

*For more information, *see also*, “Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment,” Joint Committee on Taxation staff report, June 25, 2008 (JCX-55-08), <http://www.jct.gov/publications.html?func=startdown&id=1284>.

Dr. Roseann Altschuler was scheduled to testify this morning. Unfortunately, she was unable to appear due to a death in the family. We send our deep condolences to her and to her family.

But thank the rest of you for coming. As is our regular practice, your prepared statements will be included in the record, and I would ask you to speak about 5 minutes.

Prof. Hines, it is all yours.

**STATEMENT OF JAMES R. HINES, JR., PROFESSOR,
UNIVERSITY OF MICHIGAN LAW SCHOOL, ANN ARBOR, MI**

Prof. HINES. Thank you, Mr. Chairman and members of the committee. It is a pleasure to be here this morning.

We are here to discuss the taxation of foreign income, but with your indulgence I would like us all to think for a minute about our system of excise taxation. The Federal Government has excise taxes on gasoline, alcohol, tobacco, firearms, things like that, and they are all imposed on a territorial basis, meaning that our gasoline tax applies if an American company sells gasoline in the United States but it does not apply if an American company sells gasoline abroad.

That is the way excise taxes are administered all throughout the world, and that is the right way to have excise taxes. But you could convince yourself, maybe if you thought about it, that this is a bad system of just having territorial excise taxes. The reason is that there are some countries with much lower excise taxes than the United States and maybe that difference between their excise tax rates and ours gives American companies an incentive to do extra business in those places relative to the United States. As a result, there is more foreign employment and less domestic employment, you might think.

This reasoning would not be good reasoning, but it is superficially appealing. So you could imagine someone coming before this committee and saying, we should have a worldwide system of stiff excise taxation. What would happen if we actually enacted laws saying that an American-based company has to pay U.S. excise taxes on its sales of alcohol, tobacco, or whatever around the world? Well, it is pretty clear what would happen. A lot of American companies would be in a position where they would wind up selling off their foreign operations to companies from other countries.

Take the case of gasoline. If Exxon-Mobil has to pay U.S. excise taxes on its gas sales in Mexico, what it would do is sell off some of its Mexican gas stations to British Petroleum, which is not subject to a regime like that. Would that be good for the United States if that happened? No, it would not be good for the United States because all you are doing is impairing the ability of Exxon-Mobil and other U.S. companies to earn profits. As a result, they become less productive in the United States, and it is not good for anyone here if we were to have such a thing. That is why we do not have it.

All right. That is the excise tax world, and we are very comfortable with a territorial system of excise taxes because we do not want to create the incentives for American firms to have to sell off their operations to companies from other countries.

But here is the thing: exactly the same process works with income taxes. It is not actually any different. As a result of our system of income taxation that does impose U.S. taxes on worldwide profits, especially in low-tax foreign countries, American companies have incentives to sell off their business operations or never get them in the first place, in other parts of the world. It is just exactly the same process as if we had worldwide excise taxes, it is just slightly subtler in the case of income taxes so it is not as upsetting as it would be if we were actually to think about doing this with excise taxes.

Furthermore, of course, neither the United States, nor any other country in the world, has a worldwide system of excise taxation. With income taxes, there is a dwindling number, as the chairman pointed out, of countries with worldwide income tax systems, too. The United States really stands alone now in having a largely worldwide system where we restrict the ability of American firms to claim foreign tax credits, we restrict their ability to defer U.S. tax on their foreign-source income, and as a result, we discourage American firms from conducting profitable business opportunities abroad.

The consequence of that is that it lowers their productivity in general, and in particular in the United States. Because of that, the demand for labor is less than it would be in the United States, and as a result there are fewer jobs, and the jobs that we have offer lower wages.

If you reduce the productivity of American-based companies, the impact is largely felt in the United States among the factors that are residents of the United States, primarily labor. So when we think about worldwide income taxation, I urge us to think of it as equivalent to worldwide excise taxation with all the dire consequences that are associated with that.

Now, what is the solution to this problem? The solution is to have a tax system that is more like countries in the rest of the world. In other words, not to move in the direction of stiffer U.S. taxation of foreign income, but the other way, to think about a territorial system or at least move in the direction of a territorial system of taxation.

The consequence of that would be felt mostly by American labor in the form of higher wages. Would we have to worry about loss of American tax base? It is the other way around. If you have a strong economy and a strong business sector, that is where you get American tax base. So for all of those reasons, I urge the committee to think about moving more in the direction of a territorial tax system.

The CHAIRMAN. Thank you, Prof. Hines, very much.

[The prepared statement of Prof. Hines appears in the appendix.]

The CHAIRMAN. Mr. Shay?

**STATEMENT OF STEPHEN E. SHAY, PARTNER,
ROPES AND GRAY, BOSTON, MA**

Mr. SHAY. Thank you, Mr. Chairman, and members of the committee.

I want to emphasize that the views I am expressing are my personal views and do not represent the views of either my law firm, its clients, or the American Bar Association.

With the chairman's permission, my written remarks have been submitted for the record.

The primary focus of U.S. income tax policy, including the policy regarding taxation of international business, should be how to fulfill the revenue needs of the government and their budgets passed by this Congress in a manner that improves the lives and living standards of U.S. citizens. We traditionally look at three criteria when we evaluate any income tax proposal. They are: fairness, efficiency, and administrability.

Jim has just made comments that respect the view about efficiency, as to which I think there are differing views. My focus today is really somewhat different. It is that of a practitioner who practices international tax law every day. Our international tax rules today are broken. Significant defects of the current international tax regime include permitting combined U.S. and foreign effective rates of taxation of foreign income to be so low as to encourage shifting of activity and income outside the United States for tax, rather than business, reasons.

Let me say in making that comment, that is not to say that businesses only, or even predominantly, are motivated by tax. This is all at the margin. But the point is, our current rules create that marginal incentive, and so part of the question is, how do we think about reforms that affect that marginal incentive?

Second, our rules subsidize high foreign taxes through allowing excessive cross-crediting of foreign taxes against U.S. tax on repatriations of low-tax foreign income.

Finally, our rules impose, when cross-crediting is not available, an additional tax on foreign income when it is repatriated rather than when it is earned, so it affects, it distorts, the decision whether or not to repatriate.

People refer to this as the repatriation tax. I refer to this as the deferred tax. Without a deferred tax, if there were tax at the time the income is earned, that inefficiency would be addressed.

These defects are exacerbated by use of transfer pricing. I describe in my testimony at some length why enforcing transfer pricing rules is difficult for any country. Part of the thrust of my comments is, very strongly, that there is only so far you can go with transfer pricing. You have to address and limit the incentives of transfer pricing through structural change.

For reasons I describe in my testimony, adopting formula apportionment is not a viable answer to addressing these problems in the absence of a very broad international agreement for formula apportionment, and it would take years to accomplish.

When evaluating these reform alternatives, it is essential to take account of these effective rate disparities. There is data that shows that the effective rates of large controlled foreign corporations have

declined from 34 percent in 1986 to 19 percent in 2002, and there may be more recent data.

Changing to an exemption system would compound the problem of the erosion of the U.S. tax base. The incentive for income-shifting activity to low-tax locations would increase. The exemption in tax-free repatriation of foreign earnings would expand the range of businesses that could take advantage of exemptions because they could bring their money back without further taxation.

Under an exemption system, the misallocation of expense against domestic income instead of foreign exempt income would, in effect, exempt domestic income from tax, and this risk of misallocating expenses is very much heightened in an exemption system. I discuss that at greater length in my testimony.

I respectfully submit that reducing the scope of deferral and more closely aligning the foreign tax credit rules to the purpose of avoiding double taxation as part of an overall reform achieving a lower corporate tax rate for all taxpayers would be preferred through exemption of foreign income and should be supported on grounds of fairness and efficiency.

The theoretically optimal approach to adopting worldwide taxation would be to adopt pass-through treatment. In the event that that is not viewed as feasible, less fundamental reforms, including current taxation of U.S. shareholders under expansion of subpart F, would be a substantial improvement over current law. It also is possible to rehabilitate the subpart F rules if one wants to preserve some deferral for active income, which is, I submit, very challenging and not to be preferred to taxing all income currently.

A base-broadening approach such as I have described in my testimony that contributes to a meaningful reduction in corporate rates will assist all U.S. businesses, whether they operate abroad, export from the United States, or compete against foreign imports. The result would be a fairer tax system.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Shay.

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

The CHAIRMAN. Mr. Dilworth?

**STATEMENT OF ROBERT H. DILWORTH, PARTNER,
McDERMOTT, WILL, AND EMERY LLP, WASHINGTON, DC**

Mr. DILWORTH. Chairman Baucus, Senator Grassley, members of the committee, thank you for inviting me to appear.

To put my remarks in context, the first thing I must say is they certainly do not represent the views of any firm with which I have ever been associated, or indeed of the Treasury Department. They are my own views.

I have practiced for more than 40 years. I have practiced in two law firms. I have practiced on the East Coast, the West Coast, the Midwest, and I even spent 2 years in Taiwan, which is the mother of tax incentive jurisdictions. I joined the Office of Tax Policy in 2005 because I wanted to give a little back. I am obviously nearing the end of my career.

My written testimony for the record examines several topics in greater depth. First, the various proposals to end deferral, amply explicated by my colleague, Steve Shay. The other proposal is to

curtail the foreign tax credit. Both of those are wrapped up in the President's Advisory Panel proposals and in the JCT options proposal.

In my written testimony I also refer to a laundry list of additional items that you might want to consider as part of a comprehensive overhaul of the international tax regime. In my view, we should approach international tax reform very carefully. We are, in fact, very integrated into a global economy, and the risk of unanticipated consequences can be high and hard to see before the fact.

Chairman Baucus, you said the question before us is whether we should try a minor fix or start over. I think we should not start over. I think we should fix only what is clearly broken. I think we should tailor the remedy to the problem. We should avoid the temptation to find a grand, simplifying assumption like the General Theory of Relativity. Einstein supposedly thought income taxes were complicated, and there is a reason.

Now, the pamphlet that the Joint Committee issued last night—I have obviously not studied it—refers frequently to the point that the evidence is inconclusive. It is not clear what causes taxpayer behavior.

Inferences can be drawn at the margins, but you cannot be sure. So, in the absence of certainty, I would be very careful. I do not think the passage of 40 years since the enactment of subpart F is a definition of broken.

In my view, the U.S. tax regime for cross-border trade and investment should be adjusted to better accommodate common, current business models for international business. Business is conducted across national boundaries, goods are manufactured in several countries and distributed in both the countries of manufacture and other countries. The EU is a market. It is not 37 different countries. NAFTA is a market. Subpart F assumes hermetically sealed national bubbles as the proper way to conduct foreign business. It is out of date.

Main Street businesses that conduct cross-border business have to manage their financial assets and exposures. Subpart F assumes that gains or income from managing such assets and exposures should be taxed as a form of tax-avoidance income. It is out of date. Currency risks and funding risks are no longer readily managed by dealing with the single bank that manages all those risks for Main Street firms.

U.S. multinationals are managers of portfolio investment capital assembled from all over the world and deployed in direct business activities all over the world. If we are going to tax GE very differently from NB Phillips or ABB on their non-U.S. and non-residence country activities, we should be confident that foreign portfolio investment capital will not be sensitive to that difference. It may not be, but we had better make sure we are not going to decapitalize our own U.S.-managed enterprises.

U.S. MNCs participate in joint ventures with non-U.S. MNCs. When I was a little boy—and I began my practice shortly after the enactment of subpart F—everybody did business through wholly owned subsidiaries. Now there are many, many multinational joint ventures between U.S. and non-U.S. MNCs.

If we subject U.S. MNCs to tax on the undistributed share of joint venture income, we increase the hurdle rate for U.S. MNC participation in those joint ventures.

I am out of time. I apologize.

The CHAIRMAN. Go ahead. Take another minute.

Mr. DILWORTH. I think the dividend exemption regime and the Rangel bill continue to assume that multi-country and regional business is undertaken in order to reduce taxes on high-tax manufacturing income and that they should be taxed by the U.S. in the case of dividend exemption regimes without the benefit of foreign tax credits from ordinarily high-taxed business. Those are just out of touch with the routine business practices by most MNCs, both U.S. and foreign.

So now, the unpopular part. I recommend that we repeal the foreign-base company sales provisions, the services provisions. I recommend making permanent what is in 954(c)(6), the look-through rule. Then the next at least as unpopular thought is, I would explore limiting the current deduction for foreign-related expenses to aggregate foreign-related income. This is not the Rangel bill. I would not limit the deductions solely with respect to deferred foreign income. I would instead ask myself, is total foreign income in excess of the deductions that are taken otherwise against U.S. income?

Foreign-related income should pay its way, should pay its freight. It should not reduce the U.S. tax on U.S. income, but beyond that there is no compelling need, other than behavior modification, to get people to invest somewhere else, to start disallowing the foreign tax credit or denying deductions.

Then to close up, I would recommend that the committee have a serious discussion with some other disciplines. Lawyers and economists come and talk to you, but I recommend that you also talk very carefully to FASB. I was struck that the Financial Accounting Standards Board had no participation, as far as I can tell, in either the Joint Committee materials or in the President's Advisory Panel. The people who participated had one set of views and they were useful, but earnings per share really drives behavior. You ought to talk to an expert about how earnings per share are determined.

I think I would also, having perused the report last night, get some business school professors in here to find out whether behavior at the margins is really primarily in pursuit of a tax reduction, and then also affected by other factors.

In my life as a trusted advisor to multinationals, people try to make profit first. Taxes are an afterthought. So the rational economic animal argument needs to be tested by somebody who actually is involved in business decision-making. Do people actually behave that way or is this just an inference one can derive from the 50,000-foot statistical test?

Thank you.

The CHAIRMAN. Thank you very much.

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

The CHAIRMAN. Senator Grassley, you were not here at the beginning. Do you want to make a statement?

**OPENING STATEMENT OF HON. CHUCK GRASSLEY,
A U.S. SENATOR FROM IOWA**

Senator GRASSLEY. I apologize to my colleagues and the witnesses for being late. This hearing sets the stage for the debate on international tax reform. It is long overdue. I made that very same statement 5 years ago when this committee held a series of hearings on this very same subject. With the current economic slowdown that we have now, I think it is even more important to explore what Congress should do or not do to make U.S. businesses competitive globally.

The current economic environment should be a wake-up to pay attention to how the tax rules impact U.S. businesses and their ability to thrive in a global marketplace. I agree with the premise that the U.S. multinationals should pay their fair share of U.S. taxes. It is a fact of life that we must fund our government, and taxing business entities is one of the ways to do that, even though we all know that corporations do not pay taxes, only people pay taxes, and corporations are tax collectors. But we still get a massive amount of money from that source and we are going to continue to, so we have to make it work.

Our goal, however, should be to minimize as much as possible the tax system's interference with rational business behavior. We need to carefully examine, and also carefully balance, approaches that would raise the necessary revenue, but we should be mindful that we not poison the well with anti-competitive tax policy.

Our current system is based on the framework enacted during President Kennedy's administration. Since then, we have seen an era of expanding global markets, falling trade barriers, and technological innovations that have served to take away traditional notions of national borders.

Our tax code has obviously not kept pace with these changes. Our tax policy should enable U.S. companies to operate in the global marketplace without the artificial boundaries set in place by the tax code. Globalization of the marketplace creates its own unique set of rules and complexities. Companies have responded by updating their systems and business models. Our tax code should address that reality.

One would hope that a country known for great innovation, as we are, would be able to craft a tax code that encourages economic development, collects the necessary revenues, and fosters growth of jobs. There has been a longstanding debate about whether our international tax system should be fundamentally changed. Some say that the transfer pricing regime used by virtually every major country is broken and call for tax on all foreign income on a current basis.

Without significant corporate tax rate reduction, eliminating deferral would have the effect of exporting our high tax rates and putting our companies at a competitive disadvantage in the global marketplace. Furthermore, the piecemeal cutbacks on deferral for active foreign income that we have seen here in the Senate would do nothing but complicate the tax code and create opportunities for tax planning around those cutbacks.

Others argue for completely exempting active foreign income under a territorial system, as many of our trading partners do.

However, this proposal is not without its issues. Concerns about tax treatment of royalties and transfer pricing would need to be addressed head-on in exploring this as an option.

So we have a few real choices: to build a protectionist wall or develop a tax system that fosters growth and innovation. I am on record as criticizing legislation that would eliminate or whittle away the current deferral of active foreign earnings. Beyond that, however, I do not profess to have preconceived notions as to which direction our tax rules should go. We seem to all agree that something should be done, and I believe we should be open-minded about what direction that reform should take.

The CHAIRMAN. Thank you, Senator Grassley.

A question I know a lot of Americans have is, what in the world is going on when so many American companies have subsidiaries, say, in low-tax jurisdictions like the Cayman Islands and so forth, seemingly for non-business reasons, purely tax reasons? For example, it is my understanding that when Congress passed the repatriation provision not long ago, about \$362 billion was repatriated to the United States and most of that came from low-tax jurisdictions like the Cayman Islands, Bermuda, Ireland, and so forth.

Is that a problem? A lot of Americans think it is a problem. It just does not look right. Is that something you think that, when we reform here, among all the things we have to do, is that part of it? Should we do something to make it more difficult for American companies to park that income, park their subsidiaries overseas to avoid paying taxes? Prof. Hines?

Prof. HINES. No, I do not think it is a problem. I agree with you that the optics on that are bad, but the first point is, it is not just American companies that have a lot of operations in tax havens. Other countries' companies do, too. So it is the way that international business is conducted. A lot of the function of holding companies in tax havens like the Cayman Islands is to avoid foreign taxes.

That is, a way to rationalize the foreign business operations of American companies is often to structure the holdings through tax haven holding company affiliates in places like the Cayman Islands. There is very little in the way of productive activity, manufacturing or things like that, going on in the Cayman Islands; obviously, it is financial transactions. They are the ones that are taking place there.

A lot of those holdings are directed at trying to avoid a set of structures that trigger high rates of foreign tax. The United States should be totally in favor of that, because, if our companies can structure their foreign business operations in a way that generates as much after-tax profit as possible, that is good for the United States.

If they can structure their foreign business activities in ways that avoid, say, high Japanese tax rates or German tax rates, that means we give them fewer foreign tax credits. It means that these companies wind up with higher after-tax profitability, which is only good for American owners of the companies and American workers for the company.

The CHAIRMAN. Mr. Shay, do you have a thought on that?

Mr. SHAY. As a practitioner, I look for low-tax opportunities wherever they arise. So one thing, focusing on tax havens—if you use a pejorative term—but low-tax countries that, for their own reasons, have adopted tax systems that are different from ours run the risk of trying to differentiate what income is there and what income is somewhere else. The fact is, if the homeland dividend debacle evidences anything, it is that money is fungible. It is going to find the lowest effective tax rate. If you try to silo particular approaches, then other approaches risk popping up.

So, while in general the thrust of my testimony is, yes, I think we have a problem, I think we have a very large amount of foreign earnings that are not being redeployed for tax reasons that may have been earned in various ways; and other tax avoidance schemes and low-tax jurisdictions are an important part of that. They are also an important part of regular, ongoing business. But my solution is not to target, it is to say, let us tax foreign income on a comparable basis. At that point, companies are still going to want to be reducing foreign taxes, at least to the point where they can take—

The CHAIRMAN. Right. But do we run the risk of having a race to the bottom? Lots of countries are starting to reduce their corporate rates to attract investment. Ireland, as an example. To what degree do you see that as an issue? If it is an issue, how do you address it?

Mr. SHAY. I think that the corporate tax rates of other countries operate as a very, very broad boundary. I do not think they dictate U.S. tax policy on corporations, but I think they are—

The CHAIRMAN. Not Ireland. Ireland is very aggressive. Companies go to Ireland.

Mr. SHAY. I am sorry. I thought you were asking whether that should affect how we set the U.S. rates.

The CHAIRMAN. My question is, in terms of getting revenue for government—you have to have some revenue—is there a problem, a race to the bottom, in the corporate world?

Mr. SHAY. Yes, I think there is a problem. I think my testimony supports the view that there are steps that can be taken to address that problem. But it would be pretty broad-based and it would not be singling out individual areas. It seems to me, while it is still possible to substantially reform subpart F and try to single out what is good foreign income and what is not good foreign income, what is active foreign business, what is not active foreign business, I think that that is a difficult task.

It has proven to be complex for companies to administer, which is one reason why I favor taxing foreign income, all foreign income, and giving credits for foreign taxes. That would fully address the problem that you are alluding to. The question that is raised by other panelists is: would it adversely affect the U.S. economy and U.S. businesses?

The CHAIRMAN. All right. Thank you.
Senator Grassley?

Senator GRASSLEY. In previous hearings I raised the question of what revenue neutrality means in the whole concept of tax reform. If we assume revenue neutrality against current law, then individual income taxpayers are going to have to face a 10-percent tax

increase. If we assume revenue neutrality against current-law policy reflecting this year's tax burden, then there is no widespread tax increase. If it is decided that revenue neutrality against current law is the test, then there will be major political pressure to alleviate that huge burden on individual income taxpayers.

Our last big test on this point occurred in the 1986 Tax Reform Bill. In that case, Joint Tax told us we shifted \$120 billion from individuals to business. That was \$120 billion over 5 years in 1986 dollars. Today that figure would be much higher.

So my question to the panel is this, particularly Mr. Shay: if Congress were to face similar political pressures in a reform exercise, would you caution us to forego that path? That is, would you suggest we not use tax reform to shift more burden onto business?

Mr. SHAY. Not as a per se recommendation. I guess I am not sure I am quite following the question. There is always a decision in an overall tax system as to the allocation of tax on businesses and individuals. I share the view that tax on business ultimately is borne by the participants. We do not really know the breakdown of corporate taxes very clearly, but it is partly shareholders, partly consumers. But there is no reason, on a per se basis, to say you should not increase the tax on business. This is part of a broader fairness decision that you are making.

Part of my recommendation of increasing taxation of foreign income, again, is, if you are going to tax businesses on income, it is, in my view, unwise to differentiate, to the extent we do, between foreign income and domestic income because it creates bad incentives, and it is unfair. I think we are looking for solutions to help the exporter as much as multinational or foreign activities, and for the purely domestic business as well.

So, if that results in an increased tax on business, which it probably would, although it is not really revenue-oriented as such, the proposals I am making are—you can set the tax rate, the corporate rate where you want. The proposals I am making are really designed to have a more efficient tax base across the board so that hopefully you can get to lower corporate rates within your overall revenue needs, but that there will be less incentive to artificially shift income outside the United States.

Senator GRASSLEY. Prof. Hines and Mr. Dilworth, do you want to comment?

Prof. HINES. The United States already has a very heavy business tax burden compared to other countries. That is the issue. That is part of the reason why—Steve Shay is right, and others are right, that we need to be concerned about the shifting of taxable income outside the United States to other countries. We definitely need good enforcement of our rules on that. But the reason it happens is because the tax rates are high in the United States.

Movement in the direction of higher-still business tax rates would have consequences for that, as well as consequences for productivity of the economy and all the things that go along with it—employment and affluence. So, I would be wary about a 1986-style solution where you lowered the tax burden on individuals in return for a higher burden on corporations.

Senator GRASSLEY. Mr. Dilworth?

Mr. DILWORTH. I think that the question, from the standpoint of a practitioner, is very much like what Chairman Rostenkowski said in 1986: "Don't tax you and don't tax me, tax the companies beyond the sea."

The CHAIRMAN. I think that was Russell Long.

Mr. DILWORTH. That was "tax the guy under the tree," I think. But I thought it was refined in 1986 to make sure that we hammered the foreign companies.

The CHAIRMAN. Oh, all right.

Senator GRASSLEY. Thank you, Mr. Chairman.

Mr. DILWORTH. I do not think that is a very good idea. The reason I do not think it is a very good idea is, we do not know who owns the U.S. multinationals, for openers, so some portion of it—no doubt, the burden of the tax—falls on U.S. shareholders, the wealthier among us, but some of it falls on foreigners. If they have competing alternative investment opportunities between MB Phillips and GE, we will not have done ourselves a good day's deed.

The second point, the lock-in effect, going back to Chairman Baucus's posit about, do we not have a problem with \$365 billion in Ireland or wherever, the Cayman Islands, I do not know how big a problem that is. I am not confident, as Prof. Hines is, that it is not a problem. It could very well be a problem. But I do not know what the total pool of income of all those enterprises was on a worldwide basis during the period that the income was accumulated in the foreign jurisdiction.

Was that all of the income of these 863 companies or was it just half? Was it a third? Was it a tenth? What was it attributable to? Was it attributable to U.S.-origin IP? Is that what the problem is really all about? If it is U.S.-origin IP, let us look at U.S.-origin IP and not disable the rest of the conduct of U.S. multinational business overseas by repealing deferral, because unlike Steve, I do not think anybody who has ever done section 959 calculations would confuse that with beach reading. That is what happens when you try to deal with undistributed income that has been previously taxed. You know that you are eventually going to pay tax on a number different than what you put on the tax return because you will have future losses, you will have currency fluctuation.

Finally, as far as the lock-in effect on not being able to deploy assets in the United States, we are the only country I ever heard of that prohibits foreign subsidiaries from making business investments in the residence country. We put that back in in 1962 as a vestige, almost like an appendix, to an entirely different system that was proposed in subpart F and passed the House. The Senate rejected that version, but left the section 956 piece in there.

Mr. Miller from Iowa correctly pointed out that the premise of 956, as finally passed, was strange because it allowed the deployment of assets outside the United States and not in the United States. So I think you have to break the problem down into the smaller pieces. What really bothers you about that debacle?

The CHAIRMAN. Thank you very much.

Senator Bingaman?

Senator BINGAMAN. Well, thank you all very much. Let me just ask a couple of questions. I am trying to understand differences

that each of you have with some of the suggestions of the other witnesses.

Mr Dilworth has a couple of very specific proposals here that I would like Mr. Shay's reaction to. One is the repeal of related-party base erosion components of subpart F related to mobile income. Is that something that is consistent with what you—you were advocating, as I understood your testimony, reducing the scope of deferral. Is this part of what you are saying should be done, or is this inimical to what you think should be done?

Mr. SHAY. Can I frame the question a little bit?

Senator BINGAMAN. Sure. Go ahead.

Mr. SHAY. You have some big, basic choices. You can tax foreign income currently, the sort of thrust of my recommendation. There are alternatives. Another alternative is to go back and try to reconstruct a balance in the taxation of foreign income and tax active income, leave active income deferred, tax passive income currently, and the question that you are raising is really a subset, a small question of, when you earn active income should you treat it as passive when you distribute it somewhere else in your group? Bob is saying, no, it should maintain its active character. I think there is room to disagree with that, but frankly that is a marginal question.

The important question is, do you think you, as a Congress, can decide what is good foreign income earned and what is not good foreign income earned and set up rules to determine that? They did that in 1962. They came up with a set of foreign-based company sales rules, services rules which said, if you do certain things we are going to tax that income currently, even if it is active. Basically, those certain things were if you move it from where you are earning income to a low-tax jurisdiction for a tax avoidance purpose.

That was the original 1962 compromise, with the original proposal from the administration being, tax everything currently. That compromise has totally eroded because of changes, legal changes, in the tax system, because of the way we classify corporations, because, as Bob said correctly, structuring out all according to countries is no longer relevant. We have a written description in chapter 3 of the ABA Tax Section Task Force on International Tax Reform which tells you what you could do if you wanted to go back to that approach.

Senator BINGAMAN. And that is what you are advocating?

Mr. SHAY. No, actually. That is there, if that is a direction you want to take. I think it is too difficult. It is too difficult to get it right. It is too difficult, and in the process of trying to get all those things right, other anomalies will develop. That is, frankly, what at least two of us are in the business of exploiting, and I do not mean that as a bad thing. That is all part of trying to be tax-efficient.

So my conclusion is, the better solution is, as part of an overall package of broader business tax reform, tax foreign income currently, try to bring the rate down so that you are still competitive around the world and you give credits for foreign taxes. But I frankly think a competitive rate is—there was a proposal on the House side to get you at 30.5 percent. No. I do not think you have

to be—within some range of that, I still think American business will do very well.

Senator BINGAMAN. Let me ask Mr. Dilworth to just comment as to your opinion about his main recommendation there.

Mr. DILWORTH. Well, I believe we should not lower the threshold for ending deferral. I believe the part of the ABA report that Steve was responsible for suggests dropping the ownership threshold to 25 percent, and the thesis was that such a concentrated block would give the U.S. investor influence on the behavior of the CFC, the controlled foreign corporation.

But I think, in my testimony, I suggested that you are basically going to freeze out too many companies from multinational joint ventures. Having the required distribution to fund the tax is probably going to make it too hard to put the deal together.

So, I do not support the idea of ending deferral, and I think, in my experience—and it is anecdotal—trying to figure out how to keep track of previously taxed income and keeping it right, it is just enormously difficult. I think the concept was dreamed up, with all due respect, by economists. But economists do not do stuff like that. They do important, high-level intellectual things. Grunts have to figure out section 959.

The CHAIRMAN. Thank you very much.

Senator Bunning?

Senator BUNNING. Which economists were those? [Laughter.] Which one of the 100 that we have consulted with? Never mind. I am just kidding.

Professor James Hines, which tax system, worldwide or territorial, will be better for us in the long run? Which system will do more to increase our standard of living and allow us to grow our way out of the looming fiscal crisis caused by the unwillingness of the majority in Congress to reign in mandatory spending? Which system will ultimately be better for our children and grandchildren, and why?

Prof. HINES. The territorial system is better. That is what most of the world has discovered, but the United States has not yet. The reason is that you get more efficient business operations if you have a territorial tax system. More efficient business operations produce this country's affluence. Why are we rich? We are rich because we have strong businesses here, and that is because we have embraced capitalist principles. One capitalist principle in the international tax area is, why do you want to impose worldwide taxes on your companies when it reduces their productivity as a result? Other countries do not do it, and I do not see why we would want to do it.

Senator BUNNING. That will address all the other problems I talked to you about?

Prof. HINES. There will still be an agenda for Congress on some of those other problems, but it certainly will help. I mean, the current system impairs the productivity of American businesses relative to the businesses of residents in other countries, and most of the benefits of stronger business operations are felt in the United States in the form of greater demand for factors that are resident to the United States, specifically labor and land, but mostly labor. So, if you make American business more productive, most of the re-

sults of that is higher wages and greater employment for Americans, which I think we all want.

Senator BUNNING. Thank you.

This is for all of the panel. Last year, foreign businesses acquired more U.S. businesses than at any time in our history, \$414 billion worth of business assets. With the weakness of the dollar this year, it is likely to set a new record. Does our tax system have anything to do with the fact that our U.S.-based firms are more often the targets of acquisitions than acquirers? Now that the average OECD corporate rate is 28 percent or less, is it more effective to locate headquarters outside the United States? Why should we care about where headquarters are located? Would anyone like to chomp on that?

Prof. HINES. Sure. Yes, the U.S. tax system has an impact on acquisitions and other countries' tax systems influence that, too. If you think about when there is a merger of two large companies, you can structure it in a way so that they can be a resident for tax purposes in either of the countries.

If a German firm and an American firm are going to wind up merging their assets, and these are companies that have a lot of foreign operations, there is a strong advantage to being a German resident for tax purposes because Germany has, effectively, an exemption system so that the foreign earnings of German companies are not subject to German tax, and, if a German firm acquires an American firm in a certain way, then the American firm's foreign earnings will not be subject to American or German tax as a result.

So, yes, there is a reason. There certainly are tax reasons, and there is ample evidence that these tax motives wind up affecting the bid prices in these acquisitions and the quantity of the acquisitions by foreigners. What are the consequences for the United States? That is a little subtler, frankly, to know. Does it matter that American companies are owned by foreign entities? It certainly matters, but mostly the reason it matters is because what we want is the business activities in the United States to be as productive as possible.

If a foreign owner is the most productive owner, I am all for it, and we should be all for it because that means that the business will be most efficient and it will create the greatest demand for labor in the United States, and so on.

The concern is, if you have a foreign owner who is the owner not because they are the most productive, but because the tax incentives are driving the ownership to be foreign rather than American, and, if that is true, then we must be concerned because that means you are going to give an incentive for inefficient ownership and then you have less demand for labor in the United States, less productivity.

So what we want is a system that encourages efficient ownership, and the way to do that is to have a tax system that is more similar to other countries' systems, i.e., an exemption system.

The CHAIRMAN. Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman. Thank you very much for holding this hearing, and thanks to this panel.

We all come at this from our own perspectives. Mr. Shay and Mr. Dilworth, you come at this from a perspective of practitioners. I can

tell very much that you have been in the pit, as we say, and I very much appreciate your practical advice. And Mr. Hines, you come at this from an academic background, and you have a perspective that is important for us to hear as well.

I come at this from, in my previous career I was a tax commissioner of my State and the chairman of the Multi-State Tax Commission, and I served during the Reagan administration on the Commission on Taxation of Multinational Corporations. I learned a great deal about negotiating on that commission. It was one of the most fascinating, incredibly intricate negotiations I have ever been part of.

I come at this from a perspective of somebody who tried to make certain that taxes that were in law were, in fact, enforced. As a result, I have audited hundreds of major multinationals. It is probably surprising to some that a State like North Dakota would have engaged in that effort, but my State is an energy State, so we had many energy operations in my State that were very large corporate entities. Not surprisingly, they tried to avoid paying taxes to the extent they could. My job was to try to make sure they paid what they owed.

I found a couple of things. One, I reached the conclusion that there is a lot of nowhere income sloshing around out there. It is not even a question in my mind, because I have seen it. Nobody who has not seen it through audit could dispute what we saw happening.

Second, like a couple of you as practitioners, I concluded transfer pricing as a mechanism is just broken. There is just no way you can try to recreate arm's length transactions from the interactions of hundreds of entities, wholly or partly owned. You just cannot do it, I do not care how smart you are. There is not enough time or enough resources to do it.

My own conclusion was, in a perfect world, something like formula apportionment would be a good way of resolving things, because we would look at our share of a company's property payroll and sales in relationship to the worldwide property payroll and sales, and we would get that fraction for taxation purposes—not a perfect measure, but a rough justice measure. The problem is, as Mr. Shay, you have quite correctly pointed out, it would take time to get in place a worldwide regimen that would have everybody on the same page.

So where are we? I would be very interested to hear from each of you. I have just a minute and a half left, so, if I could get 30 seconds from each of you on, what do you think we could do that would help American competitiveness, and also address the fairness question? Now, I, for one, think the Caymans is a huge problem. That Uglend House that I have shown on the floor many times, 12,000 companies call that little 5-story building down there home. They are not there to do business, as you, Prof. Hines, pointed out. They are there to do tax avoidance. Anybody who has audited those companies knows that is what is going on.

Mr. Shay, I think you have given some very good, specific recommendations here. If we were going to go for some more far-reaching reform, what would it be?

Mr. SHAY. As I say in my testimony, if it were far-reaching and did include some reduction in the corporate rate, I would tax the foreign income of U.S. companies that own a material portion of foreign subsidiaries on a current basis.

Senator CONRAD. To me, that is a very practical recommendation. Anything else? Anything more far-reaching?

Mr. SHAY. The far-reaching comment is, simply, I think competitiveness comes from us investing in Americans, educating them, allowing them to compete globally, having the smartest people in the world. So, part of where I come on this issue is, we should structure our budgets and raise the revenue necessary to accomplish that purpose. I do not think foreign income should get extraordinarily special treatment, or special treatment unless we can demonstrate it is justified. That is the short answer.

Senator CONRAD. My time has expired.

The CHAIRMAN. Yes. Does that mean no deferral?

Mr. SHAY. My recommendation is conventionally understood to refer to no deferral. That is correct.

The CHAIRMAN. All right. Thank you.

Senator Wyden?

Senator WYDEN. Mr. Chairman, thank you. It has been an excellent hearing.

Mr. Dilworth, I especially liked your comments about how the tax code is overgrown with weeds because, you look at 16,000 tax breaks since 1986, it comes to three for every working day. I think it is extraordinarily important to clean out this clutter. I think that is key to holding down rates and keeping progressivity. That is what I tried to do in my proposal, the Fair Flat Tax legislation. I think it would be very helpful if you could give us, in your view, some specific examples of tax preferences that affect the foreign operations of U.S. companies that, frankly, we would all be better off without.

Mr. DILWORTH. Well, the preferences that would make us all better off if we got rid of them would probably require first that we drop our rates. I do not think that we can start by abolishing the tax on foreign income rather than domestic income, but when I talk about the weeds, the weeds are the weeds that involve collecting information and tax on behavior that we do not actually want to discourage and in many cases have stopped collecting for more than 10 years. Much of the subpart F provision has been rendered largely inoperative by reason of various administrative law changes.

Senator WYDEN. How about preferences that favor one sort of business over another in their foreign operation?

Mr. DILWORTH. I am trying to be responsive, but I am trying to think. The way I categorize the business activities of the companies I deal with, you will occasionally have a financial services company, and they have their own set of needs because of the way they conduct business.

So there is perennially before this committee something called section 954(h), an exception from foreign-base company income. If that is viewed as a preference, I suppose that you could increase the revenue, but I do not think you would be better off necessarily by letting the provision lapse.

In the case of companies that exploit high-value intangibles, I suppose you could say, well, the transfer pricing system is broken. That is a common allegation. I am not actually persuaded that it is. Everybody talks about the Microsoft problem, but in my written testimony I refer you to the article in the same publication from some years earlier about the Xerox problem, where the transfer pricing system resulted in parking large losses in a tax haven jurisdiction.

So, if the problem is that you are worried about risk-based allocations of income among related parties and groups, then I do not know that that is a clear-cut subsidy. It is complicated. I think my own impression is that collecting tax on the basis of hypothetical arm's length transactions is enormously time-consuming. I think I refer to that in my testimony as a war of expert witnesses.

Senator WYDEN. So what would you give up to get the lower rates? I mean, that is the whole point, that at some point you have to clean out something specific. That was why I asked the question.

Mr. DILWORTH. Sir, I am going to try to stay away—

Senator WYDEN. All right. Let me see if I can get one other question in, and that deals with health care. If you look at the situation for American companies in global markets, our companies are paying more than the competition, and the competition often gets health care from the government. I think we have a pretty good example of what is at stake right now in this Boeing/Airbus debate, and you have seen many commentators say that Boeing really is up against it because it is paying a lot more for health care.

So what we have tried to do in our bipartisan health legislation—there are seven Democrats and seven Republicans on it—is to modernize the system so that employers and employees will both have more tools to hold down costs than we have with a system that, today, is not much different than it was in the 1940s.

How do you all see tax reform fitting into this debate about health care? Let us just see if we can go right down the row. Go ahead.

Prof. HINES. I think you are absolutely right that reforming health care would improve competitiveness of American businesses and probably help the American economy generally. The issue is, we are going to have to pay for it somehow. That is an opportunity to think about some fundamental issues in tax reform, because that is where the money has to come from.

So one thing that we can do, if we were to enact fundamental health reform that costs a lot of money, is to think about embracing a bigger tax that people will understand they are getting benefits for, like a value added tax that most of the rest of the world has. I think the American taxpayer will understand that they are getting high-quality health care in return for that.

Senator WYDEN. Senator Baucus is giving me extra time. I will just say, it does not have to break the bank, sir. If you look at the Congressional Budget Office's analysis of our proposal, it is revenue-neutral. It is revenue-neutral because we shift the incentives. We no longer subsidize in the tax code inefficiency and start rewarding those who hold the costs down.

Mr. Chairman, you have given me a lot of time. Can these two just answer the question?

Mr. SHAY. Well, it has not been the subject of my testimony, and I am not an expert in health care. It does seem to me, and my understanding is, the incentives currently in the code do create distortive effects that are unhelpful, and proposals that would—that should—be a part of any comprehensive health care approach need to deal with those current incentives.

My understanding is, the incentives tend to promote over-investment in health care in ways that are inefficient and drive up costs. It is very clear, and one thing that I agree with Jim on, that if we could bring down health care costs it would allow American businesses to be more competitive.

The CHAIRMAN. Let me just ask you another question with respect to the tax treatment of research and development. We want to reward research in the United States, theoretically, and we have an R&D tax credit that is designed to reward that research in the United States. But what happens to a United States company, a parent company, who jointly conducts that research in another country with a controlled foreign corporation?

As I understand it, the parent company still gets the full credit even though some of the research is conducted overseas. There may be an offsetting deduction, but the basic question is, what suggestions do you have, if any, assuming my understanding is correct, to modify the United States' research and development tax credit in a way to promote research in the United States?

Mr. SHAY. I am not sure that you actually get the credit, as such, for research performed outside the United States. I think an issue that has arisen—and I may be wrong about that—is that you can shift the results of that research to a foreign corporation, and to have the return on that research outside of the United States through cost sharing.

So, if a foreign corporation cost-shares for research that is performed in the United States, my understanding is that that research still qualifies for the credit, but the intangible that is acquired through the cost-sharing mechanism is considered owned by the controlled foreign corporation. They then take the deduction at a much lower value, but then they earn the income in a lower-tax environment.

The CHAIRMAN. So you do not think we need to consider modifying the credit?

Mr. SHAY. Well, I think the question that is raised is whether you should allow the credit when the research is paid for with the cost sharing payment from a CFC. I think that is the issue that your question is identifying.

The CHAIRMAN. Let me ask another question. This is complicated stuff, and a lot of Americans say, what in the world is going on here? I would say most members of this committee find it extremely complicated, and I do. So the real question is, is it worth our while to spend a lot of time trying to change taxation of foreign income in the United States or not? From a practitioner's point of view, it is probably maddeningly complex and difficult. A lot of members of Congress might say, well, so what? It is their profession, that is their job, their paycheck, let them work it out, and so forth.

But on the other hand, if we are losing in this country our competitive position, that is a whole different question. So I am asking you guys, all right, from an American layman's point of view, is this real, is this not real and, if it is real, from what perspective is this real?

Mr. SHAY. There are going to be different perspectives on that question, but I will give you what I think is a simple one. Taxing income is hard, as you can see. The way to think about foreign income is that we do have global businesses, they operate on a global basis. If you think of it as a bathtub and you say foreign income, you create a hole in the bathtub for foreign income.

It is not going to be surprising to you that water is going to go through that hole, and that is why addressing the taxation of foreign income and limiting the extent to which there is artificial shifting of profits outside of the United States is an important part of being sure that our overall income tax system is sound. That is the best way I can think of to characterize it.

The CHAIRMAN. Do you think the hole in the bathtub is too big?

Mr. SHAY. I am sorry?

The CHAIRMAN. The hole in the bathtub is just too big?

Mr. SHAY. Yes, that is correct.

The CHAIRMAN. That is basically what you are saying.

Mr. SHAY. Correct.

The CHAIRMAN. All right.

Mr. Dilworth?

Mr. DILWORTH. I do not.

The CHAIRMAN. You do not think so?

Mr. DILWORTH. No. The reason I do not is, I think what we are really talking about in terms of what has everybody upset is the high-value intangibles. I do not think focusing on that problem and eliminating credits and eliminating deferral just to get at high-value intangibles is the right way to go. Now, just turning to the high-value intangibles, however——

The CHAIRMAN. Well, I am asking this question with respect to American competitiveness.

Mr. DILWORTH. Yes.

The CHAIRMAN. American investments, jobs, productivity. That is the perspective I am asking this question from. That is, in order to enhance American competitiveness, investments, jobs, et cetera, to what degree is it important to make significant changes to how we treat taxation of foreign income? That is the question I am asking.

Mr. DILWORTH. Yes. My suggestion in the testimony is, let us clean up the way subpart F breaks up the foreign markets.

The CHAIRMAN. So you think it is currently broken with the effect that it hurts American competitiveness?

Mr. DILWORTH. Yes, it does because it distorts. You sort of have to figure out how to restructure your operations when you do not have a single-sale subsidiary in every country in the world, that kind of thing.

The CHAIRMAN. All right.

Mr. Hines, what do you think?

Prof. HINES. I agree with Mr. Dilworth that it is important, there are sizeable, measurable benefits from reform that are out there for

us to take if we want to enact those reforms. Think about it this way. The United States is unique right now. We uniquely, of all the countries in the world, impose heavy taxation of active foreign business income. We are the only one that does that. Why are we the only one that does it? Is it the case that 100 other countries are all wrong? No.

The CHAIRMAN. What is it? What is the reason?

Prof. HINES. The reason is, we slipped into the habit in 1962 and we have not gotten out of it yet.

The CHAIRMAN. So, do you think we should kick the habit?

Prof. HINES. I think we should kick the habit. If you do not want to kick the habit, if you want to keep our heavy taxation of foreign income, you could ask, why do we not have heavy extraterritorial excise taxes, too? Why stop at income taxes?

The CHAIRMAN. Well, because currently, if I understand, the difference between excise and income taxes, we have a deferral regime for income taxes which we do not have for excise taxes.

Prof. HINES. That is right. We could have worldwide excise taxes with deferral. I mean, it would be crazy to have a system like that. But that is the system we have for income tax.

The CHAIRMAN. But do we not have deferral in part to keep income overseas so American companies can compete overseas?

Prof. HINES. Because it is much better than not having deferral and having accrual taxes, I agree. But, as a result of the deferral regime, as other witnesses have pointed out, you have this problem of repatriation. That is, you discourage repatriation.

The CHAIRMAN. You do. Right.

Prof. HINES. There is no good reason for that.

The CHAIRMAN. This question was asked by another Senator in a different way. What is the ideal way to handle this whole subject, looking at the modern world, how companies put together deals, joint ventures? We are becoming more, if not homogenized, but a lot of these American companies morph into other countries' companies and vice versa in some respect. Everybody is looking to make a buck, as they should, to come up with new product, as they should, some new organization, partly to enhance shareholder value, and so forth.

We are still the largest—and hopefully the most influential—country in the world. So what would your suggestion as an ideal? Put aside the practicalities for a moment, and the politics for a moment. If we were to start from scratch, what would the ideal be? Sometimes I think it is important to try to figure out what the ideal would be, even though it is difficult to get there, even though it is not possible to get there.

I am thinking about Taiwan and health care. About 23 years ago, Taiwan looked around the world at all the different countries' health care systems and picked all the parts they thought were best for Taiwan, and they just built a whole new health care system basically from scratch. Now, that is health care. Health care is pretty complicated. Taxes are pretty complicated. But what is the ideal, or the direction in which the ideal would be, even though it might be difficult to get there, if the United States would lead and get some kind of a regime that makes more sense? Does anybody have a thought?

Prof. HINES. The ideal system would have three pieces to it. The first piece would be a territorial system where we tax income that is earned in the United States and not income that is earned outside. The second piece would be a better-developed set of rules for figuring out what income is earned in the U.S. and the stuff outside. Many people have expressed concern today about that, and rightly so. So, if you have a territorial system, you have to be able to determine what was actually earned inside, and we already have rules for that but we need more and better rules, and probably more resources devoted to enforcement.

The third piece is more international agreements. This is one of these things that you cannot implement by yourself. We need international agreements—tax treaties, basically—that conform to our tax system and that would do things, for example, like permit the allocation of expense deductions. If an American company incurs \$100 of expense in the United States, some of which is being used to produce income abroad, then the appropriate thing would be to allow the foreign operations of that company to get part of the deduction for that expense. We do not currently have an agreement with other countries that says that, but you asked about the ideal, and the ideal is—

The CHAIRMAN. Yes. I am asking for the ideal.

Prof. HINES. Yes. I would have a different set of international agreements to go along with the territorial system and better definition of what income—

The CHAIRMAN. So you would have a territorial system, we would have a second, better definition of what is income earned in the United States, and third, you need some treaties to address, what, basically interest allocation, or address what?

Prof. HINES. Interest and other expense allocations, transfer pricing. We already have treaties that address that.

The CHAIRMAN. All right.

Prof. HINES. And other things like that.

The CHAIRMAN. All right. Mr. Shay? Go for it. This is your—

Mr. SHAY. Well, no. I think I would agree with the latter two of Jim's points. The difference is, he would do a territorial system which would leave income untaxed if somebody can find a way to put it in a low-tax environment, and, if you get everything right, I suppose it is possible to use a territorial system.

I just do not have confidence it can be done under any realistic set of parameters, which is why I would say, lower the business tax rate and tax on a global basis, tax worldwide income and allow a credit for foreign income taxes. I hope I have not been misunderstood. I believe in the foreign tax credit. In other words, there should be a credit for foreign taxes.

But the difference is that the no-tax income that Mr. Conrad was referring to might still exist, unless we get it just right in Jim's proposal. I do not propose that we can get it just right, which is why I support my proposal, which is to tax much more broadly. I would take the comment, I think the real question of an ideal income tax system cannot be asked in the context solely of foreign income.

It is a mistake to think that, all of a sudden, you are outside the border and everything changes. It is a part of our overall U.S. tax

system. That is why I come back to the bathtub. It has to be coherent as a whole. If you have the ability to earn materially lower taxed income, U.S. income is going to become non-U.S. income because that is what we do. So, that is my overall comment.

The CHAIRMAN. Thank you.

Mr. Dilworth? I am pushing you for the ideal now.

Mr. DILWORTH. I understand.

The CHAIRMAN. I know it is hard for you to answer.

Mr. DILWORTH. Not the measured proposals I make, but the ideal. The ideal would be to abolish the corporate income tax and increase the individual tax, and quit trying to figure out the difference between partnerships, corporations, trusts, and everything else. But that is not going to happen.

The CHAIRMAN. No, no, no, no, no. I said, put aside the practicalities and the politics. I am asking for the ideal.

Mr. DILWORTH. I understand. That would be my ideal. But I would not actually go to a territorial system, and the reason I would not is, if we are going to view a domestic corporate income tax and a foreign operation—

The CHAIRMAN. You would just abolish the corporate income tax.

Mr. DILWORTH. Basically, I would. Because, if it is a collection of taxes on individuals, I would collect it from the individuals. But I do not expect anybody ever to do that.

The CHAIRMAN. Come on. That is unfair. You have to stick with my rules here.

Mr. DILWORTH. I understand. But going back to the international piece, what worries me about the territorial system is that it gets jury-rigged every time it is floated to pick up the hobby-horses of what people are worried about. So you pull out of the territorial system those things you think ought to be taxed, like U.S.-origin intangibles. Next year it will be financial services. The problem is that there is no territorial system that is stable. In its pure form it is like abolishing the corporate income tax, and you are not going to do it to the foreign, first.

The CHAIRMAN. To what degree is any of this relevant? My question is this: we are a democracy. We are a collection of hundreds of thousands of companies. We are 535 members of Congress. We react to pressures, pressures from constituents and groups that think they have a legitimate claim, and most of them do. But it is a hodgepodge. So we react to some degree to the squeaky wheel that squeaks the loudest and react somewhat on merit, sometimes on the basis of volume—that is, how loud the squawk is.

So is it relevant that we have to try to find the perfect system? Because Congress will meet tomorrow and enact legislation, theoretically addressing new needs, domestic and foreign. But as Americans, we are going to represent American companies and American individuals and so forth. The reason the code is complicated is, I think, for that reason, that Congress reacted in lots of different ways. So does it matter? The question is, irrespective of the system, will Congress—maybe a little slowly—not deal with the most important changes? So is it relevant? Is it relevant, what system we have?

Mr. DILWORTH. Yes, it is relevant.

Mr. SHAY. I think we would all agree it is relevant. One way to look at this is, once you make your decision, having an income tax base—or whatever mix if you want more consumption taxes, Jim—or a revenue-raising base is just critical for our future. We have large expenditure needs that we all know are coming down the pike that we are not paying for, so this in my view may be a small corner, but it is an important corner.

But it is part of the much bigger picture. We have to establish an income tax and excise tax. Whatever combination of tax, we have to establish a revenue system that can meet the needs of the country that are going to allow us to be competitive. We have really talked about a small element of it. It has much greater perception of importance among some groups, and that is international income.

But I encourage the committee to think about this as part of the overall tax system, and I would encourage the committee, as part of an overall tax system, to broaden the income tax base, spread the pain across a broad range of people, and lower tax rates. I thought the 1986 Act approach was basically a good approach and that gives this country flexibility to increase revenue if it is needed for war, and decrease tax rates when they are not needed. It gives us flexibility to be responsive in the international world.

The CHAIRMAN. Mr. Dilworth?

Mr. DILWORTH. I would agree with everything Steve said, up until the end. But I think the 1986 Act and the succeeding 15,000 amendments suggest that base-broadening and rate-reduction are promptly followed by rate increases, and at that point we do not have a stable tax system. I would prefer to have a stable international system that the population thinks is paying its way. Business needs stability.

The CHAIRMAN. Yes. All right. This has been very, very helpful. Clearly, we are just getting started. But thank you very much for your time and indulgence. I think we will have many future discussions. Thank you very much.

The hearing is adjourned.

[Whereupon, at 11:27 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

STATEMENT FOR SENATOR BUNNING SENATE COMMITTEE ON FINANCE “The Foundation of International Tax Reform: Worldwide, Territorial, and Something in Between” June 26, 2008

Thank you, Mr. Chairman.

The corporate and international tax system we have was designed in a different era, for a different economy. At that time, the largest corporations in the world were headquartered here in America, and tax writers confidently predicted that would forever remain the case.

That changed, long ago. Now the more than half of the world’s 50 largest companies are headquartered outside the United States, and because of a low savings rate here in America, our economic growth and our future standard of living depends as never before on the willingness of foreigners to invest here and the ability of domestic American firms to sell products and services around the globe.

We need to restructure the tax system we have to make U.S. businesses more competitive internationally and to make the United States an attractive place to locate for a global business. If we do not, more of our major firms will be acquired by foreign firms that operate far more efficiently from a tax point of view.

The United States has among the highest corporate tax rate in the world, but not every industry is fully burdened with it. Some industries, like financial services fare better than heavy industries. This distorts economic decision making. Manufacturing industries have a lower tax rate for domestic production, but the final rate is still high and uncompetitive compared to the prevailing rate in the fastest growing economies, like China and Ireland.

We also have a worldwide tax system. We need to consider whether a territorial system or changes that takes us closer to territoriality, would work better for us in the long run.

At our last hearing, several of the witnesses discussed new research that suggests that the burden of the corporate income tax—in a global economy where capital moves freely—increasingly is falling on US workers, and that it translates directly into lower wages. Recent econometric studies show that 70 percent or more of the corporate income tax is borne by labor not by the owners of capital. We need to adjust how we look at the distributional effect of changes to the corporate income tax, because of this new understanding.

I look forward to the witnesses’ testimony today, and I thank the Chairman for holding this important hearing.

Statement of Robert H. Dilworth

Hearing of the Senate Finance Committee

“The Foundation Of International Tax Reform: Worldwide, Territorial, And Something In Between”

June 26, 2008

International Tax Reform And Some Proposals To Consider

Chairman Baucus, Senator Grassley, members of the Senate Finance Committee, thank you for inviting me to speak to you today. The issues you have before you are important to me, but are probably more important to my children and grandchildren.

I. Main Street MNC Tax Adviser

I have practiced law for more than 40 years. I have been with two law firms, a Big 4 accounting firm and, for about a year and a half in 2005-2007, the Treasury Department. During that time I have practiced in the Midwest, on the West and East Coasts and, for nearly two years, in Taiwan. The views I will express are my own. They do not represent the views of the Treasury Department or of any of the law or accounting firms with which I have been associated during my career. My experiences during my tenure with those organizations, and during my time in those jurisdictions, have, of course, shaped my views.

My vantage point has been primarily that of an adviser to Main Street MNCs¹ rather than that of an adviser to Wall Street, or of an academic or a public finance economist. The view from each vantage point is different and perhaps we can together provide a collection of observations that will do some good and will minimize the harm any of one of us might cause if only the view from one vantage point were to be considered.

The proposals discussed in this statement are intended to be incremental responses to perceived problems. In the eyes of some participants in the debate, some of the proposals might seem to be more than incremental. Nevertheless, terms like “fundamental” should be reserved for changes of a different order of magnitude, such as adopting a value added tax (either in place of or in addition to the corporate income tax or the individual income tax). The issues and proposals I will discuss all assume that the United States will continue to have a corporate income tax on which we will rely for a material portion of the funding of our federal government functions. If we do add a VAT, these comments will apply to the retained corporate income tax component.

¹ A corporation with businesses conducted through subsidiaries, joint ventures and branches in more than one country.

Tax policy dealing with income from cross border trade and investment has been driven in great part by a concern that the timing and amount of U.S. taxes on foreign source income may have an important impact on business investment location decisions. Revenue needs and “fairness” are also mentioned, but usually as secondary considerations compared to the assumed economic incentives taxes “must” provide to invest within or without the United States. Some seem to think that the deferral of residual federal taxes on foreign subsidiary earnings contributes greatly to the export of jobs rather than products. I do not share that opinion.

As will be evident from my discussion, I am persuaded that the investment location argument is more ideological than empirical, whether advanced by the felt “need” to end deferral in the hope that this will bring jobs back to America (or at least keep them here) or advanced by those who assert the “need” to exempt some or all foreign source income in order for American business to survive in the new global economy. From my vantage point, ending deferral will not bring jobs back, nor will exempting foreign income usher in a golden age for American business in the global economy in which expanding foreign business will generate lots of good domestic jobs.

Instead, I see a terrain that is overgrown with weeds. A lot of good could be done if the weeds were cleaned up, but the clean up will not be a substitute for enhancing more important components of competitiveness or even of tax competitiveness. I believe that the tax burden on domestic business income is more important to tax competitiveness than the timing of U.S. residual tax on foreign subsidiary earnings. An educated workforce is far more important than tax competitiveness.

II. The Simplifying Phrases: Competitiveness, Subsidies for Foreign Investment, Fairness, the Race to the Bottom

The tax reform discussion about cross border trade and investment frequently uses one liners and even single words that seek to make the correct system self-evident. Such words and phrases include “competitiveness,” “subsidies,” “fairness” and “the race to the bottom.” Everyone wants “our” side to be competitive against the other side; no one wants to subsidize the loss of jobs in America; everyone wants to be fair. A race to the bottom sounds like a pretty nefarious thing.²

Competitiveness. President Bush tasked the Advisory Panel on Federal Tax Reform with suggesting revenue-neutral means to achieve various goals, including enhanced “competitiveness” of U.S. business. In December 2007 the Treasury Department issued its own report, “Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century.”

One of the problems in pursuing “competitiveness” is that the various potential competitors are not always differentiated from each other. Who is competing with whom? Do we wish to protect Dell Austin (or its employees) from location preferences enjoyed by Dell Ireland?

² A concern about the U.S. contribution to the race, in the form of the 1996 check the box rules, has been discussed in Rosanne Altshuler and Harry Grubert, “Governments and Multinational Corporations in the Race to the Bottom” Tax Notes 979 (February 27, 2006).

Do we instead think we should protect Dell Ireland against unfair tax advantages enjoyed by Lenovo Ireland? What about Lenovo China?

Taxes are a burden on business. Taxes on “our” businesses but not on “their” businesses are anti-competitive for our businesses. If we define our businesses to stop at the water’s edge, we will only want to make Dell Austin competitive with Dell Ireland and we can let Dell do the best they can against Lenovo China or Lenovo Ireland in overcoming the impact of residual U.S. tax on Dell but not on Lenovo.

Assuming the residual U.S. tax exposure is important enough to affect competitiveness, and if “our” businesses compete in a global economy-one in which Dell Austin’s U.S. payroll may actually increase if Dell Ireland is successful against Lenovo-we want to minimize the U.S. tax impact on Dell Ireland. And we also want Lenovo U.S. to remain a productive contributor to the U.S. economy.

We could improve competitiveness of both Dell Ireland and Dell Austin by eliminating all U.S. corporate income tax, but that is not on the table. So a balance must be struck between the benefits and burdens of each alternative. The more specific we can be about the benefits or burdens, the better off we will be.

In arguing for competitiveness, supporters assert that the tax burden on U.S. MNCs operating abroad should not be higher than the “local” taxes borne by the local competitors. In arguing against this version of competitiveness, supporters of a comprehensive end of deferral argue that U.S. MNC foreign investment is “subsidized” by the deferral of U.S. tax on undistributed earnings. The discounted present value of the deferred tax is asserted to be sufficient to be a significant contributor to the export of jobs from the U.S. to foreign countries.

Subsidies, Fairness and Race to the Bottom. These topics are addressed below.

III. The Basic Variables in Taxing Foreign Source Business Income: Time of Recognition and the Foreign Tax Credit

The two most basic components of the current federal regime for taxing U.S. MNC income from cross border trade and investment are:

(1) The provisions in Subpart F that tax a U.S. shareholder on *some* undistributed business income of a related foreign corporation before distribution to the shareholder, while the other undistributed income of the same or other related foreign corporations is not taxed to the U.S. shareholders until distributed, and

(2) The foreign tax credit that allows a U.S. taxpayer to offset U.S. federal income tax otherwise due by foreign income taxes on some or all of the U.S. taxpayer’s foreign source income in the same grouping of foreign source income.

A. Time of Recognition (“Deferral”)

Deferral is at the center of a debate that has been underway for at least 50 years. Deferral means recognizing some foreign subsidiary income only when actually distributed to the U.S.

shareholder. Completely ending deferral was suggested at least as long ago as 1961 after U.S. business had earlier proposed a broad territorial exemption system in 1955.

The debate over territoriality, ending deferral and business location impact has resumed in earnest since the issuance in 2005 of the JCT Options Report³ and the President's Advisory Panel Report⁴ advocating a "dividend exemption" system. In October 2007 Chairman of the Ways and Means Committee Rangel offered a variation on the dividend exemption system based on expense deferral (rather than disallowance as under the dividend exemption proposals) tied to deferred income.⁵

The debate is generally about ending deferral. That dividend exemption approach is generally referred to as a version of a territorial exemption system. The term "territorial" is very elastic and some proponents may not see it as a mechanism to end deferral. In important respects it is an end-deferral system because foreign source income would be either currently taxed or permanently exempt.

The current stated objectives for ending deferral are a collection of "original intent" purposes and a few newer purposes. Among the objectives described by proponents of ending deferral are: (1) Eliminate the effect of an asserted U.S. tax subsidy incentive to establish businesses in foreign countries rather than in the United States, (2) Protect progressive taxation of those Americans better able to pay for government, (3) End U.S. tax disincentives to repatriation of foreign subsidiary earnings, (4) Raise federal tax revenues, and, more recently, (5) Avoid a race to the bottom of the members of the community of industrialized (welfare⁶) states. The race-to-the-bottom argument is that if one country allows base erosion, there will be an unfair flow of business investment capital into that country and the rest of the (welfare state) community will follow suit. The tax base will be eroded across the developed world, and inevitably government services and transfer payments will have to be downsized.

The several objectives of ending deferral are worth examining more closely to see if something less drastic might be appropriate.

1. Discounted Present Value of Deferred Tax as a Subsidy to Encourage Inefficient Foreign Investment

Deferral of tax on foreign subsidiary earnings is supposed to be a "subsidy" that encourages U.S. MNCs to make foreign direct investment (of the job-producing sort) instead of domestic investment. The deferral of tax is characterized as an interest-free "loan" of the amount of residual U.S. tax "deferred."

³ The STAFF OF THE JOINT COMMITTEE ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, JCS-02-05 (January 27, 2005) (the "JCT Options Report").

⁴ The November 1, 2005, President's Advisory Panel report (the "Panel Report").

⁵ The Rangel Bill would also dramatically curtail use of a foreign tax credit to offset U.S. tax on one or another piece of the income from foreign operations.

⁶ See Reuven S. Avi-Yonah, "Globalization, Tax Competition and the Fiscal Crisis of the Welfare State," 113 Harv. L. Rev. 1573 (May 2000).

The hypothetical “loan” is the present value of the U.S. tax that will be collected later. That deferred tax amount can be deconstructed further into three categories. First, there is the future U.S. tax on income generated by the foreign corporation at an ordinary rate of return on U.S. deductible expenses incurred by the U.S. shareholder to make or carry the investment in the foreign corporation that produce the income. Second, there is future U.S. tax on the incremental return on the invested amount, which is income attributable to risks assumed by the business to generate more than an ordinary rate of return. Third, there is a future tax on extraordinary income, such as income from unique intangible property. Not all taxpayers have all three kinds of income, but to stay in business the taxpayer has to generate at least some of the first category and something in the second category.

It is useful to break down the “subsidy” components because it helps to understand that the subsidy effect attributable to the ordinary rate of return on U.S. shareholder expenses can be dealt with without resort to the more drastic expedient of completely ending deferral (with the associated collateral damage to U.S. MNCs trying to operate in a global economy). If the U.S. shareholder loses the benefit of a deduction it would otherwise take for an expense incurred to produce tax deferred foreign income, the present value of that loss will be the same as ending deferral on the income of the related foreign corporation up to the amount of the ordinary return on such otherwise deductible expense.

The proponents of a complete end to deferral must believe that the collateral damage to the conduct of international business by U.S. MNCs is a price worth paying in order to achieve the other goals. If that other goal is changing investment location decisions to bring business investment back to the United States, I think they are misinformed.

I have never actually met a businessman (or even a tax executive) who was actually involved in decision-making about the tax issues of where to locate a business (that actually employed people) who would agree that his MNC employer acted to invest somewhere because of an interest-free loan of residual U.S. corporate tax if the company invested in a foreign country rather than the United States. Businesses follow customers, efficient delivery of materials and productive work forces to such an extent that tax incentives are often just an afterthought.

Efforts to strip earnings from the tax base in a high tax jurisdiction are certainly pursued vigorously, but not for the purpose of making a high tax jurisdiction a more attractive location for direct business investment. The reduction in tax is pursued as a cost-reduction goal for the purpose of retaining for the business enterprise more of the fruits of business activity. That retained income will then be spent on a wide range of corporate purposes, including lower prices to customers, higher wages to employees, distribution to shareholders, new plant and equipment, or whatever. The main goal of a U.S. MNC’s tax management in seeking tax reduction is more likely to be based on improved financial statement presentation of earnings per share rather than reducing the actual cost of capital by a few basis points. The point is only that the investment-location effect relied upon as an explanation for why we need to end deferral is simply not understood by those whose behavior is supposed to be driven by this consideration.

Similarly, a low tax jurisdiction may be more attractive if its effective rate of tax on business activity is lower than if the tax burden is higher. But job-producing investments go to locations with productive labor forces or customers or other key components of actually running a profitable business. I practiced for a time in Taiwan, the place where pioneer industry tax incentives were supposedly invented. I had great difficulty getting U.S. or foreign MNCs interested in listening to a discussion of the available tax holidays until after a discussion of import and export restrictions, exchange controls, exposure of the parent company and its executives to claims by suppliers or customers, protection of intellectual property, counterfeiting, and other real risks, costs and benefits to the actual business. Tax holidays only make a difference if a business actually makes money. Actually making money is the big driver in investment location decisions. On average the totality of all U.S. MNCs may make money, but each MNC cannot count on being in that average number unless individually they respect business fundamentals, and even then success can be pretty "iffy."

Even if the subsidy assertion is true in some amount for some quantum of U.S. MNCs (no doubt, other people's clients) the investment location incentives of the tax deferral subsidy have often been exaggerated by using examples that ignore available foreign tax credits that would make the amount of the subsidy much smaller, even assuming some U.S. MNCs actually were to run the present value calculations.

The basic factual assumption used to explain the way ending deferral achieves one or more of these goals is to imagine a wholly-owned subsidiary doing business in a single low tax country. "Mobile Income" (a bad thing to be taxed as soon as possible in order to keep it from being generated) includes cross border sales income and cross border group finance income. Such cross border activities may have been a bad thing in 1961, but if we wish to discourage in 2008 multinational production, multinational sales and multinational group finance, we are really telling ourselves that we do not want our companies to be players in the global markets as configured in 2008. Multi-jurisdictional business is now conducted in a global marketplace with very rapid communication, trade blocs like the EU and NAFTA and consumer markets served by integrated marketing activities rather than in self-contained bubbles under a separate national flag for each bubble.

2. Progressive Taxation

The 2006 ABA Task Force on International Tax Reform report asserted in one part that ending deferral is also necessary in order to preserve "fairness" (progressive taxation). This beneficial effect seems to be based on a two-fold assumption. First, that the corporate income tax is borne by shareholders (the wealthier among us). I gather that assumption is the subject of vigorous inquiry among economists as to whether some of the tax burden is also borne by labor, customers and suppliers. For my purposes, I can simply assume that at least some important part of the corporate income tax is borne by shareholders.

I am concerned about the strength of the second assumption: that the shareholders of U.S. MNCs are overwhelmingly *U.S.* portfolio investors, and that any odd foreign portfolio investors in U.S. MNCs are indifferent to different levels of corporate income tax on otherwise similar *foreign* MNCs. The ABA Task Force Report asserted that the vast preponderance of portfolio investment is by investors resident in the country of incorporation of the MNC. The assertion

seems to be potentially at odds with recent reports by the Congressional Research Service that indicate that a rather large (and increasing) portion of the portfolio capital stock in the U.S. belongs to foreign portfolio equity investors.⁷

Before launching a comprehensive end of deferral, some quality time should be spent getting something better than anecdotal speculation about who owns U.S. MNCs and how sensitive those owners might be to differences in worldwide taxation of undistributed income of foreign subsidiaries. If it would make a difference, we will then need to determine whether we care. Again, it is a question of balance, but we do not seem to have enough information to strike a balance.

3. Disincentive to Repatriation

This argument seems to be that the prospect of taxation on “repatriation” may impel a U.S. MNC to make inefficient foreign investment of the deferred earnings rather than an otherwise equal or superior domestic direct investment. Ending deferral to solve this problem is entirely disproportionate to the problem.

The term “repatriation” can include a wide range of actions. The most obvious meaning would be a real dividend distribution. The taxable repatriation established by the Revenue Act of 1962⁸ encompasses far more than transactions like a dividend or return on investment to the shareholders. Indeed. At first it applied a sort of three-mile-limit test to the acquisition of assets in the United States (those assets were presumed to be unnecessary to the conduct of whatever legitimate non-avoidance business might be going on abroad). In 1976 the Congress created an exception to the deemed taxable event to permit portfolio investment in unrelated party assets, and discovered that the real purpose of the provision was to reach “effective repatriation.” That exception was to accommodate a perceived problem under the statute: it penalized actions we wanted to encourage.

The United States is the only country I know of that has a specific *anti-repatriation* provision *intended to prevent investment in residence-country property*. If additional U.S. direct investment by related foreign corporations is something we actually want to permit, and not to discourage or penalize, it would be a relatively simple step to amend section 956 to permit the establishment of branches or subsidiaries by the related foreign corporations. Section 956 has been amended in the past to permit U.S. investments by such companies in categories of United States property that the Congress decided were worth encouraging or at least not penalizing.

That would still leave a tax on dividend-like repatriation as distinguished from productive business investment repatriation. If we think the problem is stock buy backs, we should aim at that problem rather than just set off a cluster bomb that will have additional unintended side effects. If indeed repatriation disincentives are what we are worried about.

⁷ Donald J. Marples, “U.S. Taxation of Overseas Investment and Income: Background and Issues,” Congressional Research Service (May 21, 2008).

⁸ Section 956. Investment of Earnings in United States Property.

The Committee may find it useful to inquire into the effect (if any) of certain generally accepted accounting principles (GAAP) on repatriation. A brief summary of the interaction of FAS 94 and FAS 109 (particularly APB 23) is attached as Attachment 1. A discussion of the effect of GAAP accounting is beyond the scope of my remarks today, and CPAs will probably point out that GAAP accounting is beyond my core competence as well, but clearly GAAP treatment of residual U.S. taxes on undistributed earnings, together with the current inclusion of earnings without regard to reinvestment intentions, has a significant impact on earnings per share, and earnings per share can have a significant impact on behavior of publicly traded companies. This Committee should discuss the topic with someone who is competent to discuss the mysteries of GAAP and its investment location impact, if any.

4. Raising Federal Tax Revenue

If the justification is to raise taxes on business in order to pay for something we cannot otherwise now afford, a reality check that ought to be done is to test our confidence level that taxpayer behavior modification will not erode the intended increase in tax. In testing the assumption, it would be useful to try to determine (speculate) whether the non-U.S. business income will in any significant amount shift to foreign MNCs engaged in essentially the same businesses but that do not have a comparable exposure to accelerated collection of residual tax on undistributed income.

Another element to look at is whether portfolio capital will be induced to redeployment in foreign MNCs rather than in U.S. MNCs. The conventional wisdom has been that the "home bias" is so strong that portfolio investment is likely to be insensitive to such subtleties as the effect on after-tax earnings per share of worldwide accelerated tax vs. deferral of tax, but it would be worth a "just-in-case" check.

5. Race to the Bottom

The United States has for 40 plus years been the leader in the race to tax undistributed income and to discourage investment of foreign earnings in the home country. It is probably safe to assume that the United States is in no danger of leading the race to the bottom. My guess is that the Germans, the French, the Japanese and the rest of the OECD can take care of themselves.

If some sort of concerted action might make sense, unilateral U.S. efforts do not. We do not need to act unilaterally for the purpose of inspiring a race to the top.

B. Foreign Tax Credit ("Cross Crediting" vs. "Credit Averaging")

The second component of the core regime is the foreign tax credit. The foreign tax credit is intended to avoid double taxation (or multiple taxation) of the same income by, on the one hand, foreign governments having sufficient nexus to foreign income that they can tax it, and the United States, on the other, as the taxing jurisdiction in which the taxpayer resides. The debate about "cross crediting" results from different mental models of what is being taxed by foreign governments and whether the tax base in the United States should be reduced in whole or in part by foreign taxes.

Those who think the big problem is “cross crediting” appear to have in mind a mental model in which a single U.S. MNC has two entirely distinct businesses, one business taxed at a high rate by the only foreign country with taxing jurisdiction over that business, and the other business taxed at a low rate (or zero rate) by another foreign country with exclusive taxing jurisdiction. They see U.S. tax on low tax foreign source income offset by high unrelated foreign taxes on unrelated foreign business. Worse yet, they often see royalties received by a U.S. MNC for U.S.-developed intangible property “wrongly” treated by the Internal Revenue Code as *foreign* source. U.S. taxes otherwise due on income from U.S. value added to the intangible property can be offset by the unrelated high foreign taxes paid by the U.S. MNC.

Those who see “credit-averaging” instead of cross-crediting see a very different world. They see a global economy in which integrated businesses are conducted in or from multiple locations in many countries. For those observers the stream of income from related and integrated businesses will be exposed to tax bites in various countries that have sufficient nexus to tax some piece of the income stream. Some of the pieces of income will, from a U.S. federal tax vantage point, be subject to a high rate of foreign income tax and some to a low rate of foreign income tax. But at the end of the day there will be an aggregate amount of foreign income taxes imposed by a collection of foreign taxing jurisdictions on an aggregate amount of income from *related* foreign business.

Tax reform will be heavily influenced by the business model that tax policy makers have in mind when they try to achieve efficiency, fairness and competitiveness. No doubt there are still examples of single country businesses along the lines of what Secretary Dillon (or his Assistant Secretary for Tax Policy, Stanley Surrey) had in mind in 1961. But those examples are not particularly coincident with the business model for much of the business activity in the global economy in 2008. At least from my vantage point.

C. Careful Reform Should Accommodate the Common Global Business Model

My views tend to lie in between the book ends of those who advocate a complete end to deferral and severe curtailment of the foreign tax credit, and those who assert that American business is in serious jeopardy if broad territoriality is not enacted.

Problems that taxwriters agree need to be fixed should be fixed. Overhauling the whole international tax system just because more than 40 years have passed since 1962 would be imprudent. The relevant important changes in the world need to be agreed upon, and, if those changes indicate that the basic system is not working in some particular respect or another, that problem should be fixed.

Thus, if as some believe, there is something seriously wrong with the accumulation of income from high value U.S.-origin intangibles in a low tax country, we should address the problem in a way that minimizes collateral damage to the rest of the international business conducted by U.S. MNCs. We should not eliminate all cross crediting just to get at that problem. We should not end deferral to get at capturing income from U.S. IP in low tax countries.

It is not self-evident that generating risk-based income from IP in Ireland is bad. I sometimes wonder if the “Microsoft” Irish IP earnings problem⁹ would be as alarming if it were considered in conjunction with the “Xerox” Irish IP loss problem.¹⁰ The same basic activity led to a large loss in Xerox Ireland but to a large earnings accumulation for Microsoft. That is the nature of risk-based income allocations.

If, however, tax policy makers end up agreeing that the risk of allowing U.S.-origin IP to generate low tax income is a problem that must be solved, it might be worthwhile to address just the question of income from foreign ownership of U.S.-origin IP. My point is that overbroad sweeping changes may do much unnecessary damage to U.S. MNCs that are not conducting whatever business it is that is objectionable to tax policy makers.

I have grave concerns about the lack of information we seem to have on important aspects of the discussion. The areas about which we seem to know less than we should include (1) the present and anticipated extent of joint ventures between MNCs from more than one country, and (2) the effect of ending deferral and of limiting the foreign tax credit for U.S. MNCs upon their ability to retain existing and to attract new foreign portfolio investment capital. Pending development of reliable data on the impact of tax reform on these important issues, I recommend that we be cautious rather than adventurous in overturning the core elements of the present structure.

I also think stability in the tax environment is a useful characteristic. Again, this is another reason to fix only that which it is clearly broken (in the view of a working majority). Just being 40 years old is not a definition of “broken.” It might be interesting to this committee to consider the table in Attachment 2 that summarizes the asymmetry (and some symmetry) of the 2005 proposals with the state of the tax system following the 2004 AJCA.

I am among those who see a global economy whose participants are multinational business enterprises with operations and shareholders in many countries. Some are “U.S.” and some are “foreign.” But all those enterprises depend on debt and equity capital drawn from portfolio investment pools in many countries, not just the one country in which they happen to be incorporated or the one country in which a corporation may do business.

I also see businesses that are often conducted as joint ventures among direct investors (MNCs) from more than one country.

I am worried that intellectual capital may be mobile, more mobile than it was when I first began to practice and the IP revolution was about to be fueled by venture capitalists in Silicon Valley and Route 128.

⁹ Glen R. Simpson, “*Irish Unit Lets Microsoft Cut Taxes in U.S., Europe*,” Wall Street Journal, November 7, 2005.

¹⁰ James Bundler and Mark Maremont, “*How a Xerox Plan to Reduce Taxes and Boost Profit Backfired*,” Wall Street Journal (April 17, 2001).

IV. Pending Tax Reform Proposals: Dividend-Exemption as a “Solution” to the “Problems” of Deferral and Cross Crediting

In 2005 the Staff of the Joint Committee on Taxation and the President’s Advisory Panel on Federal Tax Reform each proposed a reform in the taxation of foreign source income. Although given quite different mandates, the recommendation of each group was a virtually identical “dividend exemption” system of taxing income from foreign direct investment.

More recently, Charles Rangel, Chairman of the Ways and Means Committee, has proposed a variation on the dividend exemption system. Under Chairman Rangel’s proposal, deductions for expenses allocated to deferred income of foreign affiliates would be deferred until the associated deferred income is taken into account. As discussed below this is essentially comparable to a partial end of deferral.

The two dividend-exemption proposals basically tweak the deferral and foreign tax credit variables. Income can be moved into or out of the exempt-income pool, foreign tax credits likely to be associated with high-taxed income can be left in the exempt pool (and thereby disallowed as offsets against U.S. tax on low taxed income) and expenses can be made nondeductible or deductible by adopting different simplifying conventions about how to associate expenses with income. Labels can be assigned that fit the advocated end result: “good” foreign business income (exempt) can be labeled “active business income” while bad foreign business income can be labeled “mobile income” (taxable). Ongoing adjustments can then be made by moving income into or out of an exempt pool or by adjusting the amount of tracing to determine the amount of nondeductible expenses attributable to exempt foreign income. In many ways, however, the proposals are quite similar to a partial end of deferral across the board and a wholesale carve back on the foreign tax credit.

The similarity to ending deferral lies in the expense allocation feature which, as noted above can be economically equivalent to ending deferral on the financial rate of return of deductible amounts incurred to make or carry the investment in a foreign subsidiary, coupled with retaining the existing anti-deferral provisions for subpart F foreign base company income (now “Mobile Income”). The broad carve back on the foreign tax credit results from the separation of business income into likely high-taxed and likely low taxed elements, and then disallowing “cross crediting” because the high taxed piece is exempt.

It is a question of balance. Is the problem that we want to solve by the restructured tax regime worth the foreseeable damage that may be caused by the change?

In my view, the dividend exemption proposals made by the President’s Advisory Panel and by the JCT should not be pursued.

V. So What Should Be Done (If Anything)?

A. Retain Existing Core Architecture

Federal income tax should be imposed on all business income, domestic or foreign, derived by businesses that have a prescribed minimum nexus with the United States. A foreign tax credit should continue to be allowed for foreign taxes on all foreign business income.

The United States should not extend a permanent territorial exemption to any U.S. shareholder's share of any income derived by a foreign corporation or business. All return on capital investment should be eventually taxable in the hands of the U.S. taxpayer investor, no later than upon actual or constructive receipt determined under general U.S. tax principles.

Business taxable income from foreign subsidiary operations, or joint ventures, should be determined under general U.S. tax accrual principles. Income should be taxed on a realized basis rather than earlier when the income may be only an undistributed estimated accretion to wealth, such as undistributed corporate earnings. Undistributed portfolio investment income (foreign personal holding company income) should, however, continue to be taxed to the U.S. shareholder of a controlled foreign corporation. A reasonable allowance for income on working capital should be excluded from treatment as portfolio foreign personal holding company income. With that limited exception for financial business income of a nonfinancial MNC, federal income tax on portfolio investment income should not be reduced by foreign income taxes on foreign business income.

A U.S. shareholder would be, as under present law, defined as the owner of a 10 percent or greater interest.

B. Repeal of Foreign Base Company Provisions Taxing "Mobile Income"

1. Repeal Related Party Base Erosion Components of Subpart F ("Mobile Income")

a. The Goals of Repeal

As enacted in 1962, Subpart F was intended to reach targeted base erosion activities that would permit an enterprise in a high tax jurisdiction (e.g., Germany) to lower its effective rate compared to a domestic enterprise in, say, Tennessee. The machinery was originally proposed to achieve what some refer to "capital export neutrality" but, as enacted, was limited to related party base erosion income. In the more recent past, Subpart F's base erosion provisions have been characterized as a tool to limit harmful tax competition and the resulting race to the bottom.

In my view, particularly if some elements of foreign-related expense deferral were to be adopted, the distortion in normal business practices that can result from applying Subpart F base erosion provisions could be eliminated without unacceptable cost to the fisc (or "subsidy" to a U.S. MNC). At present, before taking into account the temporary look through provisions and the self help activities based on the check-the-box regulations, Subpart F is supposed to discourage multi-jurisdiction group finance and multi-jurisdiction manufacture and sale. If it ever made sense to do discourage such activity, it does not make sense now.

It can be argued, of course, that the combination of the IRS' "check-the-box" rules (and particularly the "disregarded entity" portion thereof) and taxpayer ingenuity in dealing with base erosion arrangements make this proposal only a simplification rather than a substantive change. While that may be true in the short run, in the long run we should, and probably will, decide the deferral issue based on business activities rather than such things as "tax nothings."

The purpose of this proposal is to achieve at least four goals:

1. Accommodate the normal business model of participants in the global economy. That model is business conducted across national borders rather than in hermetically sealed national bubbles.
2. Accommodate the emergence of regional trade areas such as the European Union or the North American Free Trade Area in which goods manufactured in one country are supposed to move efficiently to other countries throughout the free trade area.
3. Facilitate U.S. MNC participation in joint ventures with non-U.S. MNCs. Joint ventures are made more difficult if one party is subject to tax pressure to distribute while the other is not. While expense allocation and deferral will have this effect, it will be possible for higher risk/higher return activities to be conducted without tax pressure to distribute premium returns.
4. Simplify the compliance burden imposed on Main Street in keeping track of previously taxed undistributed earnings with the need to make continuing adjustments for currency fluctuation, future losses, hedging gains or losses associated with inventories and anticipated inventories, . . .

This may be a contentious issue. The core premise, that existing U.S. tax policy embedded in deferral provides an incentive to invest abroad rather than in the United States, is an appealing explanation for why jobs have been lost. U.S. tax policy is something we can control. The assertion need not be correct in order to resonate with people worried about loss of jobs. In my experience, however, it has not in fact had much to do with why companies invest in the U.S. or in another country. If we take action to penalize the business sector for participating in the global economy, and the jobs do not come home, we will be worse off.

Expense allocations (such as discussed below) are also complicated, but they can be made simpler than the inherent complexity of taxing undistributed income and then adjusting the "previously taxed income" to reflect the effect of inevitable change in the amount taxed before it was actually realized. Allocated expenses can be based on the books and records of the U.S. taxpayer. Many taxpayers are already applying such provisions in order to apply the foreign tax credit limitations. Such an approach only makes sense, however, as a follow on to repealing the foreign base company sales and foreign base company services provisions, and the business income portions of foreign personal holding company provisions.

b. Foreign Base Company Sales Income

Repealing the foreign base company sales provisions would be an important step toward adjusting the U.S. tax system to the way normal business is conducted. It may be that the proponents of ending deferral have in mind a different business model than I do.

The prototypical example given to explain the merits of ending deferral is the low tax distribution affiliate that purchases from a manufacturing affiliate in a high tax country and resells the product in a country other than the place of incorporation of the distribution company or the place of manufacture. Before the creation of the EU successfully broke down many trade barriers in Europe, the normal business model might have been to set up a separate sales company in each destination country (a "good" way to do business under Subpart F). Today, the far more common structure would be to have a distribution affiliate in one or two EU countries that will sell throughout the EU. The notion that this common distribution model has been constructed to make high tax manufacturing in the EU more attractive than U.S. manufacture is at best a quaint echo of an academic hypothesis in 1961.

If a U.S. MNC has a German manufacturing subsidiary with an Irish distribution subsidiary and customers throughout the EU, then under subpart F the Irish subsidiary's income will be subject to current U.S. tax. If, instead, the German manufacturing subsidiary sells directly to customers throughout the EU, the income will not be subject to U.S. tax. And if the German manufacturing operation moves to Ireland, sales throughout the EU will not be subject to tax. Why? What is the U.S. interest in busting up normal business distribution practices? If Germany is not concerned about income earned by the Irish affiliate, why should the United States intervene to discourage Irish distribution affiliates? Indeed, Germany and Ireland have actually agreed with each other to work toward greater commercial and investment integration of their economies. It seems pointless to impose a U.S. tax on the distribution income in order to discourage that behavior (behavior modification is, after all, the core objective the foreign base company provisions).

In addition to EU destination sales, the Irish distribution company may also supply customers in other non-EU European countries, Asia and the Middle East. Again, there seems to be no point in trying to force the U.S. MNC to set up a local distribution subsidiary in each country into which it would sell. Again, the original premise of the anti-base erosion provisions dealing with multi-country sales was that they were inherently mobile and it was easy to base erode the *real* value-producer in the process: the manufacturer.

In the current environment, however, the fully integrated manufacturer model is not the exclusive means to produce products. Unrelated parties routinely produce the tangible property for unrelated parties who have provide intangible property (specifications) and selling services to the complete business activity. U.S. MNCs should not be discouraged from using related parties to do some parts of the overall process with related parties in different countries. There seems no sensible tax policy to require that there be only unrelated parties at each stage in the supply chain production and sale. Again, if the original model was correct in 1961, it is at least questionable in 2008.

c. Foreign Personal Holding Company Income from Related Parties and Working Capital Risk Management

Section 954(c)(6) has been in place for about two years and is scheduled to expire this year. It should be enacted permanently. It allows a U.S. MNC group to manage its working capital and long term investment capital in a normal way.

In addition, reasonable exceptions from even portfolio foreign personal holding company income (generally taxable currently to the U.S. shareholder) should be provided for hedging currency, interest rate and commodity risk, and for interest derived on working capital .

It seems to have been relatively easy to garner recurring support for an extender to accommodate the real world business needs of financial institutions: extend the life of Section 954(h). The real world needs of non-financial corporations to manage their financial assets, financial liabilities, interest rate risk and currency risk are no less real and ordinary. Why is it that industrial company management of those exposures should be penalized by subjecting them to U.S. tax before distribution? Simple revenue gain was not the goal in the beginning; the goal was behavior modification: Surely we do not think that U.S. MNCs should not have interest bearing assets or currency gains or losses. That view of U.S. MNCs (unencumbered by financial assets and liabilities), if ever correct, is out of touch with running a normal business in the global economy.

If deductions for U.S. expenses incurred to carry the U.S. MNCs investment in producing foreign-related income are no greater than the associated income that is taken into the U.S. tax base, there is no significant subsidy left – the financial rate of return on the financial assets should be equal to the implied cost of carrying the nondeductible expense. The financial asset will have an incremental deferral benefit only to the extent it is attributable to equity invested in the foreign subsidiary plus any retained earnings of the foreign subsidiary. This is simply not a large enough tax “subsidy” to warrant penalizing the normal management of group financial assets on a multi-jurisdictional basis.

C. Limiting Deduction for Aggregate Foreign-Related Expenses to Aggregate Foreign-Related Income

If tax policy makers conclude that foreign business activities should not benefit from deductions against domestic income, until foreign income is at least equal to the expenses incurred to produce it, that could be achieved by targeting the problem.¹¹ Under such an approach, a grouping principle could be developed: aggregate foreign-related expenses would be limited to the aggregate amount of foreign-related income for the year. The residual U.S. tax on deferred foreign related income would be deferred, but, in the aggregate, foreign related expenses would be paid for by foreign related income.

¹¹ It is not a universally agreed upon “problem.”

1. The basic methodology would be to adopt the principles of allocation used for purposes of the limiting fraction in calculating the maximum amount of foreign taxes that can be offset against U.S. federal income taxes under the foreign tax credit provisions.
2. The effect of deferring a deduction for foreign-related expenses to foreign related income would be to preclude deduction of such expenses against domestic income that should be excluded from the foreign business bucket.
3. The principal items affected would be interest expense, general and administrative expense and research and experimentation expense. Allocable interest expense should be calculated by taking into account indebtedness incurred by the foreign corporation which has income treated as deferred with respect to its U.S. shareholder.
4. The class of foreign business income to which deductible expenses are to be allocated should be drafted broadly.
 - a. A broadly drafted class would consist of all foreign related income attributable to active foreign related business, including business royalties, export sales, direct investment dividends and related party interest, rents and royalties from direct investment foreign affiliates. As discussed below, foreign source income might be separately adjusted to change the treatment of export sales income and royalties for U.S.-produced intangible property. Such an adjustment might be made in order to capture for the U.S. tax base the value of U.S. inputs in the income-producing process. Changing the export sales rule has been considered, and rejected, by the Congress in the past because of balance of payment concerns rather than theoretical disagreement with the economic thesis. Similar caution would still be appropriate. Export sales are foreign-related, no matter what source rule meets the need of economic accuracy. Royalties for foreign use of U.S.-origin IP warrant similar caution.
 - b. Drafting the class broadly would have the advantage of much greater simplicity. It should deal with the notion that foreign related business is not covering its deductible expenses.
5. Any deferred expenses not restored as deductions would be added to the U.S. shareholder's basis in its investment in the assets producing deferred income. If that investment is disposed of, or abandoned, the tax benefit of deferred deductions would be available subject to any limits on loss deductions generally.

6. It is likely that no other country applies such complete matching of otherwise deductible foreign related expense to foreign related income. To this extent the proposal may decrease competitiveness of U.S. MNCs compared to similarly situated foreign MNCs, tax policy makers wish to reduce the risk of an anti-competitive effect. It would be possible to limit expense deferral to some fixed percentage of otherwise deferrable expense.

This approach has some facial similarity to the Rangel Bill. It is quite different in a number of respects. First, it is ancillary to repeal of the foreign base company sales and services provisions and the business-related foreign personal holding company provisions. That would avoid the effect of slicing foreign income into high tax and low tax buckets and then taxing the likely low tax piece.

Second, it would not gut the foreign tax credit. The segregation of income from the taxes on it, as would arise under the Rangel Bill credit averaging proposal, would have much the same effect as simply denying the credit under the two dividend exemption proposals. The approach outlined above would not.

D. Additional Topics for Discussion Another Day

This statement is already too long. The tax regime has been around long enough to be beset by weeds in many areas. The following areas of further inquiry might be worth looking at, but only as part of comprehensive implementation of a balanced revision to solve real problems, not just to raise more tax revenue.¹² It would be grave error merely to select revenue raisers or competitiveness stimulants. In the long run, the business community really needs stability.

Old Chestnuts

1. Modification of Export Sales Income Source Rules. Consider modifying section 863(b) (deemed foreign source rule with respect to export sales). This deemed foreign source rule has enabled crediting of foreign income tax against U.S. tax otherwise due with respect to some foreign-related income economically earned by a U.S. taxpayer from U.S. business activity.
 - a. Complete repeal of foreign tax credit for foreign taxes in high tax countries is excessive and overbroad. The remedy should be limited to steps necessary to solving the problem. If the problem is the export sales source rule, the remedy should be to fix the export source rule rather than eliminate comprehensively credit averaging

¹² It is not, in fact, good policy to tax "the companies across the sea." This definition of "tax reform" was attributed to then-Chairman of the Ways and Means Committee Dan Rostenkowski in 1992. Quoted and ascribed to Chairman Rostenkowski in Michael J. Graetz, *THE DECLINE (AND FALL?) OF THE INCOME TAX* (New York: W.W. Norton & Company, 1997), p. 6.

of foreign taxes on income from varying pieces of a multinational business enterprise.

- b. If it is good tax policy to eliminate such cross crediting, the more targeted approach is simply to modify the source rule that causes the problem.
- c. If it is decided that it is not good policy to eliminate cross crediting against this category of foreign-related income,¹³ this recommendation could be rejected without affecting other recommendations. Even if not foreign-source, however, such income could be treated as foreign-related income for purposes of determining whether foreign-related expenses should be deductible currently.

Old Chestnuts

- 2. Consider Making Intangible Property Royalty Sourcing More Symmetrical with Income From Sale of Tangible Property, Except to the Extent Otherwise Provided by Treaty. Section 861(a)(4) and 862(b)(4) could be amended to change the source rule for royalties contingent on use of intangible property outside the United States. A different rule could be provided in a bilateral tax treaty to accommodate an agreement by the United States that a foreign treaty partner could impose withholding tax on royalties.

This, like the possible re-examination of the export source rules for tangible property, would be a more targeted approach to whatever theoretical problem exists in allowing “cross-crediting.” It is not necessary to abolish the foreign tax credit for all high tax foreign operations to get at this problem.

It would be important to try to determine whether this sort of change might lead to relocation of R&E activities to foreign countries. This would be undesirable, whatever the theoretical benefits of symmetrical taxation of tangible and intangible property.

Retain Core Architecture

- 3. Dividends, Interest, Rents and Royalties from Portfolio Investment Should be Ineligible for Cross Crediting Any Foreign Income Tax Imposed on Foreign Direct Investment Income. Reasonable working capital and business risk management income should be excluded from this category of taxable income.

¹³ The Congress decided against this option in 1986. There was a stated concern about the potential impact on U.S. exports. Caution is still appropriate.

Symmetry with Other Recommendations

4. Consideration of the Tax Consequences of Transferring Taxable Income Producing Property to Foreign Affiliates Section 367 could be amended to require income inclusion by a U.S. taxpayer transferor of tangible and intangible property to a foreign affiliate. The transfer of productive assets into a tax deferred position could attract the same sort of foreign related expense deferral that would apply to current expense associated with making or maintaining an investment in a foreign direct investment and other assets and activities that produce foreign related income. The includible amount might equal the sum of prior deductions allocable to the transferred property, including amortization and depreciation as well as research and development expenses. The recaptured amount would be added to basis and deducted by ratable amortization against future income from the foreign deferred income producing asset.
 - a. Fair market value of the transferred property should not be used because the values of property for which there is no actual market cannot be readily determined. The ensuing war of models is time consuming and hard to administer consistently.
 - b. If it were determined that a cost-based transfer for special items would be inappropriate, because of an assumed high value feature, a special rule could be developed for the potentially worrisome class of transferred property, without forcing all taxpayers into valuing assets with no ready comparables (other than the testimony of expert witnesses). Sections 367(d) and 482(d) are examples of such an approach.

Asymmetry in Treating Forms of Business Activity

5. Eliminate Separate Regimes for Foreign Business Conducted via Foreign Corporations versus Branches and Other Pass-through Entities. If we decide that certain foreign business activity should be taxed only on net income when distributed, it might make sense to consider treating all foreign business activity in the manner suggested by the Advisory Panel. The United States could treat all foreign business activities, in which a U.S. corporation has a >10% voting equity interest, as a separate entity (corporation) rather than variously as a corporation, branch or other pass-through entity based on the legal form of the business vehicle. This would eliminate electivity of tax regime for foreign business activities of U.S. MNCs, particularly loss pass through and disregarded transactions between a legal entity and its branch. This could be an example of a topic that might be ignored under the principle of only fixing what is clearly broken.

Global Economy6. Joint Ventures (10/50 Companies).

The guiding principle should be to treat direct investment in controlled foreign corporations the same as direct investment in noncontrolled foreign direct investment (i.e., 10/50 companies). Certain modifications must be made with respect to portfolio investment income of a 10/50 company.

a. Foreign Related Income and Foreign Related Expenses to Include Amounts Attributable to Joint Ventures

Expenses incurred by a U.S. corporate taxpayer attributable to direct investments ($\geq 10\%$) in noncontrolled foreign corporations could be made part of the pool of foreign-related expenses and income from transactions with or investment in joint ventures could be foreign-related income. Any unrecovered expense would, in effect, be capitalized and added to basis of the U.S. shareholder's investment.

The same principles would apply to determine deferred income and associated deferrable expense of a 10/50 company that would apply to a controlled foreign corporation.

b. Foreign Tax Credit

All foreign taxes on foreign source business income would be taken into account and allowed to offset all U.S. tax otherwise due with respect to foreign source business income. As with controlled foreign corporations, deferred expenses, when restored and deductible, would be subject to limitations comparable to present law that would prevent offsetting foreign income tax on foreign income against U.S. tax on U.S. income (section 904(d)). There should be no "10/50 basket."

c. Foreign Personal Holding Company Income

U.S. shareholders should not be taxed on undistributed foreign personal holding company income of a non-controlled foreign corporation. Deferred expenses associated with the investment in the 10/50 company would be available as a deduction if and to the extent of foreign related income. Deferred expenses would not be "grossed up" from time incurred and deferred until restored by the foregone financial rate of return on disallowed deductions.

- (i) Foreign Base Company Sales Income. No special treatment would be necessary with respect to related party sales and services income. The repeal generally of foreign base company sales income and foreign base company

services income represents a policy decision that is equally applicable to 10/50 companies.

- (ii) Foreign Personal Holding Company Exclusion: Look-Through Rules Should Apply to Interest, Rents, and Royalties. No special rules would be necessary except to distinguish related party interest, rents and royalties from portfolio asset income. Such rules would be relevant with respect to PFIC treatment of a 10/50 company.

Any such items of income received by a foreign corporation from a payer in which the recipient (or any person that controls, is controlled by, or under common control with the recipient), holds more than a 10% equity interest, would not be treated as portfolio income.

Symmetry with Old Chestnut

7. Related Party Royalties for Domestic Use of Foreign-Origin Intangible Property Should Be Foreign Source to the Same Extent that Royalties for Use of U.S.-Origin Intangible Property Would Be Domestic.
- a. U.S.-sourcing based on U.S. use should be retained in order to induce reciprocal treaty relief for royalties from foreign use of U.S. origin intangible property.

Core Architecture

8. Dividends And Interest From Domestic Corporations Should Remain U.S. Source To The Same Extent As Present Law And Subject To U.S. Withholding Tax Except To The Extent Otherwise Provided By Treaty.
- a. This is present law.

Symmetry

9. Foreign Portfolio Investment in U.S. Business Entities
- a. Present law should be retained. Dividends, interest, rents and royalties should be taxable based on gross income at appropriate withholding tax rate, subject to treaty relief.
- b. Portfolio interest taxation should be made symmetrical with taxation of portfolio dividends paid to nonresident aliens and foreign corporations. The present regime favors foreign portfolio debt investment over foreign portfolio equity investment in domestic business enterprises. Interest payments erode the corporate income tax base while dividend payments do not.

*Old Chestnuts*10. Financial Institutionsa. Domestic: Present Law Temporary Exclusion from Subpart F Should Be Made Permanent

- (i) U.S.-parented MNCs engaged in the active conduct of a banking, financing or similar business should be excluded from the regime taxing U.S. shareholders currently on undistributed foreign personal holding company income (income that is not otherwise excluded from foreign personal holding income on the basis of a related party payer). However, any income deferred from tax would result in a corresponding deferral of deductions for interest, general and administrative expense and other expenses incurred to produce such deferred foreign financing business income. Simplifying conventions should be applied to accommodate differences in currencies and other terms (maturities, interest rate basis) applicable to borrowing by such financial institutions and lending by such institutions.
- (ii) If, however, foreign base company treatment of Main Street MNCs is retained, retaining section 954(h) would be asymmetrical, at least with respect to cross border transactions.
- (iii) Branches and subsidiaries could be treated as separate entities (corporations). Interbranch transactions could be treated as cognizable intercompany transactions.

b. Foreign Parent Financial Institutions: Domestic Branches Could Be Treated as Separate Corporations

- (i) Foreign-parented MNCs engaged in the active conduct of a banking, financing or similar business that generates U.S. source income effectively connected could be subject to corporate tax on net income. Branches could be treated as separate corporations. Interbranch transactions could be treated as transactions with tax effect. The branch profits tax should be repealed if a branch would be treated as a separate corporation.

Symmetry between Portfolio Investment in U.S. and Foreign MNCs

11. U.S. Tax-Exempt Investors

Distributions from foreign MNCs could be made taxable to U.S. tax-exempt investors, perhaps as a class of "UBTI" (subject to a contrary provision in a U.S. tax treaty with the country from which a tax-exempt investor receives a dividend.) All income from investments in domestic and foreign corporations would be taxed once to the extent attributable to a U.S. tax-exempt investor's interest therein. There are, no doubt, many policy considerations involved beyond symmetry between investment in U.S. MNCs and foreign MNCs. The symmetry issue belongs on the list

Old Chestnuts

12. Arm's Length Rules for Related Party Transactions

Occasionally, tax policy makers express uneasiness about how the arm's length rules work in different international contexts. Periodically, alternatives to the arm's length approach are floated, and no comprehensive review would be complete without an examination of the topic.

Thank you for this opportunity to speak to your Committee.

Attachment 1. A Layman's Reading Of FAS 94 And FAS 109

GAAP Accounting for Foreign Earnings and Residual U.S. TaxI. Consolidation of All Majority-Owned Subsidiaries

Statement of Financial Accounting Standards No. 94¹⁴ provides that generally no distinction shall be made between foreign and domestic subsidiaries. In pertinent part, the Financial Accounting Standards Board¹⁵ explained its amendment of prior standards of U.S. GAAP:

“This Statement . . . amends ARB No. 43, Chapter 12, ‘Foreign Operations and Foreign Exchange,’ to narrow the exception for a majority-owned foreign subsidiary from one that permits exclusion from consolidation of any or all foreign subsidiaries *to one that effectively eliminates distinctions between foreign and domestic subsidiaries.*”¹⁶

As discussed below, however, the goal of equivalence between foreign and domestic subsidiaries is apparently *not* implemented in the provision for deferred tax liabilities pursuant to Statement of Financial Accounting Standards No. 109.¹⁷ The other items that affect the consolidated statement of income and loss, and assets and liabilities are generally taken into account by applying equivalent rules to both domestic and foreign subsidiaries.

FAS 94 specifically changed the principles previously in effect under ARB No. 43, Chapter 12, ‘Foreign Operations and Foreign Exchange.’ Paragraphs 8 and 9 thereof (in effect prior to the 1987 adoption of amendments that became effective for accounting periods after December 15, 1988), provided:

“In view of the *uncertain values and availability of the assets and net income of foreign subsidiaries* subject to controls and exchange restrictions and the consequent unrealistic statement of income that may result from the translation of many foreign currencies into dollars, *careful consideration should be given to the fundamental question of whether it is proper to consolidate the statements of foreign subsidiaries* with the statements of United States companies.”¹⁸

¹⁴ Consolidation of All Majority-owned Subsidiaries, Statement of Financial Accounting Standards No. 94, Financial Accounting Standards Board (October 1987) (hereinafter “FAS 94”).

¹⁵ The Financial Accounting Standards Board will be hereinafter referred to as FASB. It is the source of the controlling literature used to ascertain U.S. “generally accepted accounting principles” or “GAAP.”

¹⁶ FAS 94, Paragraph 9. Emphasis added.

¹⁷ Accounting for Income Taxes, Statement of Financial Accounting Standards No. 109, Financial Accounting Standards Board (1992, effective for years beginning after December 15, 1992) (hereinafter “FAS 109”).

¹⁸ Foreign Operations and Foreign Exchange, ARB No. 43, Chapter 12, Par. 8 (April 1972), amended and replaced by FASB October 1987, effective for years commencing after December 16, 1988, pursuant to adoption of FAS 94. Emphasis added.

It is important to note that *U.S. tax contingencies* that might affect the presentation of a “realistic” value of any foreign subsidiary income in consolidated financial statements were *not* a factor in ARB No. 43, Chapter 12, as adopted in 1972 and have never been a factor thereafter in applying the principles (“realistic” values) enunciated in FAS 94. Only *foreign exchange controls*, or *foreign exchange translation concerns*, merited explicit admonitions about the risk of an unrealistic value for undistributed income of foreign subsidiaries.

In presenting current income, gain or loss in respect of members of the consolidated group, no adjustment is made to reflect potential changes reflecting the time value of money.¹⁹ All income, gain or loss of a foreign affiliate is taken into account without regard to U.S. tax-based friction that might impair the amount ultimately available or might delay its availability. U.S. tax effects are taken into account under a different set of rules, largely self-contained and separate from the rules for reflecting the income on which such tax might be imposed. Those rules, discussed below, govern additions to (or subtractions from) the annual provision for current and deferred tax liabilities and tax assets.

This segregation of U.S. tax effects from other effects (foreign exchange controls or foreign currency conversions) is asymmetrical, at least to a lay reader of accounting literature, with the different prescriptions for realistically taking into account other potential impairments of the value of foreign subsidiary earnings. For example, ARB No. 43, Chapter 12, “Foreign Operations and Foreign Exchange,” as amended at the time FAS 131²⁰ was adopted in June 1997, provides:

“4. A sound procedure for United States companies to follow is to show earnings from foreign operations in their own accounts *only to the extent that funds have been received in the United States or unrestricted funds are available for transmission thereto.*

“5. Any foreign earnings reported beyond the amounts received in the United States should be carefully considered in light of all the facts . . . FASB Statement No. 131, *Disclosure about Segments of an Enterprise and Related Information*, discusses the requirements for reporting revenues from foreign operations.”²¹

Nothing in FAS 94, or in FASB Statement No. 131 (cited in the preceding excerpt), contemplates treating potential U.S. tax as a barrier to reflecting in consolidated financial statements “foreign earnings beyond the amounts received in the United States” within the intentment of Paragraph 5 of Chapter 12 of ARB No. 43. Such exposure to incremental U.S.

¹⁹ “Discounting” has been ruled out. Accounting Principles Board, Opinion No. 10, Omnibus Opinion-1966” paragraph 6 (“...Pending further consideration of this subject and the broader aspects of discounting as it relates to financial accounting in general...it is the Board’s opinion that...deferred taxes should not be accounted for on a discounted basis.”) See also FAS 109, paragraphs 177, 198-199.

²⁰ Statement of Financial Standards No. 131, “Disclosures about Segments of an Enterprise and Related Information,” (Financial Accounting Standards Board, June, 1997).

²¹ Accounting Research Board. ARB (Accounting Research Bulletin) No. 43, Ch. 12, “Foreign Operations and Foreign Exchange,” paragraphs 4-5 (American Institute of Certified Public Accountants Committee on Accounting Principles, 1953, and amended by the Financial Accounting Standards Board, June 1997). Emphasis added.

tax, in the event of a distribution, is simply not viewed as a cognizable or measurable “restriction” on funds of foreign subsidiaries. Instead, the correct place to deal with such taxes, if taxes are to be taken into account at all, is in the annual provision for current and deferred income taxes.

II. Additions to the Provision for Current and Deferred Tax Liabilities

FAS 109 governs the treatment in financial statements of current and deferred tax liabilities.²² Tax expense for any year consists of the sum of (i) current taxes payable plus (ii) deferred tax expense, minus (iii) current tax refunds and future refundable amounts.²³

Discounting to present value is specifically prohibited.²⁴ A dollar of tax liability that may not be paid for 10 or more years in the future is added to the income tax expense for the year in which it is accruable as a full dollar, not the discounted present value of that dollar in the year it is first properly recognized as a deferred tax liability. FASB specifically rejects use of Cary Brown principles (“discounting”) in measuring the financial disclosures of the amount of future tax.

In an apparent departure from the principle of equivalence between domestic and foreign subsidiaries,²⁵ two different rules are established for the treatment of future taxes (“deferred tax liabilities”) of foreign subsidiaries and domestic subsidiaries. FAS 109 amended APB Opinion 23, *Accounting for Income Taxes – Special Areas*, to provide, in *replacement* Paragraph 10:

“Temporary Difference. The Board believes it should be presumed that all undistributed earnings of a subsidiary will be transferred to the parent company. Accordingly, *the undistributed earnings of a subsidiary included in consolidated income should be accounted for as a temporary difference unless the tax law provides a means by which the investment in a domestic subsidiary can be recovered tax free.* However, for reasons described in FASB Statement No. 109, *Accounting for Income Taxes*, a deferred tax liability is not recognized for (a) an excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary that meets the criteria in paragraph 12 of this Opinion and (b) undistributed earnings of a domestic subsidiary that arose in fiscal years beginning on or before December 15, 1992 and that meet the criteria in paragraph 12 of this Opinion. *The criteria in paragraph 12 of this Opinion do not apply to undistributed earnings of domestic subsidiaries that arise in fiscal years beginning after December 15, 1992, and a deferred tax liability shall be recognized if the undistributed earnings are a taxable temporary difference.*”²⁶

²² FAS 109.

²³ FAS 109, Para. 16.

²⁴ FAS 109, Para. 177.

²⁵ FAS 94, *supra*

²⁶ APB Op. 23, Para. 10 (Emphasis added).

FAS 109, in amending APB Op. 23 in 1992 thus appears to have preserved, for foreign subsidiaries only, Paragraph 12 of APB Opinion 23 that permits ignoring future U.S. taxes that would be due in the event of distribution, if and so long as the foreign nontaxable reinvestment of such earnings is expected to be for the indefinite future:

“12. Indefinite reversal *criteria*. The presumption that all undistributed earnings will be transferred to the parent company may be overcome, and *no income taxes should be accrued by the parent company, if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation*. A parent company should have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely. Experience of the companies and definite future programs of operations and remittances are examples of the types of evidence required to substantiate the parent company’s representation of indefinite postponement of remittances from a subsidiary. If circumstances change and it becomes apparent that some of the undistributed earnings will be remitted in the foreseeable future but income taxes have not been recognized by the parent company, it should accrue as an expense of the current period income taxes attributable to that remittance; income tax expense for such undistributed earnings should not be accounted for as an extraordinary item. If it becomes apparent that some or all of the undistributed earnings of a subsidiary on which income taxes have been accrued will not be remitted in the foreseeable future, the parent company should adjust income tax expense of the current period; such adjustment of income tax expense should not be accounted for as an extraordinary item.”²⁷

The provisions of APB Op. 23, specifically Paragraph 12 thereof, apparently do not apply to undistributed income of a domestic subsidiary,²⁸ even if determining the correct amount of the provision is complicated. For undistributed earnings of domestic subsidiaries, the controlling concern is limited to the accurate reflection of shareholders’ equity:

“171. Not recognizing a liability for the deferred tax consequences of Opinion 23 and U.S. steamship enterprise temporary differences *overstates the shareholders’ residual ownership interest in an enterprise’s net earnings and net assets. The government has a claim (a right to collect taxes) that precludes shareholders from ever realizing a portion of the enterprise’s net assets. A tax obligation is not a component of shareholders’ equity.*”¹⁷². The Board considered whether payment of income taxes for the Opinion 23 and U.S. steamship enterprise temporary differences might be a contingency as that term is used in Statement 5. *The Board concluded that there is no uncertainty that a tax obligation has been incurred for those temporary differences. The amount of the government’s claim will never revert to the benefit of the shareholders unless there is a change in the tax law.*

²⁷ APB Op. 23, Para. 12 (Emphasis added).

²⁸ APB Op. 23, Para. 10, quoted above.

*The possibility of a change in the tax law in some future year is not an uncertainty as that term is used in Statement 5.*²⁹

FASB explained itself, in differentiating between deferred tax liability with respect to undistributed earnings of a domestic subsidiary and with respect to undistributed earnings of a foreign subsidiary, in part on the basis of perceived “complexity” of determining the amount of future U.S. tax (a worrisome problem even without trying to adjust (by discounting) for present values of future amounts whose distribution dates could not be confidently assumed):

“173. Complexity was one reason Statement 96 did not require recognition of a deferred tax *liability* for Opinion 23 and U.S. steamship enterprise temporary differences. Information received from constituents has convinced the Board that calculation of a deferred tax liability for undistributed foreign earnings that are or will be invested in a foreign entity indefinitely may sometimes be extremely complex. The hypothetical nature of those calculations introduces significant implementation issues and other complexities that occur less frequently in calculations of a deferred tax liability for an *expected* remittance of earnings from a foreign entity. For that reason, the Exposure Draft proposed to not require recognition of a deferred tax liability for undistributed earnings that are or will be invested in a foreign entity indefinitely. Based on respondents' concerns about complexity, however, the Board decided to extend that exception for foreign undistributed earnings to include the entire amount of a temporary difference between the book and tax basis of an investment in a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration regardless of the underlying reason(s) for that temporary difference.”³⁰

The exception to the general rule applies only to foreign subsidiaries. The justification was explained as resting on, in addition to complexity concerns, two other pillars: (1) the need to compromise (sic) and (2) the omission of discounting.³¹

These rules have been re-examined by FASB from time to time since 1992, and reaffirmed most recently in connection with the FASB/IASB Convergence project.³²

The U.S. GAAP rules do not affect the cost to the government of tax deferral, expressed with respect to any given amount of deferred tax. That cost is adequately measured by the present value analysis that measures the cost of the government having to borrow funds to carry the deferred tax. The rules *might*, however, affect location decisions, and included in such location decisions are decisions whether to repatriate undistributed earnings for potential deployment in domestic investment (at least so long as section 956 remains in its present form).

²⁹ FAS 109, Para 171-172 (*Emphasis added*).

³⁰ FAS 109, Para. 173.

³¹ FAS 109, Para. 169.

³² FASB Minutes of Joint Board Meeting (of FASB and IASB), October 20, 2004, available online at www.fasb.org

Attachment 2. Comparison Of Tax Reform Proposals

The following table is a brief summary of the key points of difference (or congruence) of view between "Congressional Tax Reform" and "Advisory Panel Reform." The table does not relate to the various items on my to-do list.

<u>Proposal</u>	<u>Legislation</u>	<u>Panel Report</u>
1. Repeal Foreign Base Company Sales Income	Proposed section 301, H.R. 5095, 107 th Cong. 2 nd Sess. (2002) ("Thomas Bill") would have repealed both foreign base company sales income and foreign base company services income.	Recommends treatment as "Mobile Income" ³³ with no deferral and no "cross crediting" for taxes on income likely to be highly taxed. ³⁴ Mobile Income would include the present categories of "Foreign Base Company Sales Income" and Foreign Base Company Sales Services Income.
2. Repeal Foreign Base Company Services Income	Proposal was reportedly dropped because of anticipated revenue estimate cost.	See JCT Options Report footnote 428 at p. 194.

³³ Panel Report p. 240 ("income from the sale of property purchased from or sold to a related person by a foreign corporation that is neither the origin nor the destination of that property."). There is a similar reference to "certain income from personal services" that appears likely to include present-law: foreign base company services income. The JCT Options Report contained proposals very similar to the Panel Report dividend exemption system. The JCT Options Report left open the possible elimination of foreign base company sales income and foreign base company services income. Footnote 428 at p. 194.

³⁴ Panel Report, p. 240 ("Businesses would not receive foreign tax credits for foreign taxes (including both corporate level taxes and dividend withholding taxes) attributable to Foreign Business Income....").

3. Exclude Active Financing Income from Subpart F Foreign Personal Holding Company Income	Initially adopted in Taxpayer Relief Act of 1997, ³⁵ reversing the initial inclusion of such income in FPHCI in the 1986 Act, ³⁶ a provision that reversed the decision reflected in the 1962 Act ³⁷ to exclude active financial services income from subpart F. Temporary, but regularly temporarily ³⁸ extended, most recently by TIPRA. ³⁸	Unclear. Recommends treatment as exempt Foreign Business Income, except to the extent attributable to investment of financial institution assets. ³⁹ Unclear if a change in present section 954(h) is intended. ⁴⁰
4. Related Party Look-Through Exclusion from Foreign Personal Holding Company Income (and thus from subpart F)	TIPRA amendments to IRC sec. 954(c) excludes all related party dividends, interest, rents and royalties, allocable to non-subpart F income of the payer CFC, from foreign personal holding company income of the payee. ⁴¹	Exclude <u>dividends</u> , but <u>not</u> interest, rents and royalty payments that would generally be deductible under source country tax law. ⁴² Panel Report conceptually uses "base erosion" of foreign taxable income as important criterion to use to categorize an item as (U.S.-taxable) "Mobile Income" or exempt Foreign Business Income. The TIPRA exclusion would thus be reversed.

³⁵ Section 1175, P.L. 105-34 (August 5, 1997).

³⁶ Section 1201(c), P.L. 99-514 (October 22, 1986).

³⁷ Section 12(b), P.L. 87-834. (Section 954(c)(3) as added to the Internal Revenue Code of 1954 provided that foreign personal holding company income would not include "dividends, interest or gains from the sale or exchange of stock or securities derived in the conduct of a banking, financing or similar business....").

³⁸ Section 103(a) of "Tax Increase Prevention and Reconciliation Act of 2005," P.L. 109-222 (May 18, 2006) (hereinafter sometimes referred to as "TIPRA").

³⁹ Panel Report, p. 241 ("Anti-abuse rules would be needed to prevent passive investment income earned by financial services businesses from being treated as Foreign Business Income.").

⁴⁰ I.R.C. section 954(h) has specific, rather than "anti-abuse" tests to distinguish qualifying and nonqualifying income.

⁴¹ Section 103(b) of TIPRA.

⁴² Panel Report, p. 240 ("certain types of foreign active business income that is not likely to be taxed in any foreign jurisdiction.").

<p>5. Reduce Foreign Tax Credits to simplify FTC and to enhance "cross crediting"</p>	<p>Several prospective legislative eliminations commencing in 1997,⁴³ followed by complete elimination in AJCA.⁴⁴</p> <p>Intended to achieve <u>full cross crediting</u> for foreign income tax on all foreign source business income, whether from foreign single-country subsidiaries, joint ventures, royalties or export sales income.</p> <p>Intended to reverse 1986 Act limitation on cross crediting among units of a U.S. MNC and joint ventures (which were not to be treated as <u>units</u> of worldwide enterprise).</p>	<p>"Do something"⁴⁵</p> <p>(But apparently not provide complete look-through as with CFCs.)</p> <p>If not exempt Foreign Business Income, it would be Mobile Income with <u>no cross credit</u> for high foreign tax on exempt Foreign Business Income.</p> <p>Would eliminate cross credit for high taxes on joint ventures against royalty income and export sales income.</p> <p>Would have effect of reinstating 1986 Act segregation of joint ventures from other units of the U.S. MNC global enterprise.⁴⁶</p>
<p>a. Joint Ventures (10/50 Companies) Dividends</p>		

⁴³ Taxpayer Relief Act of 1997, sec. 1105, P.L. 105-34 (August 5, 1997).

⁴⁴ American Jobs Creation Act, sec. 403, P.L. 108-357 (October 22, 2004).

⁴⁵ Panel Report, p. 240 ("Further rules would be needed to address the taxation of Foreign Business Income earned by a U.S. multinational that owns at least 10 percent of the stock of a foreign corporation that is not controlled by U.S. shareholders (so-called "10/50" companies).")

⁴⁶ STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (H.R. 3838, 99TH CONG. 2D SESS; PUBLIC LAW 99-514) (May 4, 1987), (the "1986 ACT BLUE BOOK") p. 868.

<p>b. Joint Venture (10/50 Companies) Interest, rents and royalties</p>	<p>Interest, rents and royalties to U.S. joint venture investor or to CFC joint venture investor may be eligible for general basket cross crediting if joint venture under common control with a same-country CFC lender/ licensor.⁴⁷</p> <p>More direct look-through for cases in which common control of borrower/lender or licensor/licenses not present-has not been enacted.</p>	<p>“Do something”⁴⁸</p> <p>Would eliminate cross credit for excess foreign taxes associated with dividends and branch profits of controlled and noncontrolled foreign corporations against interest, rents and royalties from controlled foreign affiliates and noncontrolled foreign affiliates.⁴⁹</p>
<p>Controlled Foreign Corporation Dividends</p>	<p>Retain general basket cross crediting for all foreign taxes on general limitation basket comprised of high and low taxed income from related CFC and 10/50 (J.V.) dividends, active business royalties, related party dividends, interest, rents and royalties where payer under common control with payee, and look-through dividends from 10/50 (J.V.) companies.⁵⁰</p>	<p>Eliminate cross crediting for high taxes on such dividends against low taxed foreign dividends, interest, rents and royalties, and export sales income.⁵²</p> <p>Dividends are exempt if attributable to income other than Mobile Income.⁵³</p>
<p>Interest, rents and royalties</p>	<p>Retains general basket category for related party CFC interests, rents and royalties in order to facilitate cross crediting.⁵¹</p>	<p>Credits associated with income that is not “Mobile Income” cannot reduce U.S. tax on Mobile Income.⁵⁴</p>

⁴⁷ IRC sec. 954(c)(3) provides an exception from foreign personal holding company income for interest and royalties received by a controlled foreign from a same-country related party, even if the related party is not also a controlled foreign corporation. The exclusion from foreign personal holding company income, in turn, may support general basket treatment under IRC section 904(d)(2)(A).

⁴⁸ Panel Report, p. 240. See Note 45 above.

⁴⁹ Panel Report, p. 240. See Note 34 above.

⁵⁰ AJCA. See Note 44 above.

⁵¹ Id.

⁵² Panel Report p. 240. See Note 34 above.

⁵³ Panel Report pp. 105, 239, 240.

⁵⁴ Panel Report, p.240 (no foreign tax credit for any foreign tax associated with Foreign Business Income).

<p>6. Expense Allocations to Reduce FTC Limitation: Worldwide Interest vs. U.S. Group Interest Only</p>	<p>Reduce U.S. interest allocable to foreign source income to account for foreign interest expense incurred to produce foreign source income.</p> <p>Intention is to increase amount of foreign source income, the U.S. tax on which can be reduced by high foreign taxes on foreign business income.⁵⁵</p> <p>This was first proposed as an amendment to the Senate version of legislation that became the Tax Reform Act of 1986⁵⁶ and finally enacted in AJCA.</p>	<p>Deny all foreign tax credits on income likely to be subject to high foreign tax.</p> <p>Excess foreign taxes on such income cannot reduce U.S. tax on other foreign source income.</p> <p>Reverses the result of the change in interest expense allocation by another means.⁵⁷</p>
<p>7. Eliminate separate foreign tax credit basket for financial services income of financial services business.</p>	<p>Financial services income of a financial services taxpayer will be general basket income permitting cross crediting of excess foreign taxes on other general basket income and vice versa.</p>	<p>Any such income that is exempt Foreign Business Income will have no foreign tax credit.</p> <p>Any such income that is Mobile Income cannot benefit from cross crediting of excess foreign taxes on other foreign general basket income. Unlikely to have excess credits on "Mobile Income."</p>

⁵⁵ AJCA, sec. 401.

⁵⁶ S. Rep. No. 313, 99th Cong. 2d Sess. 376 (1985).

⁵⁷ Panel Report discussion of level playing field at pp. 104-105, 133-134.

Testimony before the Subcommittee on Finance,
United States Senate
Washington, DC
June 26, 2008

Statement of James R. Hines Jr.

Mr. Chairman and Members of this distinguished committee, it is an honor to participate in these hearings on international tax reform. I teach at the University of Michigan, where I am the Richard A. Musgrave Collegiate Professor of Economics in the department of economics and Professor of Law in the law school, and where I serve as Research Director of the business school's Office of Tax Policy Research. I am also a Research Associate of the National Bureau of Economic Research, and the Research Director of the International Tax Policy Forum.

The United States faces serious fiscal challenges in the years ahead. The government needs revenue, and our economy needs sound economic policies that encourage business formation, investment, employment, and other activities that support the economy and thereby generate tax revenue. Business taxation is certain to be on the agenda as part of a broader package of tax measures. The topic of today's hearing is international tax reform, which is appropriate given the current state of fiscal affairs and the position of the U.S. tax system in the world economy.

Put simply, the United States is close to unique among world nations in taxing foreign income in the way that we do. Not only does the United States subject active foreign business income to domestic taxation, but we do so in a manner that strictly limits the ability of taxpayers to claim foreign tax credits and to avoid current U.S. taxation of unrepatriated foreign income. To be sure, there are aspects of the U.S. tax system that limit burdens on foreign income: in

particular, taxpayers are generally entitled to claim credits for foreign income tax payments, and there are many circumstances in which U.S. taxation is deferred until income is repatriated. But most of the world exempts active foreign business income from taxation, and among those countries that tax foreign income, their rules for claiming foreign tax credits and deferring home country taxation of foreign income are far less draconian than those of the United States.

Should we care that U.S. international tax policy differs so markedly from that of other nations, including almost all other major capital exporting countries? There are several reasons why we should care, the primary one being that other countries may be wise in pursuing the policies that they do, in which case we can learn from their reasoning and example. The theory that underlies the policy of capital export neutrality that motivates much of the U.S. worldwide tax system also implies that no nation should ever want to exempt foreign income from taxation. The fact that so many do, and the absence of a groundswell of countries converting their tax systems from exemption systems to worldwide systems that resemble ours, should tell us something.

What would represent an efficient international tax policy? It would be to do what most of the world does, and exempt active foreign business income from U.S. taxation. Exempting foreign income from taxation would promote efficient ownership of productive assets, domestic and foreign, by American businesses. Such a policy would contribute to the vitality of the U.S. economy, the benefits of which would be felt primarily by U.S. workers in the form of greater employment opportunities and higher wages. Efforts to move in the other direction by limiting deferral of home country taxes or limiting the extent to which taxpayers can claim credits for foreign tax payments unfortunately would have the effect of reducing the productivity of U.S.

business operations and thereby reducing the welfare of U.S. residents, again primarily affecting American workers.

At first blush it may appear illogical that the way to contribute to economic activity and economic wellbeing in the United States is to lighten the taxation of foreign income. On further reflection, however, it is clear that the benefits of appropriate taxation of foreign income are simply applications of commonly accepted (and perfectly valid) market principles that guide other economic policies.

Consider, for example, the economic consequences of a policy banning American firms from engaging in any foreign business activity. This is obviously whimsical, a violation of treaties and cherished international norms, not to mention an absurd and self-defeating policy. But it is worth exploring just why this would be such a bad idea for the United States, even putting aside the many real implementation problems that such a policy would encounter. The reason it would be so undesirable is that modern businesses rely on foreign operations for significant fractions of their profitability, and these foreign operations contribute to the profitability of domestic operations of the same companies. If American firms were banned from foreign business activity, then they would shortly find themselves unable to compete effectively against British, Japanese, German, Canadian, and other companies not facing the same restrictions. Furthermore, even if they did not face such competition, the primary effect of such a silly ban would be to reduce their productivity and profitability, to the great detriment of everyone connected with American business.

The issue of banning foreign business activity is relevant because some of the very intuitive arguments advanced in favor of taxing foreign business operations more heavily than we do are also arguments that could be used to support banning foreign business operations

altogether. We certainly do not want to do the latter, and therefore need to ask ourselves why we want to do the former. Of course these policies differ, and in fairness many of the concerns about taxing foreign business operations stem from an understandable desire to avoid subsidizing foreign business activity at the expense of domestic activity. But here is the point: exempting active foreign business income from domestic taxation is not a tax subsidy. This income is subject to taxation by foreign governments, and in order to earn foreign income, American firms must compete against other firms whose governments generally do not subject their foreign income to home-country taxation. These competitors drive down the rates of return to investment available in low-tax foreign locations, making them not the bargain they appear from a simple comparison of tax rates.

The opportunity to earn income in low-tax foreign jurisdictions can be thought of simply as the opportunity to do business in places where a certain kind of cost – in this case, foreign tax cost – is lower. As a general matter, the United States benefits when our companies have low-cost business opportunities. If this were a different kind of business cost – the cost of a raw material, for example – there would be no discussion of the need to impose an offsetting charge on the foreign operations of American companies that use low-cost materials abroad. We should think of the tax system similarly, and be appropriately wary about the desirability of subjecting foreign income to U.S. taxation in order to compensate for low tax rates in some countries.

An instructive way to think about the appropriate taxation of foreign income is to ask whether we would want to impose U.S. excise taxes on a worldwide basis. Suppose, for example, that the U.S. federal government were to levy a \$3 tax on each gallon of gasoline sold in the United States and sold abroad by persons resident in the United States. American taxpayers would be entitled to claim foreign tax credits for excise taxes paid to foreign

governments, so that a firm selling gasoline in a country whose excise tax rate exceeds \$3 per gallon would owe no additional tax to the United States, whereas a firm selling gasoline in a country with a \$1.75 per gallon tax would owe \$1.25 per gallon to the United States. One could imagine permitting worldwide averaging, thereby permitting taxpayers to use excess excise tax credits from sales in jurisdictions with excise taxes exceeding \$3 per gallon to claim credits to offset taxes due on sales in jurisdictions with excise taxes less than \$3 per gallon.

What would be the impact of such a home country tax regime? Firms selling in countries with excise taxes exceeding the U.S. rate would have excess foreign tax credits and therefore no U.S. tax obligations, so the tax regime would not affect them. Firms without excess foreign tax credits would face U.S. excise taxes on foreign sales that vary with local excise tax rates. Odd though such a system would be, it does not necessarily follow that it would spell the end of foreign gasoline sales by American companies in all low-tax jurisdictions, though that is certainly one possibility. American companies would persist in selling gasoline in those foreign markets in which two conditions hold: first, that American firms are profitable, and second, that the same American firms could not be even more profitable by selling their operations to foreign petroleum companies who are not subject to the U.S. tax regime. Since American firms may have significant cost or marketing advantages over their competition in certain foreign locations, it is possible that they would be able to remain in business despite the significant tax penalty associated with U.S. residence. In cases without such advantages, and where low foreign excise tax rates imply significant U.S. tax costs, American firms are likely to disappear.

The economic costs of a residence-based excise tax regime are simple to identify. American firms lose the opportunity to earn profits in foreign markets from which they are driven by U.S. excise taxes, and this, in turn, reduces the rate of return to domestic activities that

make foreign operations otherwise profitable. Since there is every reason to believe that a worldwide excise tax regime would have very significant effects on the participation of American firms in foreign markets, the associated economic costs are potentially enormous. The tax crediting mechanism creates an odd pattern of U.S. excise taxes on foreign operations, with zero and even (in some cases) negative excise taxes on foreign sales in some countries, whereas in other countries the U.S. system imposes positive tax rates that vary with local excises. Even in circumstances in which American firms sell in foreign markets despite the imposition of significant U.S. excise taxes on such sales, the volume of foreign activity will be reduced, and distorted among countries, as a result of such taxes.

What possible justification could be offered for a home-country excise tax regime such as that just described? Many, if not all, of the same arguments commonly advanced in favor of worldwide income taxation would apply with equal force to worldwide excise taxation. From the standpoint of the world as a whole, the benefits of selling an additional gallon of gasoline equals the benefit to consumers, which in turn is measured by the (tax-inclusive) price that consumers pay for the gasoline. Since sellers receive only the tax-exclusive price of gasoline, their incentives do not correspond to global efficiency except in the unlikely event that excise taxes are the same everywhere. In the absence of residence-based worldwide excise taxation, too few gallons of gasoline will be consumed in countries with high excise tax rates, and (relatively) too many in countries with low excise tax rates. Domestic excise taxation might be said to encourage American firms to move their sales offshore. A system of residence-based taxation in effect harmonizes excise taxes around the world from the standpoint of domestic producers.

An analogous argument would apply to domestic welfare, which, by the standard logic, is maximized by a worldwide excise tax regime even less generous than that under consideration.

Domestic welfare, the thinking would go, is maximized by subjecting foreign sales to domestic excise taxation without provision of foreign tax credits. The reason is that, from the standpoint of the United States, the value of selling a marginal gallon of gasoline in a foreign market equals the profit that it generates, whereas the value of selling a marginal gallon of gasoline in the United States equals the profit it generates plus the associated excise tax revenue. Equating these two requires that the United States impose equal excise taxes on foreign and domestic sales.

One simple and entirely reasonable objection to subjecting foreign sales to home country excise taxation is that excise taxes tend to be incorporated in sales prices, so that, for example, increasing a (commonly used today; destination-based) excise tax on gasoline by \$0.10 per gallon tends to be associated with roughly \$0.10 per gallon higher gasoline prices. Of course, this incidence is unlikely to be exact, and indeed, both theoretical and empirical studies of sales tax incidence find that prices can move by less than, or in some cases more than, changes in excise tax rates. But the efficiency argument is valid on its own terms regardless of the incidence of the tax. That is, the argument is unchanged whether or not gasoline taxes are incorporated fully in consumer prices. Furthermore, and this is the underlying point, the same argument that consumer prices incorporate excise taxes applies to corporate income taxes, and for the same reason: both excise taxes and corporate income taxes increase the cost of doing business, and market forces translate higher costs into higher consumer prices.

The same argument applies with equal force beyond excise taxes to worldwide residence-based taxation of state property and sales taxes. How are taxpayers likely to respond to the introduction such residence-based taxation? The obvious reaction is to shed, or avoid in the first place, ownership of activities in jurisdictions where it would trigger significant tax liabilities. Again, it does not follow that American firms would maintain no foreign operations; it is almost

certain that they would continue at least some operations, despite the tax cost. But the distortion to ownership, investment, and productivity would be enormous.

The older efficiency norms that underlie capital export neutrality and related concepts would evaluate residence-based worldwide excise, property, and sales taxation favorably. Policies that allocate economic activity around the world based on pretax returns maximize world welfare, so the capital export neutrality logic implies that total (host country plus home country) tax rates should be the same everywhere. In the absence of worldwide tax harmonization, this can only be achieved by home country tax regimes that offset any differences between domestic and foreign taxation. Home-country welfare would be maximized by a different regime, in which after-foreign-tax returns are subject to home country taxation at the normal rate.

No country attempts to tax sales or property on a residence basis, doubtless deterred by some of the considerations that are apparent from the preceding analysis. The reason to analyze these taxes is not because they might realistically be adopted by the United States or some other government in the near future, or because they contain desirable features, but instead for the light that they shed on residence-based systems of taxing corporate income earned in other countries. To put the matter directly: why is it that residence-based excise, sales, and property taxation are clearly undesirable policies, while residence-based income taxation has not enjoyed the same unpopularity?

Residence-based taxation of foreign income has the same ownership effects as would residence-based excise, sales, or property taxation, with the same (negative) impact on economic welfare. The economic consequences of income taxation seem subtler than those of, say, excise

taxation, but this is merely an illusion, since a \$10 million tax liability associated with American ownership will discourage U.S. ownership of foreign business assets to the same extent whether the \$10 million is called an income tax or an excise tax.

It is this distortion to ownership that produces the largest component of the efficiency cost associated with the U.S. regime of worldwide taxation. Compared to other countries, the U.S. system of taxing foreign income discourages foreign asset ownership generally, and in particular discourages the ownership of assets in low-tax foreign countries. Mihir Desai and I have estimated the net tax burden on American firms from the U.S. system of worldwide taxation to be in the neighborhood of \$50 billion per year, well exceeding revenue collections, since a significant portion of the net burden comes in the form of the associated efficiency cost.

What would be the consequence of exempting active foreign business income from U.S. taxation? The greater productivity associated with improved incentives for asset ownership would enhance the productivity of factors that are fixed in the United States, specifically including land but primarily labor, and thereby increase the returns that they would earn. Studies, including some of my own recent statistical work with Mihir Desai and Fritz Foley, generally find that 70 percent or more of the corporate income tax burden is borne by labor in the form of lower wages. This is likely to be at least as true of international corporate tax provisions as it is of corporate taxes generally.

What would be the domestic consequences of reducing the taxation of foreign income and thereby rationalizing the demand for foreign assets by American firms? There is a flurry of recent statistical evidence suggesting that the associated rise in outbound foreign direct investment would not reduce the size of the domestic capital stock, but instead increase it. This evidence includes a study of my own with Mihir Desai and Fritz Foley, examining the aggregate

behavior of U.S. multinational firms over a number of years, but also includes aggregate evidence for Australia, industry-level studies of German and Canadian firms, and firm-level evidence for the United States, the United Kingdom, and Germany. In a very recent firm-level study of my own with Mihir Desai and Fritz Foley, we find that for American firms between 1982 and 2004, 10 percent greater foreign capital investment is associated with 2.6 percent greater domestic investment, and 10 percent greater foreign employment is associated with 3.7 percent greater domestic employment. Foreign investment also has positive estimated effects on domestic exports and research and development spending, indicating that foreign expansions stimulate demand for tangible and intangible domestic output.

Hence there are good reasons to think that exempting active foreign business income from U.S. taxation would stimulate greater economic activity in the United States. It follows that the opposite is also true: reforms that would curtail the ability of U.S. taxpayers to defer home country taxation of foreign profits or the ability to claim foreign tax credits would reduce the productivity of U.S. business operations and thereby reduce economic activity in the United States.

One of the striking aspects of viewing international income taxation through the lens of its impact on asset ownership is that this perspective offers important implications for the treatment of domestic expenses by firms with foreign income. Businesses engaging in worldwide production typically incur significant costs that are difficult to attribute directly to income produced in certain locations. Important examples of such expenses include those for interest payments and general administrative overhead. There is a very important question of how these expenses should be treated for tax purposes. Practices differ in countries around the world, and indeed, U.S. practice has varied over time, but the current U.S. tax treatment is

squarely on the side of allocating domestic expenses between foreign and domestic income based on simple indicators of economic activity. Thus, for example, an American multinational firm with 100 of domestic interest expense is not permitted to claim as many foreign tax credits as is an otherwise-equivalent American firm without the interest expense, reflecting the theory that a portion of the borrowing on which interest is due went to finance foreign investment.

Expense allocation of the variety embodied in current U.S. tax law has a decided intuitive appeal. It carries the general implication that domestic expenses that are incurred in the production of foreign income that is exempt from U.S. taxation (as is the case, for example, of income earned in countries with very high tax rates, for which foreign tax credits are available) are effectively not permitted domestic tax deductions (via an equivalent reduction in foreign tax credit limits). While there is much to be improved in the details of the current U.S. rules governing expense allocation, the general structure of expense allocation is largely consistent with the rest of the U.S. system of attempting to tax foreign income in a manner that vaguely embodies the principle of capital export neutrality.

Taking as a premise that capital export neutrality is an unsatisfactory basis for taxing foreign income, and that the United States would instead prefer to exempt foreign income from taxation based on capital ownership considerations, then what kind of expense allocation regime properly accompanies the exemption of foreign-source dividends from domestic taxation? The answer is that domestic expenses must not be allocated at all, but instead traced to their uses, as most countries other than the United States currently treat interest expense. To put the same matter differently, tax systems should permit taxpayers to allocate general expenses that cannot be directly attributed to identifiable uses in such a way that they are fully deductible in the country in which they are incurred.

In order to understand the logic behind permitting the full deductibility of domestic expenses, it is helpful to start by noting that any other system of expense allocation will have the effect of distorting ownership by changing the cost of foreign investment. Consider the case of a firm with both foreign and domestic income, and 150 of expenses incurred domestically in the course of activities that help the firm generally, and thereby arguably contribute both to domestic and foreign income production. One sensible-looking rule would be to allocate the 150 of expenses according to income production, so that if the firm earns half of its income abroad and half at home, with the foreign half exempt from domestic taxation, then the firm would be entitled to deduct only 75 of its expenses against its domestic taxable income. (We could envision a world in which foreign governments might permit the firm to deduct the other 75 of its expenses against income earned in their country, though this is of course not the world we inhabit. The discussion that follows assumes that governments do not permit deductions for general expenses incurred in other countries, as is indeed the universal practice.) For a firm with a given level of borrowing, greater foreign investment would then be associated with reduced domestic interest deductions, and therefore greater domestic taxes. Hence the home country would in fact impose a tax on foreign income, in the sense of discouraging foreign investment and triggering additional domestic tax collections for every additional dollar of foreign investment. The only sense in which this tax differs from a more conventional tax on foreign income is that it does not vary with the rate of foreign profitability.

The fact that a simpleminded expense allocation rule acts just like a tax on foreign investment might at first suggest that those who design policy should seek alternative expense allocation systems that do not create these incentives. Unfortunately, there is no clever solution available to this problem: any system that allocates expenses based on a taxpayer's behavior will

have the effect of influencing that behavior, in the same way that a more conventional tax would. An alternative system of tracing expenses, in which taxpayers determine and report the uses to which deductible expenses are put, does not have this feature but creates ample opportunities for tax avoidance. Hence policies designed to avoid taxing foreign income necessarily must forego allocating expenses incurred domestically.

This implication of foreign income exemption seems to run afoul of obvious objections from the standpoint of tax arbitrage. Why should the United States permit taxpayers to borrow in the United States, using the proceeds to invest abroad, and thereby earn income that is exempt from U.S. tax while claiming deductions against other U.S. taxable income for the cost of their borrowing? Even the observation that this is exactly what many other countries do has the feel of not fully addressing this issue. The answer lies in the fact that greater foreign investment triggers added domestic investment, so from the standpoint of the U.S. tax system, the borrowing does not simply generate uncompensated interest deductions, but instead a domestic tax base that is equivalent to (quite possibly greater than) the tax base that would be forthcoming if the borrowing proceeds were invested domestically by the same entity that does the borrowing.

The same point can be considered from the standpoint of the taxpayer. An American multinational firm with domestic and foreign operations should be indifferent, at the margin, between investing an additional dollar at home or abroad; if not, the firm is not maximizing profits. Hence when the firm borrows an additional dollar to invest abroad, it might as well invest at home, since the two produce equivalent after-tax returns – and it is clear that if a purely domestic firm borrows to undertake a domestic investment, it is entitled to deductions for its interest expenses.

Part of the confusion that surrounds the treatment of interest expenses (and other general expenses that firms incur and that are difficult to assign to particular lines of business) is that, from a tax standpoint, the marginal source of investment finance matters greatly. That said, the marginal source of investment finance is extremely difficult to pinpoint. Debt finance is generally preferred to equity finance on the basis of tax considerations, since in a classical corporate income tax system such as that practiced by the United States, interest expenses are tax deductible whereas dividend payments to shareholders are not. Hence debt finance might be thought of as a worst case scenario from the standpoint of raising corporate tax revenue; with appropriate income measurement, marginal debt-financed domestic investments generate no tax revenue, and with inappropriate income measurement, these investments might generate positive or negative tax revenue.

If the goal of a tax system is properly to raise revenue while offering appropriate economic incentives, and these are understood to include efficient incentives for capital ownership, then the simple exemption of foreign income from taxation is insufficient without accompanying expense allocation rules. Exempting foreign income from taxation gives taxpayers incentives to allocate their resources to maximize after-local-tax profits only if there is no unwinding of these incentives through expense allocation that depends on where income is earned or where other expenses are incurred. Using a system of expense tracing that in practice often entails full deductibility of domestic expenses need not be viewed as a daring step. The same logic that underlies the efficiency rationale behind exempting foreign income in the first place also implies that expenses should be deductible where incurred.

There are sure to be both revenue concerns and other concerns associated with a reform that exempts foreign income from taxation and permits tracing for domestic expenses. Removal

of U.S. taxation of active foreign business income would increase the importance of effective enforcement of the transfer pricing rules and other rules designed to protect the U.S. tax base. It would, however, be a mistake to maintain the current regime of taxing foreign income simply out of concern over base erosion of this type, given that there are many ways of addressing these issues. For example, elimination of U.S. taxation of active foreign business income might be accompanied by allocating significant additional resources to the Internal Revenue Service for use in international enforcement. Given the alternatives before us, it would be a serious mistake to think that enforcement concerns alone dictate the maintenance of an inefficient system of taxing worldwide income.

The question to ask going forward is what is the alternative to exempting foreign income from taxation? The alternative is one in which American businesses continue to face inefficient incentives for asset ownership, incentives that their competitors from most of the rest of the world do not face. The inefficiencies for which these incentives are responsible continue to erode American living standards, not acutely, but gradually and relentlessly, thereby contributing to an economic situation in the United States that is not as promising as it might otherwise be. If worldwide taxation of active business income is a good idea, then is it not also just as good an idea to subject the foreign operations of American firms to U.S. excise taxation, sales taxation, and property taxation? And if not, what does that tell us about worldwide income taxation?

Statement of Senator John Kerry
United States Senate Committee on Finance
Hearing: The Foundation of International Tax Reform:
Worldwide, Territorial, and Something in Between
June 26, 2008

I would like to thank Chairman Baucus and Ranking Member Grassley for holding this series of hearings on tax reform. I am particularly interested in today's topic of international tax reform.

The United States has the second-highest statutory corporate tax rate among the thirty countries in the Organization for Economic Development (OECD), but the fourth lowest corporate tax revenue as a share of GDP. One rough estimate is that one-quarter of corporate income is never taxed at any level. I believe that our current international tax system contributes to this statistic.

Under our current tax system, income earned abroad is not taxed until it is repatriated to the United States. I am concerned that this "deferral" of taxation allows foreign-earned income to grow tax free, distort investment decisions, potentially lead to overinvestment abroad, create incentives for firms to earn or report profits in low-tax countries, and reduce U.S. corporate tax revenue.

Back in 2004, I proposed to fundamentally reform our international tax system by ending tax breaks that encourage companies to move jobs overseas by eliminating the ability of companies to defer paying U.S. taxes on foreign income. I made this proposal out of concern that under U.S. tax law, a company that is trying to decide between locating production or services in the United States or in a foreign low-tax haven is actually given a substantial tax incentive not only to move jobs overseas, but to reinvest profits permanently, as opposed to bring them back and re-invest in the United States.

I have introduced S. 96, the Export Products Not Jobs Act, which makes sweeping changes to our current international tax laws. The rules of Subpart F which govern the taxation of foreign subsidiaries controlled by American companies have become increasingly complicated over time, adding to the overall complexity of the tax code and making it easier for companies to exploit loopholes to escape taxes.

The Export Products Not Jobs Act eliminates deferral so companies are taxed the same whether they invest abroad or at home. Companies will be taxed on their foreign subsidiaries profits just as they are taxed on their domestic profits. Companies will be able to defer the income they earn when they locate production in a foreign country that serves foreign country's markets. This will ensure American companies can remain competitive in international markets.

Today's hearing provides us with the opportunity to explore what is wrong with our current international tax system and what needs to be fixed. I believe that our current rules have become so complicated that the system is almost completely broken.

I look forward to a thorough discussion on our current international tax system and hearing the panel of experts' suggestions for reform.

Testimony of Stephen E. Shay**United States Senate Committee on Finance****Hearing on The Foundation of International Tax Reform: Worldwide, Territorial,
and Something in Between****June 26, 2008**

Mr. Chairman and Members of the Committee:

My name is Stephen Shay. I am a partner in the law firm Ropes & Gray in Boston. I specialize in U.S. international income taxation and was formerly an International Tax Counsel for the Department of the Treasury.¹ The views I am expressing are my personal views and do not represent the views of either my law firm or its clients.

With the Chairman's permission, I would like to submit my testimony for the record and summarize my principal observations in oral remarks.

I have been invited to discuss possible U.S. international tax reforms. I will limit my comments to U.S. tax rules relating to the taxation of foreign business income, that is, income earned from conducting economic activity outside the United States.² I will identify what I view as problems in our current rules for taxation of foreign business income and discuss possible reforms.

The following sections of my testimony (i) discuss the tax policy principles that should guide consideration of U.S. income tax rules generally as well as the rules for taxing foreign business income, (ii) review and evaluate existing U.S. international tax rules, (iii) analyze the difficulties posed by related party income and deductions to administration and enforcement of international tax rules (i.e., transfer pricing issues), (iv) consider possible reforms to the U.S. rules in relation to the defects of current law.

I. U.S. Tax Policy Objectives

The principal function of the U.S. Federal income tax is to collect revenue to maximize U.S. welfare.³ The correct measure of U.S. welfare is the well being of

¹ I have attached a copy of my biography to this testimony. I would like to thank Benjamin P. Damsky, a law student at Boston University School of Law and summer law clerk at Ropes & Gray, for his assistance in preparing this testimony.

² In September, 2007, I testified before the Committee on Ways and Means regarding the issue of fairness in our international tax rules. I will draw on that testimony today.

³ Secondary roles of the U.S. income tax system include appropriating public funds, through "tax expenditures," and regulating behavior through tax penalties (which sometimes are sometimes referred to as negative tax expenditures). See J. Clifton Fleming & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437, 468-87 (2008); Daniel N. Shaviro,

individual U.S. citizens and residents. Accordingly, the primary focus of U.S. income tax policy should be how to raise revenue in a manner that improves the lives and living standards of U.S. citizens and residents.⁴ To best carry out this directive, the federal income tax system is guided by traditional tax policy goals of fairness, efficiency and administrability.⁵

The fairness criterion is based on the accepted notion that a fair tax should take account of a taxpayer's ability to pay. While there may be differences in opinion regarding the ideal tax base or rate structure to employ in taxing income, there is a broad consensus supporting application of fairness criteria to policy analysis of the income tax system. Indeed, fairness has been a principal justification for the income tax in the United States since its inception.⁶ One of the reasons to base a tax on a taxpayer's entire income is that income is a reasonable proxy for ability to pay.⁷ The source of a taxpayer's income does not affect that taxpayer's ability to pay. Thus, with respect to international taxation, all else equal, there would be no basis to exclude foreign-source income from a resident's ability to pay.

The concept of efficiency generally assumes that the value of society's goods and services can be maximized through the free market. Thus, laws and regulations, when utilized, should try to distort pre-tax economic decisions as little as possible. But, especially in the international context, deploying the concept of efficiency is not a simple task. There is a lack of consensus among economists regarding what neutrality principle (i.e., benchmark of economic efficiency) should guide U.S. tax policy in an open-economy, international setting.⁸ I will not review these arguments here.⁹ It will suffice to reiterate that the efficiency criterion generally supports rules that distort pre-tax

Rethinking Tax Expenditures and Fiscal Language, 57 TAX L. REV. 187, 199–206 (2004); David A. Weisbach & Jacob Nussim, *The Integration of Tax And Spending Programs*, 113 YALE L. J. 955, 961 (2004).

⁴ See Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 284 (2001) [hereinafter Graetz, *Taxing International Income*].

⁵ See U.S. TREAS. DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 13–19 (1984).

⁶ There is a rich academic literature about the theoretically appropriate bases on which to evaluate fairness claims and even whether such claims have normative content. See J. Clifton Fleming, Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 301 n. 12 (2001) [hereinafter Fleming, Peroni & Shay, *Fairness in International Taxation*] (noting literature). It seems clear, however, that the perception that imposing tax on income is fundamentally fair has played an important role in the continued importance of the income tax as a means of raising revenue in the United States and other developed countries.

⁷ I do not consider here issues relating to whether rates of tax on income should be progressive (i.e., increase with income) or flat. Nor do I consider how the distribution of tax burden should be analyzed, e.g., accounting for governmental transfer payments to individuals and subsidies to businesses.

⁸ See *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 680–89 (2006) [hereinafter *ABA Report*] (report authored by task force convened by American Bar Association, Section of Taxation).

⁹ For a summary of the arguments and references, see DAVID L. BRUMBAUGH & JANE G. GRAVELLE, CONG. RESEARCH SERV., REFORM OF U.S. INTERNATIONAL TAXATION: ALTERNATIVES 4–11 (2007) [hereinafter BRUMBAUGH & GRAVELLE, REFORM OF INTERNATIONAL TAXATION]; *ABA Report*, *supra* note 8, at 680–89.

economic decisions as little as possible. Therefore, granting a tax subsidy, or tax penalty, to one type of investment is disfavored.¹⁰ In the international context, the conventional application of the efficiency criterion would prescribe that the effective tax rate on an item of foreign income, taking into account foreign taxes, should not be materially lower than the effective rate on domestic income. A corollary is that relief should not be given to high foreign effective tax rates through cross-crediting.

The administrability criterion recognizes that the costs of administration and enforcement, to government and taxpayers, are not productive costs and should be kept to the minimum possible. While recognizing that taxpayers with international income are generally sophisticated and able to deal with complex provisions, a system whose complexity fosters wasteful tax planning and which is difficult to administer by tax authorities is undesirable. While tax law uncertainty is undesirable, it is inevitable, and to constrain taxpayers from taking undue advantage of the uncertainty it is necessary and, to the point of marginal return, efficiency enhancing to invest resources in enforcement.

The policy criteria of fairness, efficiency and administrability conflict. The critical point is that when an inefficient tax situation is present, the total costs and benefits of that rule – including fairness, and administrability – are all considered. Only then can the rule be properly evaluated.

I will next briefly outline the current U.S. rules for taxing U.S. persons' foreign business income, make observations about how these rules operate in practice and evaluate the current rules under the preceding tax policy criteria.

II. An Evaluation of Current U.S. Rules For Taxing International Income

A. Overview of Current U.S. Rules

Worldwide taxation subject to a limited tax credit for foreign income taxes. The United States taxes the worldwide income of U.S. citizens, resident aliens and domestic corporations. Generally, the United States allows a taxpayer to elect to credit foreign income taxes paid or deemed paid. The credit for the foreign income tax paid is allowed against U.S. tax subject to a limitation that the credit may not exceed the pre-credit U.S. tax that otherwise would be paid by the taxpayer on foreign-source net income in the same limitation category as that on which the foreign tax is paid. Today, there are only

¹⁰ The President's Advisory Panel on Federal Tax Reform articulated a standard for evaluating proposals that favor one activity over another that should be applied to evaluate proposals to tax foreign income more or less favorably than domestic income:

Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs, and can lead to an inefficient use of resources. A rational system would favor a broad tax base, providing special tax treatment *only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers.*

PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, FINAL REPORT xiii (Nov. 1, 2005), available at <http://www.taxreformpanel.gov/final-report/> [hereinafter PRESIDENT'S ADVISORY PANEL REPORT] (emphasis added).

two foreign tax credit limitation categories, one for passive income and another "general" category that includes all non-passive income.

U.S. source taxation of a foreign corporation. In contrast to the taxation of U.S. persons, foreign persons are taxed by the United States only on a source basis on certain U.S.-related income. Foreign persons that carry on a U.S. trade or business are taxed on their net income effectively connected with that trade or business. If resident in a treaty country, the foreign person's income must be attributable to a so-called "permanent establishment" in the United States. Foreign persons earning U.S. source income not connected with a U.S. trade or business are taxed on U.S.-source interest, dividends, royalties and other fixed or determinable, annual or periodical ("FDAP") income at a rate of 30% (or lower treaty rate) on the gross amount of the income. A foreign corporation's earnings that are effectively connected to the U.S. are subject to a second level branch profits tax that also may be reduced or eliminated by treaty.¹¹ A foreign corporation is not taxed by the United States on foreign income unless the foreign income is effectively connected with a U.S. trade or business.

U.S. shareholder taxation of income earned through a foreign corporation. Most active foreign business income earned by a foreign (non-U.S.) corporation is not taxed to its U.S. shareholders until distributed. In international tax, this concept is referred to as "deferral." If and when the foreign corporation's earnings are distributed (or deemed to be distributed), the United States will allow a U.S. corporate shareholder who owns 10% or more of the voting power of the foreign corporation a credit for foreign income taxes paid.¹² This "indirect" or "deemed paid" credit mitigates double corporate taxation of the foreign dividend.¹³ An individual U.S. taxpayer may (through 2010) treat certain dividends from publicly traded foreign corporations (and foreign corporations qualifying for the benefits of a comprehensive income tax treaty with the United States) as qualified dividend income ("QDI") eligible for the 15% tax rate on long-term capital gain, provided that the foreign corporation was not a passive foreign investment company in the current or preceding year.

Anti-deferral rules. A series of so-called anti-deferral rules are intended to discourage use of foreign corporations as mechanisms to avoid U.S. tax on certain passive and other "base company" income. The two principal anti-deferral regimes today are the controlled foreign corporation rules and the passive foreign investment company

¹¹ The determination of whether a corporation is domestic or foreign is essentially elective. A corporation is domestic if it is incorporated under the laws of the United States, one of the states of the United States or the District of Columbia or is a business entity that is otherwise organized under such laws and elects to be taxable as a corporation.

¹² Because the U.S. tax on foreign income earned by a foreign corporation is deferred until the earnings are repatriated, rules are required to associate the foreign taxes to the earnings that are repatriated, either as an actual dividend or as income inclusions under subpart F. In addition, to permit the foreign tax credit limitation to operate effectively, the limitation categories are applied on a look-through basis to income of a controlled foreign corporation and a non-controlled section 902 corporation.

¹³ A dividends received deduction is not allowed with respect to a dividend from a foreign corporation of earnings that were not effectively connected with a U.S. trade or business.

rules.¹⁴ The tax rules relating to a United States shareholder's share of income earned by a controlled foreign corporation, in addition to limiting deferral for passive income, also end deferral for certain active business income that is earned through the use of "base companies" and is subject to an effective rate of foreign tax that is lower than the U.S. rate. The investment in U.S. property rules generally are designed to prevent earnings of a controlled foreign corporation that have not been taxed to a U.S. shareholder from being made available, directly or indirectly, to a U.S. shareholder.

A United States shareholder's gain on the sale of stock in a controlled foreign corporation generally will be treated as a dividend to the extent of the shareholder's share of the controlled foreign corporation's earnings. What was once considered a negative provision for taxpayers that recaptured the benefits of deferral, is in many cases favorable or neutral. The dividend income will carry foreign tax credits to a 10% corporate shareholder and may constitute qualified dividend income eligible for the 15% rate (until 2010) to an individual shareholder.

A U.S. shareholder in a passive foreign investment company ("PFIC"), that is not also a U.S. shareholder in a controlled foreign corporation, is subject to the rough equivalent of current taxation of the foreign corporation's earnings (or appreciation in value) under one of several alternative taxing regimes. As currently designed, the PFIC rules are intended to cause taxable U.S. shareholders in foreign investment companies to elect to be taxed in a manner that is comparable to the tax that would be imposed on a shareholder in a U.S. mutual fund (a "QEF election") or, if the foreign shares are marketable, to elect mark-to-market treatment if the information necessary to make a QEF election is not available.

Transfer pricing. The Internal Revenue Service has broad authority to reallocate income, deductions or expenses between commonly controlled taxpayers if they engage in transactions that do not satisfy an arm's length standard. Regulations under section 482 prescribe the method for determining whether loans of money or transfers of tangible property, intangible property, and services are within a range of arm's length prices. Normally, if an arm's length price determined under methods prescribed in the regulations falls within the inter-quartile range of arm's length prices as finally determined, no transfer pricing adjustment will be made. I will discuss some of the challenges that transfer pricing poses to our international tax rules later in my testimony.

B. Planning Opportunities Under the Current U.S. International Tax Rules

As I have testified previously, the current U.S. rules, while complex, represent the best of all worlds for well-advised U.S. multinational taxpayers. Current U.S. tax rules relating to foreign business activity are, in practice, a hybrid between actually taxing

¹⁴ A "controlled foreign corporation" is a foreign corporation that is more than 50% owned, by vote or value, considered either directly or indirectly under constructive ownership rules, by United States shareholders. A "United States shareholder" is a U.S. person that owns 10% or more by vote, directly or indirect under constructive ownership rules, of the foreign corporation. A "passive foreign investment company" is a foreign corporation that has 75% or more passive income or 50% or more passive assets.

worldwide income and taxing foreign income at a lower or even zero rate (i.e., exempting foreign income).

The most advantageous feature of the current rules for U.S. multinationals is deferral. First, deferral is essentially elective: if foreign income is earned through a foreign corporation, instead of directly by a U.S. person, and the earnings are reinvested in a foreign business, the U.S. tax may be deferred. If U.S. multinationals earn income from active business operations carried on through foreign corporations in low-effective-tax rate structures, enhanced by transfer pricing planning (discussed below), the U.S. multinationals generally pay no residual U.S. tax until they either receive dividends or sell their shares. Over a long enough period, deferral can be quite valuable and even approach exemption.¹⁵

In addition, U.S. anti-deferral rules have been narrowed, directly or through interpretation, in recent years.¹⁶ In 2004, Congress adopted a so-called "homeland dividend" provision, which temporarily allowed corporations to repatriate offshore deferred earnings at a low rate.¹⁷ As a result, the perceived benefit of deferral may now have increased, if taxpayers believe such a provision will be enacted again at some point in the future.¹⁸ All of this taken together with the adoption of elective entity classification and the inherent flexibility of transfer pricing, there is substantial scope for tax planning, often involving low-taxed countries, to reduce foreign taxes and accelerate

¹⁵ If a taxpayer will suffer a loss, it may establish its foreign business through a limited liability entity that elects to be taxed as a pass through for U.S. tax purposes so that the tax benefit for the loss may be used currently on its U.S. federal income tax return.

¹⁶ See e.g., I.R.C. § 954(c)(6) (2006) (expanding the ability to shift income from high to low taxed affiliates without triggering current income inclusion to a United States shareholder); I.R.S. Notice 2007-13, 2007-5 I.R.B. 410 (limiting the circumstances in which services performed by a controlled foreign corporation will be considered to benefit from assistance of a U.S. person and therefore be subject to current income inclusion to a United States shareholder); Prop. Treas. Reg. § 1.954-3(a)(4)(iv), 73 Fed. Reg. 10716, 10719–22 (Feb. 28, 2008) (providing that a controlled foreign corporation that makes a substantial contribution to manufacturing of the personal property sold will satisfy the manufacturing exception to current income inclusion as base company sales income notwithstanding that the manufacturing itself is performed under contract with a separate manufacturer if certain enumerated activities, including oversight, direction, material and vendor selection and quality control, among others, are performed by its own employees).

¹⁷ The 85 percent dividends received deduction of section 965 effectively exempted from U.S. tax substantially all of the earnings repatriated under that relief provision. Ostensibly, 15% of the repatriated earnings were subject to U.S. tax at up to 35% for an effective rate of 5.25% on the dividend. In many cases, the U.S. tax was eliminated by foreign tax credits so the earnings were effectively exempted from U.S. tax. While billed as an economic relief measure, the homeland dividend provision would be more accurately described as a partial amnesty from U.S. tax for low-taxed offshore profits. For a perceptive critique of the "farce" that homeland dividend relief represented, see Charles I. Kingson, *The Great American Jobs Act Caper*, 58 TAX L. REV. 327, 388–91 (2006) [hereinafter Kingson, *Great American Jobs Act Caper*]. An IRS study indicates that 843 mostly very large corporations (out of 9700 corporations that had controlled foreign corporation subsidiaries) repatriated almost \$362 billion. Melissa Redmiles, *The One-Time Received Dividend Deduction*, in I.R.S. STATISTICS OF INCOME BULLETIN, SPRING 2008, at 102, 103. There is no empirical analysis to date that demonstrates that the repatriation had a meaningful impact on U.S. economic activity or employment.

¹⁸ See George K. Yin, *Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers*, 88 TAX NOTES 173, 175 (2008) [hereinafter Yin, *Reforming Taxation*].

utilization of remaining foreign taxes as credits.¹⁹ If the United States allows unlimited deferral, it is reasonable to expect that use of low tax regimes will continue to increase.²⁰

Another tax benefit for U.S. multinational taxpayers that earn high-tax foreign income is to use excess foreign tax credits against other low-taxed foreign income. The effect of this cross-crediting is to provide an incentive to a taxpayer with excess foreign tax credits to earn low-taxed foreign income and to credit the foreign tax against U.S. tax on this income. This effectively shifts the burden of a foreign country's high taxes to the United States. Excess foreign tax credits even can be used to offset U.S. tax on royalty income and income from export sales that is treated as foreign-source income for U.S. tax purposes (though this income generally would not be taxed by the source country).²¹

Companies may also combine these effective tax reductions with other beneficial features of the U.S. international tax regime. Other benefits include tolerance for moderate to aggressive transfer pricing, defective expense allocation rules, and deductibility of overall foreign losses against domestic income. All considered, the overall effect can be more beneficial to taxpayers than an exemption system.²² This is borne out by estimates that government tax revenues would *increase* if active foreign business earnings are exempt from U.S. tax when distributed as a dividend.

The lack of friction on U.S. planning has allowed average effective foreign tax rates on the 7,500 largest U.S. controlled foreign corporations ("CFCs") to decline from 33.98% in 1986 to 19.24% in 2002, well beyond what could be explained by declines in other countries' nominal tax rates.²³ The U.S. Treasury has found evidence that correlates this pattern with income shifting from high nominal tax rate countries to low tax rate countries.²⁴

¹⁹ See *ABA Report*, *supra* note 8, at 705; Kingson, *Great American Jobs Act Caper*, *supra* note 17, at 370–87.

²⁰ See e.g., Martin A. Sullivan, *The IRS Multibillion-Dollar Subsidy for Ireland*, 108 TAX NOTES 287 (2005). Charles Kingson correctly observes that repealing the application of the PFIC rules to United States shareholders in a controlled foreign corporation in 1997 eliminated the only tax-based limit on the amount of controlled foreign corporation earnings that could be deferred by a member of the U.S. control group. See Kingson, *Great American Jobs Act Caper*, *supra* note 17, at 382–85. U.S. shareholders with less than 10% holdings remains subject to the PFIC rules and the PFIC asset test in particular. It would have made more sense to repeal the PFIC asset test for U.S. portfolio investors and retain it as a limit on deferral for greater than 10% U.S. shareholders in a controlled foreign corporation.

²¹ See generally J. Clifton Fleming, Robert J. Peroni & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 TAX NOTES 103 (2003), 31 TAX NOTES INT'L 1145 (2003).

²² See e.g., Harry Grubert & Rosanne Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income* 9–10 (Rutgers Univ. Dep't. of Econ., Working Paper No. 2006-26), available at <http://www-snde.rutgers.edu/scripts/Rutgers/wp/rutgers-listwp.exe?200626>.

²³ See Yin, *Reforming Taxation*, *supra* note 18, at 174 tbl. 1 (presenting average foreign income tax rates over time of 7,500 largest CFCs of U.S. parent corporations).

²⁴ See U.S. DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES 58 (2007) [hereinafter TREASURY TRANSFER PRICING REPORT]. The Treasury emphasizes that this is a correlation and not proof that there is "inappropriate income shifting." *Id.* The Treasury is careful to hypothesize a series of non-transfer pricing reasons for this result, including that: "CFCs in low-tax jurisdictions may have more asset intensive operations, which

C. Evaluation of Current U.S. Rules for Taxing Foreign Income of U.S. Persons

Should we be concerned with the developments just described? The answer is yes. First, much of the income shifting is from the United States, so planning results in erosion of U.S. tax on income properly in the U.S. tax base. Such revenue loss can be ill afforded under present budgetary conditions. Second, reliable availability of low effective foreign tax rates will, at the margin, result in distortions of investment decision – including some shifting of productive investment from the United States to foreign locations.²⁵ Third, there is a real risk of erosion of confidence in the fairness of a tax system that allows a subset of taxpayers to benefit to such a great extent from tax rules that are difficult to justify as a matter of tax policy.²⁶

There is no *a priori* reason for allowing a special position for foreign business income, whether the income is earned directly by individuals or indirectly through foreign activities of U.S. or foreign corporations.²⁷ If U.S. taxation of foreign business income is lower than on domestic business income, U.S. persons who do not earn foreign business income will be subject to heavier taxation solely because of where their business is located. To justify relief from U.S. tax on foreign business income, there should be an identifiable benefit to individual U.S. citizens and residents.

It has been argued, however, that exemption treatment is warranted here because otherwise U.S. companies would not be able to compete on a level playing field with foreign and local competitors. This argument does not appear to be supported by strong empirical evidence that distinguishes the claim from a claim that also may be made by a purely domestic business. U.S. businesses located in the United States also have to compete with foreign businesses. The location of a business does not insulate it from international competition. Additionally, the historical success of U.S. businesses in foreign markets belies the presence of any relative or disabling disadvantage.²⁸

I am not aware of objective empirical evidence that the benefits of allowing U.S. companies deferral or excessive credits for foreign taxes is optimal in that it generates more benefits to U.S. citizens and residents than they cost in the losses from distortion of

is associated with higher profit margins. . . . [and] CFCs in more research-intensive industries may operate in lower tax jurisdictions, and in fact may develop their own intangibles to exploit." *Id.* I am not aware of likely empirical support for these hypotheses.

²⁵ Professor Yin writes: "In summary, the U.S. tax treatment of foreign direct investment by U.S. persons has become so favorable as to exert a potentially powerful lure in favor of such investment." Yin, *Reforming Taxation*, *supra* note 18, at 175.

²⁶ See generally Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 6; Graetz, *Taxing International Income*, *supra* note 4; Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POLICY INT'L BUS. 145 (1998) [hereinafter Kaufman, *Fairness*].

²⁷ See Fleming, Peroni & Shay, *Fairness in International Taxation*, *supra* note 6, at 311; see also generally Graetz, *Taxing International Income*, *supra* note 4; Kaufman, *Fairness*, *supra* note 26.

²⁸ For a sample of anecdotal sources regarding the successes of U.S. multinational corporations in foreign markets, see Russell Gold, *Exxon to Boost Spending, Broaden Exploration*, WALL ST. J., Mar. 6, 2008, at B1; Christopher Hinton, *Monsanto Net Early Triples*, WALL ST. J., Jan. 4, 2008, at C14; Kathryn Kranhold, *GE's Strength Abroad Helps It Weather Weakness in U.S.*, WALL ST. J., Jan. 19–20, at A3; Tom Lauricella, *Economic Split Seen in Corporate Earnings*, WALL ST. J., April 18, 2008, at A1.

economic decisions and higher taxes on U.S. citizens and residents and domestic businesses. If the reduced level of U.S. tax on corporate income allowed under current U.S. international tax rules shifts the tax burden to U.S. citizens and residents beyond what can be justified to avoid double taxation of income, then it likely has an overall undesirable effect.

Our current international tax rules offer substantial planning opportunities to reduce foreign taxes and to shift income to entities with low-effective tax rates. The effect is not only wasteful administration costs due to extensive planning, but distortion of economic decisions by creating incentives to structure business activity in a manner that takes advantage of low or reduced effective tax rates. As discussed below, the incentive of substantially lower effective foreign taxes fosters aggressive transfer pricing that is beyond the ability to transfer pricing rules to conduct.

The current rules permit excessive cross-crediting of foreign taxes that subsidize the cost of high foreign taxes for taxpayers and create an additional incentive to earn low foreign taxed income. In the absence of excess foreign tax credits to offset U.S. tax on the repatriation of foreign earnings, a further inefficiency of deferral is that the U.S. tax on repatriation skews the decision against repatriation.

To summarize, significant defects of the current U.S. international tax regime include:

- (i) Permitting the combined U.S. and foreign effective rates of taxation of foreign income to be so low as to encourage shifting of activity and income outside the United States for tax rather than business reasons;
- (ii) Subsidizing high foreign taxes through excessive cross-crediting of foreign taxes against U.S. tax on repatriations of low-taxed foreign income; and
- (iii) Imposing, where cross-crediting is not available, additional tax on foreign income when repatriated, instead of when earned, so as to create a disincentive to repatriated earnings.

Before turning to possible reforms to the current U.S. rules, it is worthwhile to review the particular challenge that transfer pricing generally, and transfer pricing for intangibles in particular, poses to any international tax regime. There is a large scope for transfer pricing planning that is inevitable in a cross-border environment under any plausible approach to transfer pricing. This exacerbates the structural defects in any international tax regime and should be a major factor in considering why a tax system allows foreign business income to go untaxed by the United States.

III. The Problem of Transfer Pricing

A. The International Consensus Behind the Arm's Length Principle

The need to allocate income and deductions among related parties is a central feature of international income taxation. Following the leadership of the United States, a fairly remarkable international consensus has developed around the idea that the market-based principles of the arm's length separate transaction method should guide the international division of income to the extent possible.²⁹ When the U.S. Internal Revenue Service seeks to make a transfer pricing adjustment using arm's length methods, it does so knowing that most other countries accept the principles underlying the basis for the allocation. Notwithstanding the substantial benefits that arise from having a consensus guiding principle and how it should be applied, the application of the arm's length principle in practice is challenging for all governments.

B. When Income or Deductions Are Misallocated: What is At Stake

The benefits (or detriments) of a misallocation of income or a deduction recognized by both countries is measured by the return that is earned on the difference in tax that results from the improperly allocated income or deduction.

Example 1. If U.S. Multinational (USM) has a marginal effective tax rate of 35% on its US income and a marginal effective tax rate of 10% on income earned in Country X by a foreign affiliate, F Sub, the tax benefit of allocating income from USM to F Sub would be a tax saving of 25% of the amount of income transferred.

A comparable analysis applies to a USM deduction that benefits F Sub and that, if charged to F Sub, would be allowed to F Sub to offset its income taxed in Country X.

Example 2. Under the facts of Example 1, USM incurs a payment that benefits F Sub and that, if charged to F Sub, would be allowed as a deduction. USM does not charge F Sub for the deduction and no allocation of the deduction is made. The tax benefit of not allocating the deduction to F Sub would be a tax saving of 25% of the deduction amount.

These are classic transfer pricing issues and are the subject of section 482 of the Code as well as income tax treaty provisions designed to allow countries to reach agreement on the appropriate arm's length allocation of income and deductions.

A somewhat different analysis applies to deductions that benefit foreign income in whole or in part but would not be allowed as a deduction in the foreign country. These deductions, including an allocable share of corporate overhead, research and development and interest expenses of a parent company, have been a source of controversy in the

²⁹ See ORG. FOR ECON. CO-OPERATION AND DEV., ARTICLES ON THE MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND CAPITAL *passim* (2005) available at <http://www.oecd.org/dataoecd/50/49/35363840.pdf> (using arm's length valuation); ORG. FOR ECON. CO-OPERATION AND DEV., TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS *passim* (2005).

determination of the U.S. foreign tax credit limitation. Similar issues arise in an exemption system of avoiding double taxation. The policy issue raised by each of these kinds of deductions is the extent to which the country of residence should allow a deduction that supports assets that generate income in the source country, even where the source country would not allow the deduction if the expenditure were charged to the source country.

Allowance of a deduction against domestic income to earn exempt income results in a revenue loss equal to the tax saved from the amount expensed.³⁰ If the tax rate is 35%, deducting an expense of \$100 results in saved tax of \$35. The benefit of expensing is the return on the \$35 until the deferred income is included in taxable income.³¹ If the source country does not allow the deduction (i.e., it would not accept that the deducted amount should be charged to the source country business), should the residence country nonetheless allow the deduction?

Example 3. Assume the same facts as in Example 1. USM incurs \$100 of R&D expense in relation to a product line sold by F Sub. Country X, however, will not allow F Sub to deduct a cost reimbursement or royalty paid to USM in relation to the R&D expenditure. As a result, F Sub pays a 10% tax on income that otherwise would have been deducted.

If the United States does not tax F Sub's income, allowing the deduction provides a 35% benefit in addition to the exemption of the income that is taxed at a 10% rate by Country X. In other words, allowing the deduction creates a negative tax on (i.e., subsidizes) the exempt foreign income.³² Also, in this circumstance, the tax rate of the foreign nation does not factor into the amount of domestic revenue lost by allowing the deduction. The foreign rate will only work to determine how attractive at the margin the foreign investment is to a U.S. resident.

These examples illustrate the consequences of misallocating income and deductions. It is critical to understand that when a deduction properly allocable to foreign income is allowed against domestic income, the foreign investment is advantaged resulting in an inefficient pre-tax distortion of taxpayer behavior. Nor are these simply hypothetical scenarios. Under-allocation of expenses to foreign income is prevalent in the U.S. international tax rules.

The following discussion will illustrate why enforcing proper transfer pricing for income and expenses can be so challenging.

³⁰ Under a well-known tax equivalence, generally attributed to Cary Brown, a deduction against current income of an amount invested is equivalent (under several assumptions) to exempting the yield from that investment. See E. Cary Brown, *Business-Income Taxation and Investment Incentives*, in INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN E. HANSEN (Lloyd A. Metzler, et al., eds., 1948). For a modern usage, see Alvin C. Warren, *The Business Enterprise Income Tax: A First Appraisal*, 118 TAX NOTES 921, 921–24 (Feb. 25, 2008).

³¹ A recent proposal by Chairman Rangel would defer a deduction until income is repatriated to deal with this issue. See *infra* text accompanying notes 51–54.

³² See *ABA Report*, *supra* note 8, at 760 (stating how U.S. resident taxpayers generally prefer to allocate deductions domestically).

C. Information Asymmetry and the Limits on Enforcement of Any Transfer Pricing Regime

Notwithstanding the potentially high stakes, transfer pricing is difficult for any government to administer and enforce. At the heart of the problem facing the government is that the taxpayer possesses all the relevant facts to evaluate the transfer pricing decision. Moreover, applying the arm's length standard is difficult for both the taxpayer and the government in many circumstances because the character of the goods and services is highly fact specific. There is an unavoidable uncertainty in the application of substantive law. This problem is particularly acute for income from intangible property and high value services. In this context, the effects of practical hurdles to government enforcement are magnified and operate to taxpayer advantage.

It is important to understand the difficulties facing any government in administering and enforcing transfer pricing rules. Most often, a government trying to evaluate a taxpayer's transfer pricing decision faces a steep information asymmetry.³³ Taxpayers need not routinely disclose relevant facts on either tax returns or consolidated financial statements.³⁴

If the government does start an audit, it must ask the right questions in order to elicit information that is relevant to a pricing analysis. They must learn enough about the business and its economics to determine when income and margin are out of line. Well-advised and disciplined taxpayers prepare their cases as soon as the audit starts (in addition to prior planning for these issues) and know where the sensitive points are. While a taxpayer must answer truthfully and fully an information document request ("IDR"), they have no obligation to direct the government to the right question or data absent an IDR request. Even for large taxpayers subject to continuous audit, there is a material risk of non-detection of a broad range of inappropriate transfer pricing. Too often, when the IRS does propose an adjustment it is so over the top that they lose credibility with the trier of fact (whether an appellate conferee or a judge) that they do not recover during the case.

Even if the IRS's proposed adjustment has sufficient merit to support an adjustment, it often is the case that the taxpayer can persuade a reviewer (an appellate conferee or trial counsel) that the government has sufficient "hazards of litigation" that the taxpayer's allocation would be sustained (even with the burden falling to the taxpayer

³³ See Ilan Benshalom, *Sourcing the "Unsourceable": The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions*, 26 V.A. TAX REV. 631, 647 (2007) [hereinafter, Benshalom, *Sourcing the Unsourceable*]. The problem of information asymmetry is especially acute in the case of the allocation of expenses. It is extremely difficult for the government to readily identify how expenses should be allocated to a category of income or activity.

³⁴ There is reporting of related party amounts under section 6038, but these reports do not highlight when the pricing may be inconsistent with the arm's length standard. Although many taxpayers with large intercompany payments prepare section 6662 transfer pricing documentation, it is designed to demonstrate the reasonableness of the taxpayer's method. It generally is prepared to support the taxpayer's position without highlighting major exposures. It remains unclear whether and how the relatively new financial standards known as "FIN 48" will affect this calculus.

to demonstrate that the government's proposed allocation is unreasonable and the taxpayer's allocation is reasonable) to achieve a compromise at less (and often substantially less) than a 100 percent taxpayer concession. Moreover, unless the taxpayer's conduct is egregious, if the IRS does persuade a trier of fact that the IRS adjustment should be sustained, it is difficult for the IRS to effectively impose a transfer pricing penalty (and is particularly difficult in the context of settling a controversy). In the face of such difficulties and the large expense to the Government of trying a case, settlements are common and necessary to allow the tax enforcement system to function. While there are (relatively rare) transfer pricing controversies where penalties are applied, the penalty structure generally is not sufficient to create a significant taxpayer disincentive to taking full advantage of the preceding difficulties in enforcement (and it is unlikely that such a penalty system could be adopted).³⁵

These features of transfer pricing make it rational for a taxpayer to take positions that are, at a minimum, moderately aggressive. To fail to do so is to leave a tax decision maker open to criticism that the tax planning has "left money on the table." Whether a taxpayer goes further is largely a function of its appetite for tax risk and whether the taxpayer (in particular a public company) can persuade its auditors that either it is not necessary to establish a reserve or that a modest reserve is sufficient. None of the preceding discussion is intended to refer to tax positions that are not fully justified from a legal and ethical perspective. Indeed, that is the point.

D. The Challenge of Intangible Property

The advent of market and taxpayer recognition of the value of intangible property rights such as patents, know-how and trademarks has added pressure on the ability of governments to employ the separate transaction arm's length method. Almost by definition, these property rights exclude the rights of third parties to use the protected invention or brand mark or logo. Whether the person possessing the intangible property right licenses the right in an arm's length transaction to a third party involves a business calculation of the likely share of the return that must be allowed to the licensee. The conventional view, although evolving, is that a highly valuable intangible right will not be shared with third parties. In the absence of reliable third party benchmarks, taxpayers have substantial latitude to determine the return to the intangible.

Intangible property, while not passive when used in the business, nonetheless is particularly mobile property. International legal protections for forms of intellectual property have substantially improved in recent decades so that it is feasible as a commercial and legal matter to transfer legal ownership to companies organized in a wide range of countries. The tax law has well-developed tax ownership concepts for intangible property that allow the tax ownership of intangible property to be divorced from legal ownership. These economic and legal features of intangible property make it possible to locate intangible property in low-taxed environments within the taxpayer

³⁵ See generally Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law is Uncertain*, 27 VA. TAX. REV. 241 (2007) (discussing optimal penalty structures).

group to earn low-taxed income without materially sacrificing the legal protections and value of the intangible property in question.

The fundamental difficulty with administering transfer pricing rules where comparable third party transactions are unavailable or inexact lies in: (i) the operational flexibility available to a multinational in planning and executing a transfer pricing strategy,³⁶ (ii) the necessary flexibility of the transfer pricing rules to allow taxpayers to structure their affairs (as well as an arguably excessive electivity of methods),³⁷ and (iii) the information asymmetry and procedural advantages described above in documenting and defending transfer pricing controversies. Cost sharing for intangible property is one example of where these advantages are particularly favorable.

Treasury regulations have allowed cost sharing of intangible costs from the 1960s. A primary argument made for cost sharing is that it reduces uncertainty in transfer pricing. Cost sharing is used by taxpayers to increase the future profit that can be allocated to the cost sharer by reason of its deemed joint ownership of the intangible. In many cases, the cost sharer is an affiliate in a lower tax jurisdiction than the developer of the intangible. In such a case, cost sharing represents a "bet" that the lower value of deductions for cost sharing payments will be less, on a present value basis, than the savings from earning future intangible income in the lower tax jurisdiction.

In practice, there are several aspects of cost sharing that are problematic and non-arm's length:

- Cost sharing is elective to the taxpayer; this implicitly permits a substantial degree of "cherry-picking" of intangibles to be cost shared.³⁸
- As with all related party transactions, information asymmetry favors the taxpayer and allows it to price the cost sharing favorably and frame the documentation and supporting "data" in the way that reduces the apparent exposure.³⁹
- Parties to cost sharing agreements may include affiliates whose interest is financial rather than as a developer or user of the intangible in business it conducts itself.

Intercompany services with embedded intangibles also present opportunities to make identification of the intangible pricing issue and valuation of the intangible difficult.⁴⁰

³⁶ See Benshalom, *Sourcing the Unsourceable*, *supra* note 33, at 646–47 ("[The] characteristics [of arm's length transfer pricing] render futile the attempt of the transfer pricing rules to determine the reasonable price at which affiliated transactions would have been valued if made with unrelated parties.").

³⁷ The section 482 regulations treat results within a defined range as "arm's length" and not subject to adjustment. This is only one element of the regulations' flexibility.

³⁸ It would be interesting to know what percentage of related party cost sharing agreements involve one or more unsuccessful products compared with arm's length agreements (that are not actually *de facto* partnerships).

³⁹ See TREASURY TRANSFER PRICING REPORT, *supra* note 24, at 48–50.

E. Policy Implications of the Transfer Pricing Problem

The conclusion to be derived from the preceding analysis of the inherent substantive and procedural limitations on a government's ability to enforce transfer pricing rules, particularly when applied to intangible property, is that the taxpayer has a fundamental and systemic advantage over the government in applying the regime. While it is indeed important to improve our substantive transfer pricing rules, it is unrealistic to believe that this alone will bring about robust transfer pricing compliance.

An alternative to the current arm's length separate transaction method is a formulary apportionment regime – a method that, based on several inputs such as allocation of property, wages and sales, will determine how income is split by formula. Substituting formulary apportionment for the current system will not, however, be a panacea for the above-described pressures on transfer pricing. If, as is the case under U.S. state formula apportionment methods, income allocated under a formula apportionment method to another taxing jurisdiction is exempted by the jurisdiction applying the formula apportionment method, the existing tax rate differentials will continue to exist.⁴¹ If the present effective tax rate differentials are permitted to remain unchanged, the same taxpayer advantages described above will allow taxpayers to manipulate the factors underlying formula apportionment to the same or a greater extent as under the arm's length separate transaction method.

There is no precedent for employing formula apportionment in a system with worldwide taxation and a foreign tax credit. In order for a formula apportionment regime to work in the context of a foreign tax credit, the two taxing jurisdictions would have to have sufficiently similar income allocation formulas so that the income apportioned by the residence state to the other state bears some resemblance to the income actually taxed by the other state. Otherwise there will be substantial risk of double taxation and double non-taxation in everyday business transactions that today are handled adequately under the arm's length separate transaction method that is the subject of the international consensus described above.

It might be possible to develop a new international transfer pricing consensus around a common formulary apportionment method that could be adopted on a global basis and the preceding issues surmounted. Such a process, however, likely would take a decade or more to achieve an outcome that would be uncertain at best.

The policy implication of the preceding analysis is that, in the face of the inherent limits on the ability of a government to monitor and enforce any transfer pricing regime,

⁴⁰ *Id.* at 50–51. While the Treasury Department has identified these and other issues as allowing scope for income shifting, and has documented that income shifting is occurring, the Treasury's remedy appears to be limited to proposing regulatory changes to the rules.

⁴¹ It is possible that under formulary apportionment methods, income (particularly from intangibles) would be allocated away from low tax countries where little economic activity involving property, payroll or sales takes place. That will depend, of course, on the specifics of the rules adopted. Experience at the level of U.S. states suggests that these rules remain subject to manipulation. Moreover, if income is allocated under U.S. rules to higher tax foreign countries, it could encourage such countries to adopt rules that would allow them to tax such income.

it is important that there be structural limits on the ability of taxpayers to take advantage of effective tax rate differences in implementing transfer pricing within a controlled group. The only reform that address this issue as well as the inefficiency of a deferred tax on repatriation is increased current taxation of foreign income.

IV. Possible Reforms to Current U.S. Rules for Taxing Foreign Business Income

This part discusses possible reforms to the current U.S. international tax rules. For the reasons explained below, I would favor increased current taxation of foreign income (with a foreign tax credit) as part of a package of reforms that broadens the corporate tax base and reduces the U.S. corporate tax rate.

A. The Exemption System Alternative

The major approaches by which a country taxes income earned by its residents in a foreign country are worldwide taxation, subject to a credit for foreign taxes, and an exemption system (also referred to as a territorial system).⁴² Due to some exemption features of our current system, the U.S. worldwide system is more accurately described as a hybrid between worldwide and exemption systems. Countries that employ exemption systems have, likewise, worldwide taxation features in their systems.⁴³

The President's Advisory Panel on Federal Tax Reform is the most recent exemption proposal.⁴⁴ The Advisory Panel proposal would:

- Exempt foreign source active business income when earned and when repatriated as a dividend. Active business income earned through a foreign branch also would be exempt. There would be no requirement that the income be subject to any foreign income tax.
- Currently tax investment income and mobile active income under Subpart F type rules.

⁴² There have been a number of proposals to exempt foreign business income, including in the President's Advisory Panel on Federal Tax Reform's Simplified Income Tax Proposal. The President's Advisory Panel's exemption proposal would exempt a domestic corporation from tax on (i) dividends from a foreign corporation attributable to certain active business income, and (ii) active business income earned through a foreign branch. See PRESIDENT'S ADVISORY PANEL REPORT, *supra* note 10, at 124–25. The Joint Committee on Taxation Staff also has an exemption proposal that is more detailed than the President's proposal. See STAFF OF JOINT COMM'N. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 191 (Comm. Print 2005).

⁴³ See Hugh J. Ault, *U.S. Exemption/Territorial System vs. Credit-Based System*, 32 TAX NOTES INT'L 725, 726 (2003). The only countries with "pure" territorial systems are countries that do not have an income tax on business income. Substituting a consumption tax for an income tax would have extremely broad ramifications and, while ideologically appealing to some, is widely understood to be impractical. See generally AM. BAR ASS'N, A COMPREHENSIVE ANALYSIS OF CURRENT CONSUMPTION TAX PROPOSALS (1997); Bruce Bartlett, *Fair Tax, Flawed Tax*, WALL ST. J., Aug. 25, 2007, available at http://online.wsj.com/public/article_print/SB118800635034508655.html. For an analysis of international aspects of shifting entirely to a consumption tax, see Stephen E. Shay & Victoria Summers, *Selected International Aspects of Fundamental Tax Reform Proposals*, 51 U. MIAMI L. REV. 1029 (1997).

⁴⁴ See PRESIDENT'S ADVISORY PANEL REPORT, *supra* note 10, at 102–05, 132–35, 239–43.

- Currently tax non-dividend payments to controlling shareholders, including royalties, rents, interest, service fees and income from intercompany transactions.
- Allow a credit for foreign taxes on foreign source income not eligible for exemption; eliminate the separate limitation categories of section 904.
- Disallow deductions for interest and overhead-type expenses allocated to exempt foreign income. Significantly, research and development expense would be allocated entirely to taxable income and not to exempt foreign income.
- Exempt pre-effective-date earnings currently subject to deferral.⁴⁵

The principal attractions of a foreign exemption proposal are that it would eliminate the tax on repatriation of earnings under a deferral regime and would foreclose relief for high foreign taxes through cross-crediting. It nevertheless leaves other problems of current law unsolved, and, in fact, adds to them.

Significantly, the incentive for income shifting activity to low-tax locations would increase.⁴⁶ Moreover, the exemption and tax-free repatriation of foreign earnings would expand the range of businesses that could tax advantage of exemption to businesses who need to repatriate their funds to the United States. In light of the preceding analysis of the ability to constrain transfer pricing aggressiveness, it would seem foolhardy to risk even greater erosion of the U.S. tax base.

Moreover, under an exemption system, expenses must be allocated between exempt and non-exempt income.⁴⁷ As noted above, the misallocation of expense against domestic income instead of foreign exempt income, in effect, exempts domestic income from tax due to the taxpayer's foreign operations.⁴⁸ This risk of misallocated expenses is a heightened concern in an exemption system.⁴⁹

⁴⁵ Professor Yin suggests consideration of three changes to the Advisory Panel proposal: (i) require that exempt income be subject to tax somewhere; (ii) consider a small tax on repatriation, similar to the 5.25 % under section 965, and (iii) make exemption prospective for post-enactment earnings. See Yin, *Reforming Taxation*, *supra* note 18, at 180–81.

⁴⁶ As noted by Edward Kleinbard, "[t]erritorial tax systems, by contrast, reward successful transfer pricing gamers as 'instant winners' by enabling the successful U.S. firm to recycle immediately its offshore profits as tax-exempt dividends paid to the U.S. parent." See Edward D. Kleinbard, *Throw Territorial Taxation From the Train*, 114 TAX NOTES 547, 554 (2007) (emphasis in original).

⁴⁷ See generally Harry Grubert, *Enacting Dividend Exemption and Tax Revenue*, 54 NAT'L TAX J., 811 (2001) [hereinafter, Grubert, *Enacting Dividend Exemption*] (estimating the effect on revenue from exempting dividends when considering changing taxpayer behavior).

⁴⁸ See *supra* Part III. B.

⁴⁹ In a worldwide system with deferral, if a U.S. multinational does not have excess tax credits or does not seek to repatriate income, the allocation of expenses will not have any effect on its tax liability. See Grubert, *Enacting Dividend Exemption*, *supra* note 47, at 813.

To conclude, the benefits from an exemption system are not likely to be superior on efficiency or fairness grounds to reforms based on current taxation of foreign business income with an appropriately limited foreign tax credit.⁵⁰

B. Chairman Rangel's Deduction Deferral and Foreign Tax Credit Pooling Proposals

Chairman Rangel has proposed to address the problem, discussed above, of allowing expenses supporting foreign income to be deducted without an income inclusion.⁵¹ Under Chairman Rangel's proposal in H.R. 3970, expenses allocable to deferred foreign-source earnings generally will not be allowed until the earnings are repatriated. Foreign tax credits and earnings and profits would be determined on a consolidated basis for all CFCs. Foreign taxes would be associated with repatriated earnings pro rata based on the ratio of repatriated earnings to all deferred earnings.⁵² These reforms would be part of a broadening package of reforms that would allow a reduction in the nominal corporate tax rate of 35% to 30.5%.⁵³

There is much to be applauded in Chairman Rangel's proposal. It would (i) reduce the value of deferral by the amount of deferred expenses (and therefore would be critically affected by how expenses are allocated), and (ii) reduce the scope for using cross-crediting planning to reduce tax on non-deferred earnings and other foreign income. The bill would deny taxpayers their current ability to selectively repatriate high foreign tax earnings, which is an important step, but it would not address the inefficiency of a deferred tax on repatriation of earnings.⁵⁴

Chairman Rangel's bill would appear to leave the current U.S. expense allocation rules largely intact. Because these rules tend to overallocate expenses to domestic income, the proposal likely would continue an incentive to earn foreign rather than U.S. income but it is difficult to gauge its effect since it rests on how expenses ultimately are allocated. Indeed, one concern about Chairman Rangel's proposal is the extent to which weight would be placed on the proper allocation of deductions. This is an even more difficult transfer pricing area for the IRS to enforce than allocation of income, because the classification of expense is much less visible and harder to monitor than allocations of income.

C. Reforming Worldwide Taxation

I respectfully submit that reducing the scope of deferral and more closely aligning foreign tax credit rules to the purpose of avoiding double taxation would be preferred to

⁵⁰ Based on analyses that rest more on efficiency and administrability considerations, other commentators also express skepticism regarding territorial taxation proposals. *See generally id.*; BRUMBAUGH & GRAVELLE, REFORM OF INTERNATIONAL TAXATION, *supra* note 9.

⁵¹ H.R. 3970, 110th Cong. 1st Sess. § 3201 (2007).

⁵² *See id.*

⁵³ H.R. 3970, § 3001.

⁵⁴ *See Yin, Reforming Taxation, supra* note 18, at 178.

exemption of foreign income and should be supported on grounds of fairness and efficiency.

The theoretically optimal approach to adopting worldwide taxation would be to adopt pass-through treatment for earnings of a foreign corporation.⁵⁵ This conduit approach would have the benefit of maintaining the character and source of the income and subjecting the income to the applicable tax rate of the shareholder. It would permit current pass-through of losses. This would constitute a fundamental reform of the international rules that is preferable to the current rules, an exemption system or Chairman Rangel's proposal.

In the event that basic reform is not possible, there are less fundamental reforms to the current rules that would address many of the problems of current law described above. Current taxation of U.S. shareholders under an expansion of Subpart F, while second best to a conduit approach, would be a substantial improvement over current law and probably would enjoy broader support than pass through taxation.⁵⁶ One approach would be to tax 10% or greater U.S. shareholders (by vote) in a controlled foreign corporation⁵⁷ currently on their share of the controlled foreign corporation's income as part of a package of reforms that permit reduction of the U.S. corporate tax rate. There are a number of other changes that should be considered to the specifics of these rules.⁵⁸ These rules have a history of use since 1962, and changes could be implemented without substantial re-design.

If a proposal for fuller current inclusion still goes too far for some, it would also be possible to rehabilitate the Subpart F rules. The Subpart F rules could be made to achieve their intended purpose of restricting deferral to business income earned where it is taxed (and taxed where it is earned). In other words, by updating Subpart F anti-deferral rules to take account of use of branches, including hybrid entity branches, it would be possible to restrict deferral for active foreign income that is not shifted for tax-

⁵⁵ I and my co-authors, Professors Robert J. Peroni and J. Clifton Fleming, Jr., have outlined a proposal for a broad repeal of deferral. Essentially, our proposal would apply mandatory pass-through treatment to 10% or greater shareholders in foreign corporations. See Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Deferral: Consider Ending It Instead of Expanding It*, 86 TAX NOTES 837 (2000).

⁵⁶ I acknowledge the substantial benefits of Edward Kleinbard's proposal for a more fundamental reform of business income generally. See Edward Kleinbard, *The Business Enterprise Income Tax: A Prospectus*, 106 TAX NOTES 97 (2005). That proposal also is beyond the scope of this discussion.

⁵⁷ A controlled foreign corporation is one more than 50% owned, by vote or value, directly or indirectly under constructive ownership rules, by 10% U.S. shareholders, by vote. See *supra* note 14.

⁵⁸ Less than 10% U.S. shareholders and 10% U.S. shareholders in foreign corporations that did not have a controlling U.S. shareholder group would be taxed under current law rules on distributions when received. The passive foreign investment company (PFIC) rules would continue to apply, however, the PFIC asset test should be eliminated for portfolio investors and the passive income threshold should be reduced to 50% from 75%. The PFIC taxing rules, a deferred tax with an interest charge, qualified electing fund pass-through taxation, or mark-to-market taxation, would apply to a U.S. shareholder in a PFIC.

motivated reasons to lower tax countries. Such a proposal was outlined in the American Bar Association Report of the Task Force on International Tax Reform.⁵⁹

In connection with any of these proposals for increased current taxation of foreign income, the current foreign tax credit mechanism should be improved, for example by repealing the sales source rule and rationalizing source rules for income from intangibles. As further an example, income from the licensing of intangibles should be sourced consistently with the sale of inventory (after repeal of the sales source rule) subject to an adjustment to allow a credit for foreign withholding tax, if any, on the royalty.⁶⁰ Current expense allocation rules permit the over-allocation of expenses to U.S. income, thereby expanding the foreign tax credit limitation. These rules should be reviewed and revised to limit their scope to what is appropriate to avoid double taxation. Other changes to limit cross-crediting of foreign taxes also should be considered.

A taxpayer's ability to control inter-company pricing is a fundamental attribute of international taxation. As I have argued above, while changes to the transfer pricing rules to decrease the government's substantive and procedural difficulties in enforcement are desirable, their benefits will be limited by the practical limitations on enforcement described above. Thus, the focus must be on reducing the effective tax rate differentials that drive transfer pricing planning in the first place. Reducing the scope for deferral under any of the approaches just described is key to constraining aggressive transfer pricing and protecting the U.S. tax base.

The changes described above would address the defects of current law by: (i) moving toward equalizing the taxation of foreign and domestic income, (ii) reducing the cross-crediting subsidy for high foreign taxes, and (iii) reducing the inefficiency of a deferred tax on repatriation. Moreover, taken together, these changes would reduce incentives to engage in aggressive transfer pricing. A base-broadening approach, such as described, that contributes to a meaningful reduction in corporate tax rates, would assist all U.S. businesses – whether they operate abroad, export from the United States, or compete against foreign imports. The result would be a fairer tax system.

I would be pleased to answer any questions the Committee might have.

⁵⁹ See *ABA Report*, *supra* note 8, at 787–803.

⁶⁰ Approaches to these proposals may be found in the *ABA Report*, *supra* note 8, at 772–74.

COMMUNICATIONS



**Senate Finance Committee Hearing on
“The Foundation Of International Tax Reform:
Worldwide, Territorial, and Something In Between”
June 26, 2008
Submitted for the Record by 3M Company on July 15, 2008**

3M Company (“3M”) appreciates the opportunity to provide written comments for the record in conjunction with the international tax reform hearing held by the Senate Finance Committee (the “Committee”) on June 26, 2008.

3M is a large U.S.-based employer and manufacturer established over a century ago in Minnesota. Today, 3M is one of the largest and most diversified manufacturing companies in the world. We are a global company conducting the majority of our manufacturing and research activities in the United States. 3M thanks the Committee for studying the critical issue of tax reform and for considering our perspective in this important debate.

In examining business tax reform, 3M respectfully urges the Committee to continue making the global competitiveness of American businesses and workers a key objective of reform. From 3M’s perspective, this means a simplified and stable tax system designed to encourage U.S.-based manufacturing, research and development (“R&D”), and intangible property (“IP”) ownership, while enabling American businesses to successfully compete in foreign markets. To achieve these goals, 3M believes the best course would be a significant reduction in the corporate tax rate, a permanent extension and enhancement of the research credit and a new incentive to encourage U.S.-based IP ownership. If Congress decides not to pursue a significant rate reduction, incentives for U.S.-based manufacturing should be enhanced and the current residence-based international tax system should be replaced with a territorial system.

Background

In 1902, five northern Minnesota entrepreneurs created the Minnesota Mining & Manufacturing Company, now known as 3M. These businessmen initially set out to mine mineral deposits found in Two Harbors, Minnesota for use as grinding-wheels abrasives. When the deposits proved to be of little value, these optimistic and tenacious businessmen persevered. The company began developing sandpaper products and later moved its headquarters to St. Paul, Minnesota. Eventually, 3M’s technical and marketing innovations began to produce successful products. In 1916, 3M was finally a profitable company and paid its first dividend.

Today, 3M is one of the largest and most diversified manufacturing companies in the world. 3M is home to such well-known brands as Scotch, Scotch-Brite, Post-it, Nexcare, Filtrete, Command, and Thinsulate and is composed of six business sectors: Consumer and Office; Display and Graphics; Electro and Communications; Health Care; Industrial and Transportation; and Safety, Security and Protection Services.

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Washington, DC 20005. 202.414.3000

Ahead of their peers, 3M's founders insisted on a robust investment in R&D. Looking back, it is this early and consistent commitment to R&D that has been the main component of 3M's success. Today, 3M maintains 40 different technology platforms. These diverse platforms allow 3M scientists to share and combine technologies from one business to another, creating unique, innovative solutions for its customers. The financial commitment to R&D equated to \$1.4 billion of R&D spending in 2007 and a total of \$6.6 billion during the past five years, and produced high quality jobs for 3900 researchers in the United States (and 7000 total worldwide). The results are equally impressive with 571 U.S. patents awarded in 2007 alone, and over 40,000 global patents and patent applications.

3M achieved \$24.5 billion of worldwide sales in 2007. 3M is one of the 30 companies on the Dow Jones Average and is a component of the Standard & Poor's 500 Index. Owned by millions of shareholders directly and indirectly through mutual funds, 3M has consistently delivered positive results to its owners. It has paid dividends to its shareholders every quarter since 1916. 3M paid dividends of \$1.4 billion in 2007 and a total of \$8.1 billion over the past five years. Most remarkably, for the last 50 consecutive years, annual dividends have consistently increased.

This success is attributable to the people of 3M. Generations of imaginative and industrious employees in all of its business sectors throughout the world have built 3M into a successful global company.

3M: A U.S. Company Competing in A Highly Competitive Global Economy

3M is a U.S. company that manufactures and sells its products throughout the world. Headquartered in St. Paul, Minnesota, 3M has operations in 27 U.S. states, where over 60% of 3M's worldwide manufacturing operations are located. Approximately 34,000 of its 76,000 worldwide employees are located in the United States and received a total payroll of approximately \$3 billion in 2007. In addition, 3M conducts over 60% of its worldwide R&D activities in the United States. The U.S. market accounts for 37% of 3M's global business, with approximately \$9 billion of U.S. sales in 2007.

While its U.S. presence is strong, 3M is increasingly a global company. 3M operates in more than 60 countries and sells products into more than 200 countries. In 2007, 63% of 3M's sales were outside the United States, a percentage that is projected to rise to more than 70% by 2010. In the current global economy, where international markets are growing faster than U.S. markets, being able to compete successfully in the global marketplace is critical to 3M.

Global market competition has made "localization" critically important for the company's future success. If 3M is going to successfully compete against its foreign competitors, it must invest in new facilities outside the United States to be closer to its non-U.S. customers. 3M must hire international employees with an in-depth understanding of their markets. 3M's success has depended on our ability to tap into the talent of a richly diverse global employee base to share ideas and innovate. Local knowledge and execution, supported by 3M technologies, products, and brands, is an overarching strength and competitive advantage. It enables 3M to provide international customers with leading-edge products, strong marketing support and responsive service, thereby achieving borderless customer success.

This business-driven need for further localization, as well as the need to simplify 3M's historically complex supply chains, has led 3M to adopt a new regional sourcing initiative. 3M is now pursuing more customer-focused supply chains with an increased localization target – meaning that more of our products sold in a region will be produced in the same region as that of the customer. This shift to greater localization is not tax-driven, but rather results from competitive pressures to better serve the needs of our global customers.

Reforming the Current U.S. Business Tax System

Tax reform is essential to ensure long-term competitiveness of American businesses and workers. From 3M's perspective, business tax reform should focus on a significant reduction of the corporate income tax rate, making the research credit permanent, creating incentives for U.S.-based IP ownership, and simplifying the tax code.

1. **Significantly Lower the Corporate Income Tax Rate.** The most important thing Congress could do to ensure that the U.S. tax system encourages manufacturing in the United States would be to significantly reduce the corporate tax rate. From 3M's perspective, the current high corporate tax rate has two adverse effects on domestic investment: it reduces the after-tax return on domestic investments and acts as a disincentive to repatriate foreign earnings that would otherwise be used to make domestic investments.

The United States has the second highest corporate tax rate among OECD countries. Because 3M maintains the majority of its manufacturing and R&D activities in the United States, our effective tax rate has become one of the highest among our competitors. In 2007, 3M's worldwide effective tax rate was 32.1%, having paid more than \$1.07 billion in combined U.S. federal and state taxes.

In an increasingly global marketplace, 3M's high effective tax rate is a competitive disadvantage. The high U.S. tax rate increases the cost of U.S. manufacturing operations. This increased cost translates into higher prices to customers, lower wages to employees, and lower returns to investors, which in turn hinder 3M's ability to compete in the global marketplace.

In addition, the high U.S. tax rate imposes an undue cost barrier to repatriating foreign earnings under the current international tax system. Although 3M's U.S. market is significant, it does not generate sufficient cash to fund increasing domestic capital investment, research expenses, wages and benefits to employees and retirees, and dividends to shareholders. The high cost of repatriating foreign earnings (in some cases from subsidiaries located in countries that once imposed higher taxes than the United States) impacts the level of 3M's domestic investment. American businesses should be encouraged to successfully compete in foreign markets and repatriate foreign earnings back to the United States. A significantly reduced corporate tax rate would partially mitigate the disincentive to repatriate foreign earnings to make domestic investments.

If Congress decides not to pursue a significant corporate tax rate reduction, incentives for domestic manufacturing should be enhanced, and the current residence-based international tax system should be replaced with a territorial system.

- **Manufacturing Tax Incentives.** The current U.S. tax system does not encourage a competitive and sustainable business climate for domestic manufacturing. The manufacturing deduction enacted in 2004, while providing a helpful effective rate reduction of approximately 3% for domestic manufacturing, is not enough by itself to make the United States a competitive destination for manufacturing activities of global businesses. If the overall corporate tax rate cannot be significantly reduced, 3M believes that an enhanced domestic manufacturing tax incentive would be necessary to improve the competitiveness of American manufacturers and workers.
- **Territorial System.** The worldwide base of the current international tax system adversely impacts the competitiveness of American businesses that operate overseas for business reasons, like 3M, relative to competitors that are based in jurisdictions that exempt foreign income. The deferral of residual U.S. tax on foreign earnings helps to mitigate this competitive disadvantage, but it creates another problem. By imposing a residual U.S. tax on foreign earnings upon repatriation, the current system acts as a disincentive for companies to repatriate those earnings for domestic investment, making foreign investment of those earnings comparatively more attractive. The current system's problems are amplified by the high U.S. corporate tax rate.

In the absence of a significant corporate tax rate reduction, 3M supports movement toward a territorial system for taxing foreign income, as advocated by Professor Hines at the hearing. When an American business successfully competes in foreign markets, the tax system should not discourage repatriation and investment in the United States. Imposing a high U.S. tax rate on American businesses when they repatriate foreign earnings undermines the competitiveness of American businesses in foreign markets, the attractiveness of domestic investment, and the creation of U.S. jobs.

Another way to eliminate the disincentive to repatriate, of course, would be to move toward a pure worldwide system by ending deferral and taxing all foreign income on a current basis. The Committee heard testimony from Mr. Shay, who advocated this approach. Without a significant corporate tax rate reduction, a pure worldwide system would greatly damage the ability of American businesses like 3M to meet the needs of global customers and compete in foreign markets.

Some advocates for a pure worldwide system often assume that tax is the pivotal factor in capital investment decisions. These advocates believe that the current system of deferral drives business investment, operations, and jobs overseas. Tax is not the driver for 3M's decision to further localize overseas operations. Having made the business decision to regionally localize operations, tax is one of many factors in determining the jurisdiction within a particular region in which to locate, but the decision to localize is not tax-driven. As previously mentioned, 3M must tap into international talent and resources to best meet the needs of global customers, which often require non-U.S. capital investment.

- 2. Make an Enhanced and Simplified Research Credit Permanent and Provide Incentives for U.S. IP Ownership.** In addition to lowering the corporate tax rate, the research credit should be made permanent and incentives should be adopted to encourage U.S.-based IP ownership.
- **Permanent R&D Tax Credit.** 3M strongly supports the bipartisan efforts of Chairman Baucus and most of the other Committee members to move toward a permanent enhanced R&D credit. Making the Alternative Simplified Credit permanent, increasing the available credit, and simplifying the determination of the credit will help to ensure that the United States can compete against other nations that offer attractive incentives to lure R&D investment and jobs out of the United States. Recent lapses in the credit have caused confusion for American businesses and have impacted investment decisions and earnings reports. The research credit should be made permanent to promote long-term investments in R&D.
 - **Incentives for U.S. IP Ownership.** The R&D tax credit is appropriately targeted to encourage R&D activities in the United States, but it does not provide an incentive to maintain U.S. ownership of the IP produced by the research. Congress should consider creating an incentive for U.S.-owned IP similar to those adopted by other countries, such as the Netherlands, Spain and Belgium, which permit a deduction or exclusion for a portion of royalties received for the use of IP created by the licensor. Such an incentive may address concerns regarding the migration of IP offshore.
- 3. Simplify the Code.** 3M is concerned with the high cost of compliance under the current U.S. tax system. Certainty and simplicity in tax legislation and its administration are important. Business investments are long term and sudden changes in tax policy without adequate transition cause significant disruption and an inability to plan properly. In addition, the non-economic activities designed to shift, shelter, and avoid U.S. tax should be discouraged.

Significantly reducing the corporate tax rate and making an enhanced and simplified R&D credit permanent will have the effect of simplifying compliance with the tax code, while reducing the benefits of non-economic tax planning. A territorial international tax system would be a simpler way of mitigating double taxation of foreign income than the current system. 3M acknowledges the view that the manufacturing deduction creates some added complexity, but we believe the need to promote the competitiveness of the U.S. manufacturing sector outweighs concerns about complexity.

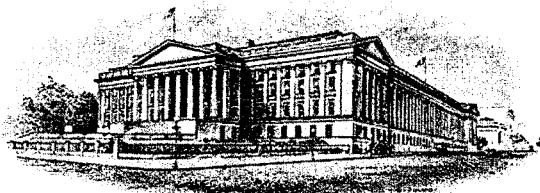
Summary of 3M Tax Reform Recommendations

As an American company with 34,000 U.S. employees and the majority of its worldwide manufacturing and R&D activities in the United States, 3M believes a key tax reform policy objective is to improve the global competitiveness of American businesses and workers. From 3M's perspective, this means a simple and stable tax system that encourages U.S.-based

manufacturing and U.S.-based R&D activities and IP ownership. To achieve these policy goals, 3M recommends the following:

1. Significantly lower the corporate income tax rate, or alternatively, enhance domestic manufacturing incentives and replace the current residence-based international tax system with a territorial system for taxing foreign income;
2. Make permanent and enhance the R&D credit and provide incentives for U.S. IP ownership; and
3. Simplify the tax code.

We thank the Committee for the opportunity to share our perspective as an American employer interested in preserving and enhancing the global competitiveness of American businesses and workers. 3M stands prepared to work with you in any way we can to support you on this critical public policy matter.



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

STATEMENT FOR THE RECORD OF THE SENATE COMMITTEE ON FINANCE HEARING ON INTERNATIONAL TAX REFORM HELD ON JUNE 26, 2008

Chairman Baucus, Ranking Member Grassley, and Members of the Finance Committee, the Office of Tax Policy of the United States Department of the Treasury is pleased to present these comments for the record, as well as the attached Treasury Department report entitled, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*.

The global economy has changed markedly over the past half century, and so too has the U.S. role in that global economy. Trade and investment flow across borders in greater volume and with greater ease. As we look to the future, many factors, including education, immigration, and trade policies play an important role in the lives and living standards of U.S. workers and in the ability of U.S. companies to compete globally. By influencing incentives to acquire and use capital, the U.S. international tax regime, and U.S. business taxes more generally, also play an important role in economic decision making.

Increasingly, the ability of U.S. companies to grow and prosper depends on their ability to do business globally. In the 1960s, the decade during which many of our current tax rules regarding cross-border activities and investment were first enacted, international trade and investment flows were much less important than they are today to the U.S. economy and to U.S. companies. Thus, the United States was free to make decisions about its tax system based primarily on domestic considerations. Moreover, our trading partners generally followed the U.S. lead in tax policy.

Circumstances have changed since the 1960s. Globalization – the growing interdependence of countries resulting from increasing integration of trade, finance, investment, people, information, and ideas in one global marketplace – has resulted in increased cross-border trade and the establishment of production facilities and distribution networks around the globe. Businesses now operate more freely across borders, and business location and investment decisions are more sensitive to tax considerations than in the past.

As barriers to cross-border movement of capital and goods have been reduced, differences in nations' tax systems have become a greater factor in the success of global companies. Globalization has made it imprudent for the United States, or any other country, to enact tax rules that do not take into account

what other countries are doing. Our major trading partners recognize this. Many have modified or plan to modify their business tax systems to improve their global competitiveness. For example, during the past two decades, many of our major trading partners have lowered their corporate tax rates, causing the United States to go from being a low statutory corporate tax-rate country to being a high statutory tax-rate country. Moreover, during the same period, many of the member countries of the Organisation for Economic Co-operation and Development (OECD) have changed how they tax the foreign earnings of their companies, increasingly moving toward systems that exempt from tax the active foreign earnings of their multinational companies.

As our major trading partners respond to the realities of the global economy, U.S. companies increasingly suffer a competitive disadvantage. The U.S. business tax system imposes a burden on U.S. companies and U.S. workers by raising the cost of investment in the United States and burdening U.S. companies as they compete with foreign companies in foreign markets. Business taxes play a key role in the economy because they influence the incentive to acquire and use capital – the plants, offices, equipment, and software that corporations employ to produce goods and services. In general, an economy with more capital is more productive and ultimately attains a higher standard of living than economies that have accumulated less capital. Workers gain when businesses have more capital and, correspondingly, workers stand to lose when the tax system leads businesses to invest less and have a smaller capital stock.

The current U.S. system for taxing multinational companies has been developed in a patchwork fashion, resulting in a web of tax rules that is unlikely to promote maximum economic efficiency. The United States cannot afford to be left behind as other nations modernize their business tax systems, including the taxation of foreign earnings. In general, inaction would make the United States a less attractive place in which to invest, innovate, and grow. As capital moves more freely across borders, and emerging countries begin to approach U.S. levels of education and training, some advantages that the United States currently has will erode. Americans deserve a tax system that is simple, fair, and pro-growth – in tune with the nation's dynamic economy.

The tax relief proposed by President Bush and enacted by Congress in the past few years has helped lay the foundation for considering ways to ensure that the U.S. tax system helps U.S. businesses and U.S. workers compete in a global economy. In 2005, the President established the President's Advisory Panel on Federal Tax Reform to identify the major problems with the current tax system and to provide recommendations on making the tax code simpler, fairer, and better suited to the modern economy. The Tax Panel's report recommended two options for comprehensive overhaul of our federal income tax system – the Growth and Investment Tax plan and the Simplified Income Tax plan. These approaches differ somewhat, but both would reduce taxes on business and capital income.

Last year Secretary Paulson, recognizing that an examination of our business tax system in the context of the global marketplace was overdue if the competitiveness of U.S. businesses and U.S. workers in a global economy is to be maintained, initiated a review of the nation's system for taxing businesses. On July 26, 2007, the Secretary hosted a conference on *Business Taxation and Global Competitiveness*, where distinguished business leaders and policy experts discussed how the current business tax system can be improved to make U.S. businesses more competitive in today's global economy. The conference highlighted the need for reform. The participants stressed that the U.S. business tax system has not kept pace with changes in the world economy. The conference participants expressed a conviction that in order for U.S. companies and U.S. workers to compete and thrive in today's global economic climate, the U.S. business tax system also must adapt to these changes.

Treasury Report on Business Taxation and Global Competitiveness

In December 2007, the Treasury Department released a comprehensive study addressing business taxation and global competitiveness as a follow-up to the July 2007 conference. This report, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, examines how business taxation in the United States compares with that of the United States' major trading partners. It also outlines several broad approaches to business tax reform, including some approaches to taxing foreign earnings.

International Comparison of Business Taxation

Since 1980, the United States has gone from a high statutory corporate tax-rate country to a low-rate country, following the Tax Reform Act of 1986, and, based on some measures, back again to a high-rate country today. During the past two decades, many of our major trading partners have lowered their corporate tax rates, some dramatically. Within the OECD, the United States now has the second highest statutory corporate tax rate at 39 percent (including state corporate taxes) compared with the average OECD statutory tax rate of 31 percent.

Statutory corporate income tax rates are the most common measure of the tax burden imposed on corporations. The evolution of OECD corporate tax rates over the past two decades suggests that corporate tax rate setting is an interactive process subject to the pressures of international competition. In the early 1980s, the United States had a relatively high statutory corporate tax rate of nearly 50 percent (i.e., combined federal and average state rates). The Tax Reform Act of 1986 lowered the U.S. federal statutory corporate tax rate to 34 percent, and the U.S. combined statutory corporate tax rate fell to 38 percent, well below the then-prevailing OECD corporate tax rates. OECD rates trended steadily down over the ensuing decade, while the top U.S. federal statutory corporate tax rate increased to 35 percent in 1993. The average and median OECD statutory corporate tax rates fell below the U.S. corporate tax rate in the 1990s and have continued to decline. Now, the United States is once again a high corporate tax rate country.

The decline in OECD corporate tax rates appears likely to continue. Other countries are reducing their corporate tax rates, leaving the United States further behind. Effective this year, Canada reduced its corporate income tax rate from 21 percent to 19.5 percent, lowering its combined central and local corporate rate to approximately 33 percent. Canada has indicated also that it will reduce its central corporate tax rate to 15 percent by 2012. Germany reduced its total corporate tax rate from 38 percent to 30 percent, Italy reduced its corporate tax rate from 33 percent to 27.5 percent, and the United Kingdom reduced its corporate tax rate from 30 percent to 28 percent. Smaller countries among the OECD also have been particularly aggressive in cutting their corporate tax rates, with Iceland, Ireland, Hungary, Poland, the Slovak Republic, Greece, Korea, and Luxembourg reducing their corporate tax rates significantly in recent years.

Of course, statutory corporate tax rates provide an incomplete picture of the corporate tax burden because they reflect neither the corporate tax base nor investor-level taxes. Depreciation allowances – the rate at which capital investment costs may be deducted from taxable income over time – are a key determinant of the corporate tax base and an important factor distinguishing the statutory corporate tax rate from the effective marginal corporate tax rate. The difference between the statutory corporate tax rate and the effective marginal corporate tax rate varies depending on the source of finance – debt or equity – because interest is generally deductible, but dividends are not. The required rate of return for debt-financed investment, therefore, is lower than the required return for equity-financed investment. Most OECD countries offer accelerated depreciation for equipment investment. However, in contrast to

its high statutory corporate tax rate relative to other OECD countries, the United States has relatively generous depreciation allowances for equipment. In the OECD, only Greece and Italy have more generous depreciation allowances.

Worldwide vs. Territorial Tax Systems for Taxing Foreign Earnings

The increased globalization of U.S. businesses and the decline in corporate tax rates abroad have focused attention on the U.S. corporate tax rules in the international context.

Under current law, corporations formed in the United States are subject to tax on their worldwide income, meaning that they are subject to immediate U.S. tax on all of their direct earnings, whether earned in the United States or abroad. However, U.S. corporations with foreign subsidiaries generally are not taxed on the foreign subsidiaries' active business income (such as from manufacturing operations) until the income is repatriated. That is, until that active business income is returned to the United States, typically through a dividend to the parent corporation, U.S. tax is deferred. Not all foreign subsidiary income is subject to deferral, however. For example, U.S. tax is not deferred on passive or easily moveable income of foreign subsidiaries of U.S. corporations, under the anti-deferral rules in subpart F of the Internal Revenue Code.

To prevent double taxation of income by both a foreign country and the United States, a U.S. corporation is generally allowed a foreign tax credit for foreign taxes paid by it. In addition, a U.S. corporation is generally allowed a foreign tax credit for foreign taxes paid by a foreign corporation, of which it owns 10 percent or more of the voting stock, on earnings the foreign corporation repatriates. The foreign tax credit is claimed by a taxpayer on its U.S. tax return, and reduces U.S. tax liability on foreign source income.

The major alternative to a worldwide system is a territorial system in which the home country exempts all or a portion of the foreign earnings from home-country taxation. The U.S. system was developed at a time when the United States was the primary source of capital investment and dominated world markets. The global landscape has shifted considerably over the past several decades, with other countries challenging the U.S. position of economic pre-eminence.

Although a predominantly worldwide approach to the taxation of cross-border income was once prevalent, it is now used by less than one half of OECD countries. Instead, many of these countries now use predominantly territorial tax systems. Furthermore, the United Kingdom and Japan, large U.S. trading partners that still have a worldwide system of taxation, are both studying the adoption of a more territorial tax system.

Approaches to Business Tax Reform

Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century, attached to this statement, seeks to advance the dialogue on the key linkages between tax policy and American competitiveness in the global economy. To that end, the study outlines specific business tax areas that can be addressed, including the taxation of cross-border corporate income. Shaped by the discussion at the Treasury Department's July 2007 conference on competitiveness and the evolution of the global marketplace, the report discusses three bold approaches for business tax reform: (1) replacing business income taxes with a business activities tax (BAT), a type of consumption tax, (2) eliminating special business tax provisions coupled with a business tax rate reduction, and (3) eliminating special business tax provisions coupled with faster write-off of business investment, potentially combined with the exemption of active foreign earnings. The study also discusses implementing specific changes to our

current system of taxing business income that focus on important structural problems within our business tax system. As noted in the study, these changes could take place within or outside the context of broad tax reform.

Rather than present a particular recommendation, the report examines the strengths and weaknesses of the various approaches. The various policy ideas discussed in the report represent just some of the approaches that could be considered. The report does not advocate any specific recommendation nor does it call for or advance any legislative package or regulatory changes. The report discusses the issues posed in this statement for the record in greater detail.

Each of the approaches discussed in the report would improve the competitiveness of the United States compared to our current system for taxing U.S. business. Nevertheless, the approaches differ in a number of dimensions. The BAT described in Chapter II of the report would possibly provide the largest benefit in terms of its effect on expanding the size of the economy – ultimately increasing output (measured in terms of Gross Domestic Product, or GDP) by roughly 2.0 percent to 2.5 percent – but raises a number of serious implementation and administrative issues.

The second and third approaches focus on fundamental reform of the existing system for taxing business income by broadening the tax base, and either lowering the business tax rate or providing a faster write-off of the cost of investment. These approaches would replace a vast array of special tax provisions, which are sometimes highly targeted to encourage particular economic activity, with broad tax relief for U.S. businesses.

These approaches also examine the possibility of the adoption of a territorial tax system in the United States. The report outlines a few types of territorial tax systems. It describes a type of territorial tax system that exempts dividends from abroad from home-country tax and that is generally referred to as a “dividend exemption” system. The report describes a “basic dividend exemption system.” It also describes a few alternative territorial types of tax systems.

The present U.S. system for taxing the foreign source income of U.S. multinational corporations has several undesirable effects. The present system distorts economic behavior. For example, corporations may forgo U.S. investment opportunities to avoid the imposition of U.S. taxes. The current system also distorts the choice of where to exploit intangible assets, such as patents, and the choice of where to locate income and expenses for tax purposes. Finally, the current system is very complex, and a dividend exemption system would reduce some of the complexity related to the taxation of repatriated earnings.

Moving to a type of territorial system, therefore, could have several advantages as compared to present law. More than half of OECD countries use some type of dividend exemption system, and a dividend exemption system could reduce some of the economic distortions imposed by the current U.S. tax system.

However, there may be drawbacks to the adoption of a dividend exemption system in the United States. Various complex provisions would need to remain in the Internal Revenue Code, including those related to non-exempt income as well as income inclusions resulting under the current subpart F rules. Moreover, rules regarding the pricing of transactions between U.S. corporations and their foreign affiliates (the so-called “transfer pricing” rules) would come under increased pressure, as the move to a territorial system would increase the incentive to shift income and assets to low-taxed offshore jurisdictions. However, extending the exemption system to include additional forms of business income

(such as active royalties) could relieve some of that pressure and in addition allow for further simplification, but could raise other issues and concerns.

Last, the study also discusses implementing specific changes to our current system of taxing business income with a focus on important structural problems within the current system, including the taxation of certain foreign earnings. The international tax issues considered in the report include targeted reforms to the anti-deferral rules of subpart F and simplifying the U.S. tax rules for taxing the foreign earnings of small businesses.

Conclusion

The U.S. business tax system must help U.S. companies and workers compete globally by taking into account the increasingly integrated global economy. With a view to maintaining our competitiveness, U.S. tax policy must respond to and anticipate changes in the global marketplace. The current U.S. system is far from optimal, and we cannot afford to be left behind as other nations modernize their business tax systems, including the taxation of foreign earnings. The U.S. system for taxing businesses needs to be reevaluated to consider how it can be improved to attract and generate the investment and innovation necessary to advance the living standards of all Americans. The Administration looks forward to working with the Finance Committee on this important topic.

Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century –
(http://www.treas.gov/press/releases/reports/hp749_approachesstudy.pdf)

United States Senate
WASHINGTON, DC 20510

Statement for the Finance Committee Record
Senator George V. Voinovich
“The Foundation of International Tax Reform: Worldwide, Territorial, and
Something in Between”
June 26, 2008, at 10:00 a.m.

When I learned of the Finance Committee’s hearing regarding international tax reform, I was pleased to see the Committee addressing a critical issue for our country’s competitiveness. As we adjust to the challenges of the growing global market place, it is critical we do everything we can to strengthen our economy and continue to lead the world in terms of innovation and development. Last week, I introduced S. 3162, the Manufacturing, Assembling, Development, and Export in the USA—or MADE in the USA—Tax Act, legislation that addresses one large piece of tax reform, in the hopes of starting a conversation that will inform policymakers as we develop a more comprehensive reform in the next couple of years. The purpose of my legislation is to provide tax relief to improve the competitiveness of U.S. corporations and small businesses, and to eliminate incentives that favor foreign competition and encourage companies to move jobs and profits overseas.

A number of factors contribute to a company’s decision about where to locate activity and jobs, including wages, workforce skills, transportation costs, and local regulations. But there is no doubt that taxes are an important factor. Recent economic research concludes that in a global economy, workers bear the brunt of higher corporate tax rates, through lower wages and fewer jobs. Therefore, it is imperative that we have a tax code that makes the United States an attractive place to locate production, research, and other activity. While the MADE in the USA Tax Act would not address the “wage pull” that sends jobs to places like China and India, it would deal with the “tax push” that encourages jobs to leave the United States.

The MADE in the USA Tax Act would eliminate tax breaks that encourage companies to move jobs overseas or that benefit foreign competitors and then use that revenue to cut tax rates on large and small businesses that invest and create jobs in the United States. The centerpiece of the legislation is a one-fifth reduction in the federal corporate rate, to 28 percent from 35 percent. Of the 30 member countries of the Organization for Economic Co-operation and Development – which includes the major industrialized nations of North America, Europe, and Asia – the United States has the second-highest combined federal-state corporate tax rate at 39.3 percent, lower only than Japan’s rate of 39.5 percent. The average is 27.6 percent, and Ireland has the lowest rate at 12.5 percent.

Even Communist China, our biggest economic rival in the 21st century, recently cut its corporate tax rate to 25 percent. It will be that much harder to compete with China for jobs and investment when businesses operating in the United States have to pay a tax rate 15 percent higher than they would have to pay in China.

In fact, a constituent of mine from Norwalk, Ohio, Tom Secor, who owns his own small business, came to my office and told a story about a business trip he made to China. He said that he saw an editorial in a Chinese newspaper that was discussing all the concerns that Americans have with Chinese competition. The conclusion of the editorial was that the Americans could solve most of their problems with Chinese competition if they would just reform their own tax code! Imagine that: even Communist China knows that the United States needs tax reform to stay competitive, but for some reason we refuse to learn that lesson ourselves!

In addition to slashing the corporate rate on U.S. production, my legislation would also take steps to make small businesses more competitive and simplify the tax rules for individuals operating in the global economy. Specifically, my legislation would:

- Increase the domestic activities deduction for partnerships, S corporations, and sole proprietorships to 12 percent from 9 percent;
- Make permanent the 2003 expansion in small business expensing;
- Simplify the international tax rules for Americans working abroad by repealing complex and punitive rules enacted in 2006; and
- Repeal the burdensome 3-percent withholding requirement for contractors, also enacted in 2006.

These tax reforms, which will help create high-paying jobs in the United States, will be paid for by repealing a number of existing tax breaks that favor foreign competition and that encourage companies to move jobs and profits overseas. Among those tax breaks I would eliminate are:

- Tax shelters that allow foreign competitors to hide their U.S. income offshore, creating an unlevel playing field for domestic businesses such as small manufacturers and domestic insurance companies;
- Tax credits for moving our nation's technological innovation – such as patents, copyrights, and 'know-how' – overseas, along with the high-wage manufacturing jobs that accompany that intellectual property;
- Tax loopholes that encourage U.S. corporations to reincorporate as foreign corporations;
- A tax exemption for executives of offshore hedge funds if the executives put their money in certain deferred compensation plans; and
- Tax breaks for foreign oil and gas production.

Reducing the tax rates on corporate and small business income should lead to job creation and wage increases for American workers. And paying for these tax cuts by eliminating tax breaks for foreign production and offshore tax shelters means we can accomplish these goals in a fiscally responsible manner. My legislation is intended to be revenue neutral, as I believe that we can enact pro-growth tax policy without increasing the national debt.

Some of my colleagues will suggest that we can just increase marginal rates to raise the revenue we need. But in a competitive global economy, I can't understand why we would choose such a self-defeating approach. Higher marginal rates on an already-broken tax system would only discourage economic ingenuity and reduce U.S. competitiveness.

Tinkering with the current tax code won't get it done. Tinkering is what got us into this mess in the first place. It's time to rip the tax code out by its roots and replace it with something that works. We must create a new tax system that is conducive to job creation and economic growth. We should start by addressing one of the biggest problems with the current code: it rewards moving production activity – and the good-paying jobs that accompany such activity – overseas. It taxes domestic production heavily, but taxes foreign production lightly. It imposes the second highest corporate tax rate in the developed world, but collects one of the smallest amounts of corporate tax as a share of the economy. Such a system sounds absolutely perverse, but that's what we have in the United States. The MADE in the USA Tax Act is intended to fix that.

I know there is bipartisan support in this chamber to move forward on fundamental tax reform. It probably won't happen this year, but that doesn't mean that we shouldn't get started right away. That is why today's Finance Committee hearing is so important. I am pleased the Finance Committee is gathering information on this critical issue and I look forward to hearing the witnesses' testimony. We need to start setting the table so that a new president and a new Congress can hit the ground running in 2009, and enact comprehensive tax reform that makes the code simple, fair, and pro-growth. I hope my colleagues of the Finance Committee to take a close look at the MADE in the USA Tax Act, and join me in trying to make it a key part of our future efforts.

